



# Financial Market Report

## 1 • 2010

- Diverse results for international banks
- Domestic banks post positive financial results
- Criticism levelled at CDS markets
- Tasks of the European Systemic Risk Board taking shape



Bank of Finland

Financial Markets and Statistics

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# 1 Financial intermediation

## 1.1 Subdued lending in euro area housing markets

Elina Salminen

**As a result of the financial crisis and economic recession, the volumes of new housing loans have plummeted in many euro area countries. These are still more than a third less than in 2006–2007. Recently the housing market has been boosted by low interest rates, but the amount of new housing loans is still well below its peak.**

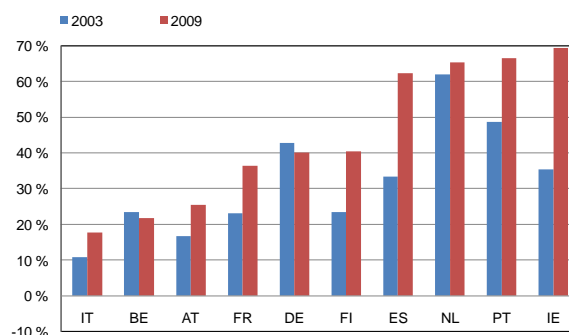
The stock of housing loans has risen sharply in the past decade in Europe, by as much as by several times 10% per annum. Loan repayment periods lengthened and larger loans were granted. Favourable developments in households' income, lower interest rates and longer maturities have enabled households to take larger housing loans. Housing loans are euro area households' largest liability item and one of the largest MFI receivables.

As a result of the robust growth in the stock of housing loans, its ratio to GDP has increased in nearly all euro area countries (Chart 1). In Italy, the stock of housing loans-to-GDP ratio has remained very low, whereas in Ireland, Spain, Portugal and Finland, it has increased notably. In the Netherlands, the stock of housing loans is already large.

Developments in housing loans are greatly affected by the countries' legislative and cultural characteristics. In Italy and Greece, only 10–20% of

households have a housing loan, whereas in Germany, Spain, Portugal and France the figure is ca 25–30%, and in Ireland and the Netherlands ca 35–40%.<sup>1</sup> In Finland, ca one-third of households had a housing loan in 2009, and the average loan size was EUR 76,500.<sup>2</sup>

Chart 1. Stock of housing loans-to-GDP ratio in selected euro area countries



Sources: OECD and European Central Bank.

The current annual growth rate of the stock of housing loans in Finland seems to be clearly exceeding that in the other euro area countries. In Finland, the stock of housing loans grew by 6.5% in January, compared to slightly under 2% in the euro area. However, in Finland, growth in the stock of housing loans has not been as rapid as eg in Spain and Ireland; it peaked at 25–35% per annum.

The assessment of the annual growth rate of the stock of housing loans is hampered by the fact that banks in many euro area countries have securitised housing loans and derecognised them from their

<sup>1</sup> Source: ECB, Occasional Paper Series No. 101, March 2009 (data compiled from national sources in 2003–2007).

<sup>2</sup> Source: Federation of Finnish Financial Services: Kotitalouksien säästäminen ja luotonkäyttö 2009 (Survey on household saving and the use of credit, 2009).

balance sheet<sup>3</sup>. Securitised housing loans are not included in the stock of housing loans, which slows the growth in the stock of housing loans but does not change households' housing debt. According to the European Securitisation Forum, of the euro area countries, the level of securitisation is highest in Ireland relative to the size of the country. Securitisation is extensive also in Spain, Portugal, Italy and Greece.<sup>4</sup> Of the reference countries, only in Austria and Finland is securitisation of minor importance.

It is thus more useful to examine the amount of new business on housing loans<sup>5</sup>, than the stock of housing loans. In many euro area countries, a record amount of new business on housing loans was agreed in 2006–2007. Since then, the volume of new business on housing loans has decreased considerably.

The amount of new business on housing loans has fallen most in Ireland and Spain. In January 2010, the amount of new business was in Ireland 61% lower than in 2006–2007 on average, and in Spain 53% lower. In Greece, Portugal, the Netherlands and Finland, the amount of new business on housing loans has decreased by over 40% compared to the average in 2006–2007. In France, Germany and Italy, the amount of new business on housing loans has fallen by 7–13%.

As for Ireland and Spain, the collapse is due partly to the dramatic rise in unemployment and the bursting of the property bubble. Figures for Austria and Belgium indicate that the amount of new business on housing loans has increased compared to 2006–2007.

<sup>3</sup> Loans can be transferred to special purpose vehicles, which are not included in the MFI sector, after which they no longer appear in the MFI sector balance sheet.

<sup>4</sup> Data Report Q3/2009.

<sup>5</sup> New business includes agreements that are signed as a result of the renegotiation of an existing loan agreement.

However, an exceptionally large proportion (ca one-third) of housing loans signed in Austria is tied to the Swiss franc, and hence they are not included in statistics on euro-denominated housing loans. As a result of the financial crisis, Austrian authorities restricted the granting of currency loans, which boosted the demand for euro-denominated loans. The amount of new business on housing loans has decreased notably also in Belgium, from the peak in 2005.

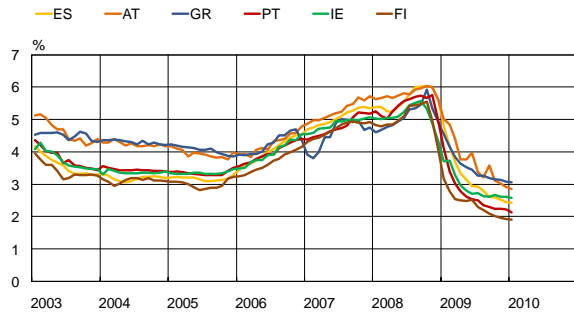
#### Lowest interest rates in Finland

The reference rates for housing loans differ considerably between countries. In Germany and France, long-term and fixed rates are preferred, whereas in Finland, Portugal, Spain, Greece, Ireland, Austria and Italy, housing loans carry variable rates<sup>6</sup>. For example in Portugal and Finland, nearly all new housing loans are tied to maximum 12-month or shorter rates, whereas the euro area average is 43%.

In countries in which housing loans with variable interest rates are preferred, interest rates on housing loans reflect developments in market interest rates, and therefore they have fallen to a historical low. The lowest interest rates on housing loans are found in Finland, which indicates that Finnish households prefer the shortest-term reference rates, the 1-month and 3-month Euribors.

<sup>6</sup> Tied to Euribor and Prime rates.

Chart 2. Interest rates on new business on housing loans in the euro area, interest rate fixed for a maximum of 12 months



Sources: European Central Bank and national central banks.

The historically low level of interest rates has boosted the housing market. In many euro area countries, the trend in new business on housing loans has in fact turned up. The sharpest upturns have occurred in France and Belgium.

## 1.2 Municipality Finance – expanding role in municipality funding

Pertti Pykkönen and Eero Savolainen

**Finland's municipal sector has been financing persistent deficits by issuing new debt. The bulk of municipality debt is in loans, but municipalities have tapped the securities markets for funding. The composition of debt has changed in recent years, as Municipality Finance has assumed an expanding role.**

Finnish municipalities have been in deficit for some time. The municipalities<sup>7</sup> sector has been in deficit in the National Accounts continuously since 1997, with the exception of 2000. To cover the deficits, municipalities have been forced to increase borrowing. For example in 2004–2008, the municipal sector posted a cumulative deficit of EUR 4.2 billion. To cover it, municipalities took on EUR 5.7 billion in new debt.<sup>8</sup>

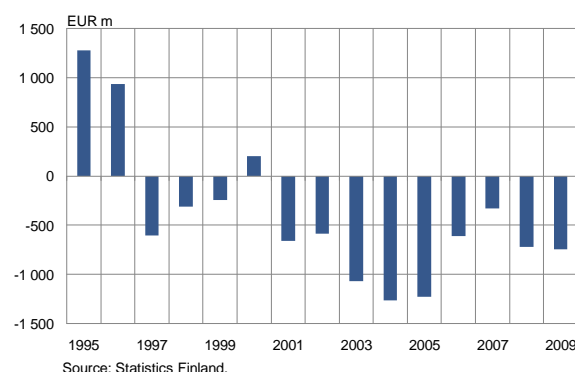
The exceptionally steep and swift fall in the real economy caused by the financial crisis has not significantly affected the financial position of municipalities. Preliminary data from Statistics Finland show that according to National Accounts, municipalities' deficit was 0.4% of GDP in 2008–

<sup>7</sup> In the National Accounts, municipalities, joint municipal authorities and Government of Åland form the local government sector. In this article, the term 'municipalities' refers to the entire local government sector. Non-financial corporations owned by municipalities are part of the non-financial corporations sector.

<sup>8</sup> In the same period, municipalities acquired financial assets worth EUR 2.1 billion, ie net acquisition of financial assets totalled EUR 3.6 billion

2009. In the Bank of Finland's macroeconomic forecast of March 2010, the deficit-to-GDP ratio is expected to remain unchanged in the coming years.

Chart 3. Municipalities' surplus (+) / deficit (-)

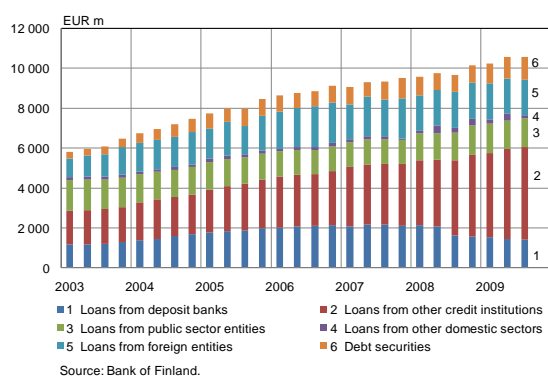


Growth in municipalities' stock of loans accelerated in 2008 to over 8%, from slightly over 3% in 2007. The growth rate has continued to pick up. In September 2009, the stock of loans increased by nearly 10%. Municipalities' stock of debt totalled EUR 9.4 billion at the end of September. Despite the rapid growth, municipalities' stock of debt relative to that for the Finnish economy has remained stable, at slightly under 4%<sup>9</sup>.

The structure of Finnish municipalities' debt financing has changed in recent years. Deposit banks' share of municipal sector funding has decreased, and the share of loans from deposit banks in municipalities' stock of loans has decreased from ca one-fourth to 15% in just a few years time. An example of the changes in the operations of commercial banks is Nordea, which in 2008 sold to Municipality Finance nearly EUR 0.6 billion worth of loans granted to municipalities and municipally-owned companies.

<sup>9</sup> The credit stock for the Finnish economy totalled EUR 259 billion at the end of 2009.

Chart 4. Municipalities' interest-bearing debt



Municipality Finance is now the key source of funding for municipalities, and it already accounts for nearly half of the lending to municipalities (in the Chart: loans from other credit institutions). In 2009, Municipality Finance raised EUR 41 million in a share issue, and it has been able to meet municipalities' increased demand for loans. Municipality Finance's funding has the highest credit rating (Aaa/AAA), and eg in 2009 it acquired nearly all of its funding from the international capital markets. In addition to euro-denominated bonds, investors were offered a large amount of foreign currency-denominated bonds (eg Swiss franc, Japanese yen, US dollar). Municipality Finance's acquisition of funding will become more diverse if the proposed amendments to the Mortgage Banks Act take effect, whereby not only banks but also Municipality Finance would have the right to issue covered bonds collateralised by a housing or real estate property or guaranteed by the public sector.

Developments in government sector loans to municipalities have been mixed: government lending to municipalities has decreased, whereas employee pension insurers have notably increased their lending to the municipal sector. In contrast, municipal sector borrowing from foreign entities has remained at ca EUR 2 billion for a number of years.

Municipalities acquire part of their funding directly from the money and capital markets. Bonds are issued mainly by a couple of the largest cities – the issues are directed at domestic investors but also foreign investors. The amount of short-term market funding, ie local government securities, has recently increased rapidly, and their amount outstanding exceeds EUR 1 billion.



## 2 Banks and insurance corporations

### 2.1 Signs of a recovery in international banks' results but also risk of a prolonged crisis

**Eeva Alho**

**International banks' financial results for 2009 give a mixed picture of the banking sector's soundness and earning capacity. European banks recorded significant impairment losses, whereas in the United States, the reform of accounting regulations reduced the amount of impairment losses recognised in profit or loss. Nordic banks significantly cut lending in the Baltic countries.**

In the international banking sector, new positions were taken as banks sought to recover from the crisis by re-focusing on business and corporate restructuring. Results for 2009 indicate that international banks can be divided into sound and weaker banks. Profitable banks were able to carry out their strategy and seek growth, whereas weaker banks reduced their risky operations either voluntarily or as required by government support schemes. Large banks that survived the financial crisis with minor damages reported a profit for 2009, but the majority of banks that recorded a loss during the crisis were only able to reduce their losses.

International banks sought growth particularly in the emerging markets and Asia. They took advantage

of structural changes and positioned themselves for the future increase in wealth in the emerging economies, which is expected to boost the demand for asset management services. In contrast, weaker banks did not seek growth but instead tried to consolidate their operations by focusing on core banking business and giving up non-key business units and market areas. Results for 2009 indicate that focusing on core banking was difficult for banks that recorded the largest losses, which were due to the decline in net interest income and growth in impairment losses. Profitable banks reported robust operating profits because they succeeded in boosting customer volumes and in lowering their funding costs.

Household borrowing was brisk, due to low interest rates and the decline in housing prices. The growth potential of the stock of loans to households is, in many countries, threatened by rising unemployment. Demand for corporate loans eased, due partly to the fact that non-financial corporations shifted from bank loans to the recovering securities markets for their funding. Demand for corporate loans was also dampened by the postponement of investments and restructuring, in an environment of uncertainty. Corporate lending was dampened also by the increase in bankruptcies. Growth in impairment losses reflected, in particular, SMEs' funding difficulties and operations in emerging markets and property markets.

Banks' profits were boosted by fees, due to favourable market conditions and a pick up in securities issuance. The rapid growth in income from trading reflected the recovery in the markets during the year, and it will probably level off. US banks' results

for 2009 were also burdened by repayment of capital support granted under the Troubled Asset Relief Program (TARP). In 2009, the number of banks covered by the FDIC decreased by nearly 300, half of which went bankrupt.

European banks suffered from an increase in impairment losses also on their operations in the United States, whereas loan losses reported by US banks turned down in the second half of the year. The assessment of developments in the US banking sector is however hampered by changes in accounting regulations. In April 2009, the Financial Accounting Standards Board eased the requirements on measuring receivables at market value because the drying up of markets during the crisis hampered the measurement of illiquid balance sheet items.

The changes affect particularly mortgage-backed securities and enable the use of internal valuation models. It increases bank management's discretion in reporting results. Banks are not required to recognise in profit or loss the impairment loss on real estate assets held to maturity. The reform is based on the assumption of economic recovery and a levelling off of the decline in housing markets. According to assessments by analysts, results of the largest deposit banks in the United States give an overly positive picture of the soundness of the banks, due to the understating of impairment losses and overoptimistic valuation of real estate assets.

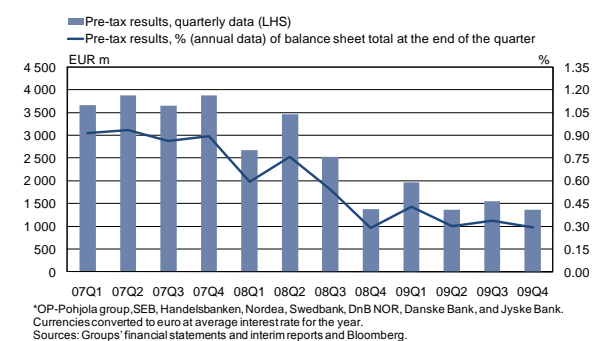
To bolster capital adequacy, international banks reduced their trading operations and risk-weighted capital. Banks succeeded in raising long-term market financing, which compensated for the repayments of capital support to the government. As a means of consolidating their operations, banks also tried to focus more on core banking business. Capital support eg in Ireland has been conditional on increased lending

– so as to spur the economy. Increased employment there has led to increased defaults, and the corporate sector's outlook is weak.

### Nordic banks' Baltic risks

Nordic financial groups' net interest income improved slightly in 2009. Results were burdened by a sharp increase in impairment losses on the previous year. Growth in non-performing loans however slowed in the fourth quarter compared to the first half of the year.

Chart 5. Quarterly operating profit of large Nordic financial groups\*



Nordea's impairment losses more than tripled, but they were still moderate relative to the lending stock (0.54%). Nordea's loan loss provisions nevertheless increased particularly in Latvia and Lithuania. Loans to the Baltic countries accounted for over 3% of the group's lending stock. In contrast, Swedbank's results for 2009 turned negative, due to its Baltic banking business. Impairment losses reached EUR 2.4 billion, which is 1.4% of the bank's lending stock. A total of 15% of the lending stock was in loans to the Baltic countries, Ukraine and Russia. Swedbank however continues to reduce its exposures in the area.

The largest Baltic lending stocks are held by the Swedish banks Swedbank, SEB and Nordea. They each posted a loss on Baltic business in 2009. Nordea did post a profit on its Baltic business in the first half

of the year, but results on its Baltic business – with the exception of Estonia – turned negative for the year as a whole. All Nordic financial groups recorded considerably higher loan loss provision on their Baltic lending stock than on the rest of their lending stock.

**Table 1. Lending stock and loan losses on Baltic operations, end-2009**

	Lending stock, EUR m			Loan losses relative to lending stock, %		
	Estonia	Latvia	Lithuania	Estonia	Latvia	Lithuania
Swedbank	7 023	5 072	4 487	2.7	10.0	8.5
SEB	4 707	3 887	7 185	2.5	7.8	7.1
Nordea	2 365	2 890	2 090	1.0	3.0	1.8
DnB NOR	397	2 283	3 061	1.7	7.4	6.0

Sources: Groups' interim reports and fact books.

Swedbank's and SEB's Estonian lending stock decreased slightly in the latter part of 2009, whereas that of Nordea remained virtually unchanged. All the Nordic banks have reduced their lending stocks in Latvia and Lithuania. Relative to lending stock, Swedbank suffered the largest loan losses, despite a decline in its loan loss ratio at the end of 2009. The

other Nordic financial groups' loan loss ratio increased in the second part of the year. The majority of Swedbank's loan losses were accounted for by loans to property companies in Latvia.

Sweden's central bank (Riksbank) expects loan losses to continue to burden banks' Baltic business. Weak economic growth in the area and the need to limit risky operations have forced banks to downsize their Baltic operations. Foreign banks' lending policies have a major impact on the availability of corporate funding and economic recovery in the area. The Estonian banking sector is almost entirely dominated by foreign banks, and in Lithuania, foreign banks account for 80% of the balance sheet total of the banking sector. In Latvia, the share of domestic banks is higher.

**Table 2. Large US, European and Nordic financial groups' results in 2009, EUR m**

	Pre-tax results			Net interest income			Other income			Expenses			Impairment losses		
	1-12/2009	1-12/2008	Change, %	1-12/2009	1-12/2008	Change, %	1-12/2009	1-12/2008	Change, %	1-12/2009	1-12/2008	Change, %	1-12/2009	1-12/2008	Change, %
Bank of America	2 950	3 360	-12	31 875	34 417	-7	49 078	20 807	136	45 139	31 510	43	32 863	20 354	61
Citigroup	-5 277	-39 725	-87	33 096	40 782	-19	21 226	-1 631	-1 401	32 357	52 536	-38	27 242	26 339	3
Goldman Sachs	13 417	1 772	657	5 012	3 244	54	25 553	13 617	88	17 148	15 089	14	0	0	0
JPMorgan Chase	10 871	2 104	417	34 610	29 424	18	33 345	21 604	54	35 422	33 006	7	21 662	15 918	36
Morgan Stanley	580	-1 362	-143	670	2 201	-70	15 135	11 635	30	15 225	15 199	0	0	0	0
Wells Fargo	12 178	2 504	386	31 344	19 077	64	28 663	12 697	126	33 168	17 146	93	14 661	12 124	21
FDIC-pankit*	11 475	7 249	58	267 810	271 425	-1	-87 471	-129 505	-32	..	..	..	167 586	133 689	25
AIB	-2 656	1 034	..	3 233	3 867	-16	1 626	1 201	35	1 897	2 357	-20	5 355	1 822	194
Barclays	12 867	7 243	78	13 208	13 669	-3	21 956	14 162	55	19 730	17 121	15	8 920	6 458	38
BBVA	5 736	6 926	-17	13 882	11 686	19	5 685	6 636	-14	8 358	8 455	-1	5 473	2 940	86
BNP Paribas	9 000	3 924	129	21 021	13 498	56	19 688	14 578	35	23 340	18 400	27	8 369	5 752	45
Credit Agricole	1 499	1 172	28	17 492	15 956	10	..	..	..	12 182	12 635	-4	4 689	3 165	48
Credit Suisse	5 689	-7 976	..	4 482	5 514	-19	17 799	2 264	686	16 257	15 222	7	335	533	-37
Commerzbank	-4 659	-407	..	7 189	7 220	0	3 759	1 700	121	11 393	4 981	129	4 214	3 553	19
Deutsche Bank	5 202	-5 741	..	12 459	12 453	-7	15 493	1 160	1 236	20 120	18 278	10	2 630	1 076	144
Dexia	1 403	-3 877	..	5 030	6 073	-17	1 133	-2 517	-145	3 607	4 119	-12	1 096	3 292	-67
HSBC	4 790	7 062	-32	27 559	32 295	-15	25 644	34 909	-27	23 272	37 254	-38	17 922	18 921	-5
ING	709	-931	..	12 372	11 042	12	35 821	48 245	-26	43 726	57 879	-24	3 043	1 361	124
Lloyds	-6 963	-8 001	..	14 065	17 761	-21	13 124	8 263	59	12 830	14 583	-12	26 511	17 734	49
Royal Bank of Scotland	-2 131	-9 887	..	14 994	18 788	-20	17 526	5 226	235	19 231	19 293	0	15 361	8 857	73
Santander	11 764	11 421	3	26 299	20 945	26	13 082	12 544	4	16 421	14 949	10	9 484	6 601	44
Societe Generale	800	4 008	-80	21 730	21 866	-1	..	..	..	15 766	15 528	2	5 948	2 655	120
UBS	1 697	18 203	-91	4 272	3 929	9	10 707	-3 407	-414	16 677	18 725	-11	1 214	1 965	-38
Unicredit	3 300	5 458	-40	17 616	19 385	-9	9 956	7 492	33	16 191	17 176	-6	8 313	3 700	125
Danske Bank	639	299	114	3 698	3 624	2	4 275	2 152	99	3 884	3 855	1	3 450	1 622	113
DnB NOR	1 314	1 362	-4	2 697	2 453	10	1 790	1 398	28	2 253	2 096	8	919	393	134
Jyske Bank	85	173	-51	611	492	24	332	336	-1	501	509	-2	357	145	146
Nordea	3 075	3 396	4	5 281	5 093	4	3 792	3 107	22	4 512	4 338	4	1 486	466	219
OP-Pohjola	464	372	25	1 070	1 189	-10	981	634	55	1 408	1 392	1	179	58	209
SEB	326	1 219	-73	1 883	1 828	3	2 389	2 189	9	2 743	2 483	11	1 203	316	281
Svenska Handelsbanken	1 326	1 498	13	2 125	1 878	13	999	1 069	-7	1 470	1 293	14	328	157	109
Swedbank	-914	1 350	-168	2 006	2 121	-5	1 354	1 442	-6	1 894	1 904	-1	2 381	308	672

\*Combined data on commercial and savings banks supervised by US supervisor FDIC.

Sources: Banks' interim reports and Bloomberg.

## 2.2 Property risks of US, Irish and Spanish banks

Eeva Alho

**The wealth of many American homeowners has turned negative as the value of property used as collateral for many mortgages has fallen below the loan principal. Pay-option mortgages are popular, and a wave of loan recasts is on the way. Irish and Spanish banks' risks in commercial property and construction have intensified since the collapse of property markets, following an overheating of the markets.**

US banks have reported an improvement in the quality of loan receivables linked to housing markets and that the growth in loan losses has reached its peak. In the light of recent signs, concerns remain. The terms and conditions of mortgages – the possibility of relinquishing the loan and property with just an announcement – have distorted the incentives for loan servicing, even for financially sound mortgage holders.

The US government aims to prevent the eviction of millions of Americans by restricting banks' foreclosure proceedings. The Home Affordable Modification Program is designed to help struggling mortgage holders by lowering the interest rate, extending the loan term and deferring part of the principal payment. Creditor banks collect downsized mortgage payments for the first few years, after which the monthly payments are raised.

Banks' credit risks are nowadays also caused by mortgage holders classified as financially sound, as payment defaults by mortgage holders with high credit ratings have increased. In the United States, customers

have been offered *pay-option loans*, usually with an adjustable interest rate. The borrower can decide on the amount of monthly principal payment, and he is encouraged to invest the savings from a smaller monthly payment. Banks charge higher fees on these pay-option loans, and part of the risk is transferred to investors via securitisation and part remains on the banks' balance sheet. Banks can record as front-loaded income the full principal repayment, even if the actual payment is smaller.

If the mortgage holder opts to pay less than the full monthly amount, the difference is added to the principal, which will generate a higher monthly payment when the loan is renegotiated. According to market estimates, the peak period of pay-option mortgage recasts will be in 2010–2012. Due to the cumulation of loan principal, these loans are considered to be more difficult to modify than conventional mortgages and subprime loans, and foreclosures may rise, despite the loan modification programme.

### **Risk of contagion from properties destabilises the concentrated Irish banking sector**

The weakness of the Irish economy and the large loan losses increased banks' losses in 2009. The proportion of problem receivables was high, and the majority of non-performing loans relate to properties and construction. Property values have halved since 2007, and payment defaults caused by unemployment are reflected in higher loan losses also on mortgages.

Non-performing loans have ended up in the hands of the country's largest banks, which had, in the midst of market overheating, acquired banks that were funding property development. When construction activity came to a halt, Anglo Irish Bank, the largest financier of property development, collapsed and was nationalised. This triggered a domino effect in the

country's highly-concentrated banking sector; even banks that had financed Anglo Irish Bank and were less involved in direct property lending started to falter.

In early 2010, the European Commission approved the Irish support scheme by which the toxic property loan receivables of the largest financial institutions will be transferred to the government-backed 'bad bank', National Asset Management Agency (NAMA). The aim is to boost lending to financially sound companies and households.

Loans worth EUR 81 billion will be transferred to the bad bank; in return, banks will obtain government-guaranteed bonds. The loans will be valued at discounts of more than 30% of the nominal value – reflecting the decline in property prices – which the banks will record as impairment loss. Markets expect that the need to raise fresh capital will also lead to the nationalisation of Allied Irish Bank and Bank of Ireland. The Irish banking supervisor has demanded restrictions to prevent the concentration of lending to one sector and the creation of risk concentrations.

### Spanish banks have become major property owners

Spanish banks are nowadays among the largest property owners in the country. Banks ended up acquiring properties from households, property companies and property developers to which they had granted loans, as the Spanish property market was fuelled by cheap loans and finally collapsed. To avoid reporting bad loans on balance sheets and impairment losses, banks have swapped their loan receivables for the properties used as collateral. According to market estimates, the properties transferred to banks' assets are valued fairly high. Spanish banks have also reduced their losses by transferring property assets to special property companies.

As a result of the arrangements, large banks and locally operating *caja* savings banks have succeeded in reducing the proportion of non-performing loans in their lending stock. The largest Spanish banks reported strong results for 2009, despite an increase in loan loss provisions for both retail banking and property development funding. The proportion of non-performing assets in the lending stock, for the largest banks, is already over 4% and for *caja* banks over 5%. According to market estimates, the proportion of non-performing loans is growing. *Caja* banks dominate half of the Spanish banking sector, and due to their key role in local property funding, they are vulnerable to property risks.

Credit rating agency Standard & Poor's has warned of the Spanish banking sector's risk outlook and future loan losses, due to the high debt ratio of the corporate sector, rapid growth in lending, and banks' exposure to property risks.

The central bank of Spain has demanded that Spanish banks bolster their balance sheets and increase their loan loss provisions in case companies are unable to service their debts. According to the central bank, the banking sector's property loan portfolios totalled EUR 445 billion at the end of 2009. The Spanish government has proposed the introduction of REITs (real estate investment trust), which would enable banks to sell some of their property assets.

## 2.3 Finnish banking profitable despite difficult operating environment

Eero Savolainen

**The profitability of banks operating in Finland continued to weaken in 2009. Despite the difficult operating environment, banks posted a clear profit. Net interest income declined and loan losses increased, whereas income from capital markets grew robustly. Capital adequacy improved in 2009.**

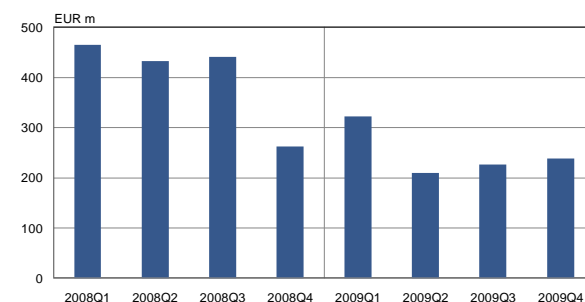
The pre-tax profits of Finnish banking declined in 2009, by slightly over one-third on the previous year (Table 3). Results for the fourth quarter of 2009 improved by 5% on the previous quarter but decreased by 10%, year-on-year. Financial results improved in the second half of 2009 and results for the fourth quarter were second best in 2009, following an exceptionally good first quarter.

The composition of banks' income changed considerably. Net interest income continued to decrease, due to the narrowing of the total margin, whereas other income, particularly net income from trading and investment, grew robustly. Total income in 2009 thus remained virtually unchanged on the previous year. In addition, due to moderate developments in expenses, the cost-to-income ratio of Finnish banking weakened only slightly.

Impairment losses on loans and other receivables increased more than threefold on the previous year. Impairment losses however remained minor considering the economic situation: loan losses amounted to ca 0.4% of the lending stock in 2009. The

loan losses were caused mainly by Finnish corporate customers. Loan losses due to households were mainly in consumer credit.

Chart 6. Pre-tax profits of Finnish banking, quarterly data\*



\* Nordea's banking operations in Finland, Danske Bank's banking operations in Finland, OP-Pohjola Group's banking and investment services, Aktia's banking business, savings banks, local cooperative banks, Bank of Åland, Evli Bank.

Sources: Banks' interim reports and financial statements, and Bank of Finland.

Finnish banking groups' nonperforming assets (repayment more than 90 days in arrears) increased significantly over the year. At the end of 2009, nonperforming assets totalled EUR 1,210 million (EUR 762 million a year earlier). They amounted to ca 0.6% of the lending stock. Nearly half of the nonperforming asset total was due to loans to domestic households and slightly over a fourth was due to domestic corporate loans. The amount of nonperforming foreign loans tripled in 2009.

Finnish banks' capital adequacy improved in 2009. According to preliminary data, capital adequacy for the banking sector was 14.5% at the end of 2009. In addition, the quality of regulatory capital was good: Tier 1 capital accounted for ca 95% of total regulatory capital. The amount of regulatory capital exceeding the minimum capital adequacy requirement increased in 2009, totalling ca EUR 9 billion at the end of 2009.

According to the Financial Supervisory Authority, banks' liquidity improved in 2009 as a result of lower risk premia and better availability of funding. The price of long-term funding remained above pre-crisis levels, despite the lower risk premia.

Banks' operating environment will be challenging again in 2010. The low level of interest rates will put pressure on net interest income. Moreover, banks will have difficulties achieving the same exceptionally high

level of net income from trading as in 2009. The majority of banks thus expect that results for 2010 will not exceed results for the previous year.

Table 3. Items from income statements of banks operating in Finland, 2009 and changes on the previous year

	Net interest income		Other income, net		Total expenses		Loan losses, net		Profit before tax	
	EUR m	Change	EUR m	Change	EUR m	Change	EUR m	Change	EUR m	Change
Nordea Group	5 281	4 %	3 792	22 %	4 512	4 %	1 486	..	3 075	-9 %
Nordic banking	3 938	-8 %	2 124	2 %	3 160	2 %	1 151	..	1 751	-38 %
Banking in Finland	788	-32 %	617	14 %	815	6 %	186	..	404	-53 %
*Nordea Bank Finland	1 202	-34 %	1 623	61 %	1 068	10 %	381	..	1 376	-20 %
Danske Bank Group	3 696	2 %	4 273	99 %	3 882	1 %	3 448	..	639	114 %
Banking	3 640	1 %	1 382	-4 %	3 252	-3 %	3 020	..	-1 250	..
Banking in Finland	405	-10 %	210	15 %	455	-14 %	231	..	-72	..
*Sampo Bank Group	459	-5 %	239	-8 %	438	-14 %	227	..	33	..
OP-Pohjola Group	1 070	-10 %	981	55 %	1 408	1 %	179	..	464	25 %
Banking and investment services	981	-12 %	720	47 %	1 063	3 %	167	..	471	-11 %
*Pohjola Bank	241	39 %	653	48 %	501	7 %	129	..	265	123 %
Savings banks	151.9	-7 %	59.0	62 %	137.5	4 %	7.0	..	66.4	-2 %
Aktia Group	152.2	51 %	81.2	208 %	154.8	29 %	31.7	..	47.0	612 %
Banking	146.9	57 %	46.8	53 %	107.3	16 %	31.0	..	55.4	78 %
Local cooperative banks	89.8	-20 %	29.3	47 %	79.2	5 %	3.2	..	36.6	-31 %
Bank of Åland Group	39.1	-7 %	71.4	121 %	77.2	48 %	2.9	..	30.5	53 %
Evli Bank Group	3.2	14 %	50.6	-5 %	48.5	-15 %	0.0	..	5.3	-857 %
1. Finnish banking	2 605	-17 %	1 804	30 %	2 783	2 %	628	..	997	-38 %
2. Finnish financial groups	3 167	-19 %	3 135	51 %	3 411	3 %	832	..	2 059	-15 %
3. Financial groups operating in Finland	10 484	2 %	9 337	54 %	10 299	3 %	5 158	..	4 363	4 %

Other income includes eg net fee income, capital gains/losses from sales of tangible and intangible assets, capital gains from sales of wound-up operations, and shares in profit/losses of associated companies. Expenses include depreciation and write-downs on tangible and intangible assets, refunds to shareholders and profit distributions to staff.

.. = change not meaningful.

1. Savings banks, Aktia Group's banking, local cooperative banks, Bank of Åland Group, Evli Bank Group, eQ Group, OP-Pohjola Group's banking and investment services, Nordea Group's banking operations in Finland, and Danske Bank Group's banking operations in Finland.

2. Savings banks, Aktia Group, local cooperative banks, Bank of Åland Group, Evli Bank Group, OP-Pohjola Group's banking and investment services, Nordea Bank Finland Group, and Sampo Bank Group.

3. Nordea Group, Danske Bank Group and the Finnish banking groups listed in this table (excl. Nordea Bank Finland and Sampo Bank).

Sources: Banks' interim reports and Bank of Finland.

## 2.4 Rising asset prices have improved the solvency of the insurance sector

**Pertti Pylkkönen**

### Rising equity prices and declining risk premia on corporate bonds supported insurance corporations' profitability and improved their solvency in 2009.

The recession was reflected in insurance corporations' operations in 2009 as sluggish growth in premium income. Insurance corporations' total premium income amounted to ca EUR 16 billion, a modest increase on the previous year.

Non-life insurers' and employee pension insurers' premium income remained virtually unchanged. Non-life insurers' premium income was constrained by difficulties in the corporate sector, whereas the growth in employee pension insurers' premium income came to a halt as a result of a worsening of employment conditions. In contrast, life insurers' premium income grew rapidly, totalling ca EUR 3 billion, up from slightly over EUR 2.6 billion in 2008. This was due to the growth in capitalisation agreements, as premium income from conventional life insurance policies and individual pension plans remained unchanged from 2008. Expectations of the launch of a new pension saving product, ie long-term saving, may have reined in the sales of new pension insurance policies.

Despite the subdued growth in premium income, the financial results of the majority of insurance corporations improved in 2009, due to high returns on investments. The insurance business of the largest non-life insurers was fairly profitable, and their combined expense ratio remained well below 100.

The sluggish growth in premium income weakened life insurers' results. Measured at fair value, however, life insurers' results improved considerably due to the increase in the market value of investments.

Employee pension insurers' results measured at fair value improved significantly in 2009. Their aggregate financial result at current value was EUR 5.5 billion, compared to a negative result of over EUR 11 billion in 2008, due partly to a sharp decline in equity prices.

Finnish insurance corporations' solvency improved in 2009. The changes in solvency varied significantly depending on the weight of the equity portfolio. The largest improvements in solvency were recorded for employee pension insurers. They had a considerably higher proportion of share performance-based investments than the other insurers. Thanks to the temporary act that came into force at the end of 2008, employee pension insurers avoided the massive forced sales of shares and benefited from the subsequent rise in equity prices.

### Financial crisis changed the composition of insurers' investment portfolios

The weight of equities in insurance corporations' investment portfolios calculated at market value has decreased. The weight of hedge fund investments has also decreased from pre-crisis levels.

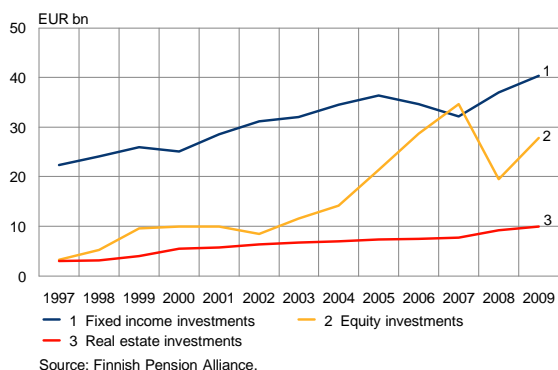
The total market value of pension insurers' investments was EUR 78 billion at the end of 2009. As a result of the rise in asset prices, the market value of investments rose by nearly one-fifth, from slightly over EUR 65 billion in 2008. The proportion of equities in the market value of investments was highest in 2007, at nearly 40%. At the end of 2009, equities accounted for less than 30% of the market value. The risk-weighted proportion of equities is even slightly lower. The proportion of various types of



fixed-income investments was slightly over 50% at the end of 2009. The proportion of bond investments has remained at pre-crisis levels. The composition of the bond investment portfolio has however changed slightly. Employee pension insurers increased their investments in bonds issued by domestic non-financial corporations; at the end of 2009 they totalled nearly EUR 1 billion.

The financial crisis was reflected in a rise in the proportion of promissory notes. The amount of TyEL premium loans granted by employee pension insurers increased to nearly EUR 5 billion, which is tenfold the amount in 2007. The reduced availability of bank financing and the tightening of terms on bank financing since autumn 2008 boosted the demand for these loans. The stabilisation of the financial markets and the low level of investments has however also reduced the demand for TyEL premium loans.

Chart 7. Pension insurers' stock of investments



The proportions of equities in the total investment portfolios of life insurers and non-life insurers were considerably smaller than in the portfolio of employee pension insurers. In the two former sectors, direct equity investments accounted for less than 15% of total investments.

Life insurers' investments totalled slightly less than EUR 27 billion at the end of 2009, half of which was accounted for by direct fixed-income investments, mainly bond investments. Investments in bonds issued

by Finnish non-financial corporations grew last year by nearly 50%, totalling ca EUR 1 billion. In line with the nature of life insurance business, premium income from unit-linked insurance is reinvested mainly via equity and fixed-income funds. Indirect investments, ie mutual fund investments, thus account for nearly one-third of life insurers total investments. Life insurers' real estate portfolio remained virtually unchanged in 2009, at ca EUR 1 billion.

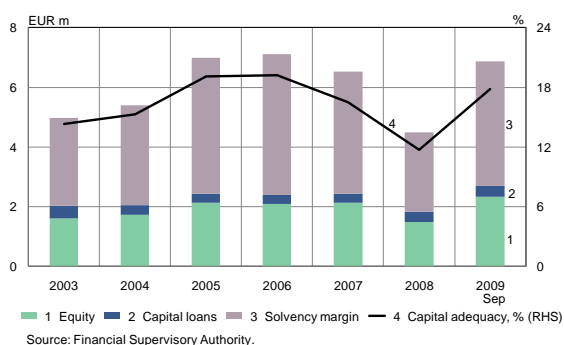
Of non-life insurers investment portfolio (EUR 11.5 billion), ca two-thirds was accounted for by various fixed-income investments. In line with the nature of non-life insurance business, equity investments are moderate and real estate investments are fairly minor. Direct equity investments accounted for over 10% of total investments, and equity investments and equity investments via funds together accounted for slightly less than one-fifth of total investments. The proportion of real estate investments in the investment portfolio was over 5%. Hedge fund investments play a marginal role in non-life insurers' investment activities.

The rise in asset prices improved the solvency of insurance corporations overall. In addition to successful investments, the solvency of employee pension insurers is supported by a temporary act that entered into force at the end of 2008. Under the act, the solvency margin does not depend on the risks inherent in the investments because the solvency margin is defined as a fixed percentage of technical provisions. Employee pension insurers' solvency buffers were bolstered by making part of the clearing reserve eligible for inclusion in the solvency margin. In addition, the temporary act changed the division of employment pension assets between solvency margin and coverage of pension liabilities, but employment

pension funds were not granted external capital support.

Life insurers' total solvency capital improved considerably as a result of the increase in solvency margin, totalling EUR 4.4 billion in September 2009. The solvency ratio rose to 17.8% at the end of September, from 12% at the end of 2008.

Chart 8. Life insurers' solvency capital



The financial market crisis affected non-life insurers' solvency less than that of other insurers, but their solvency and solvency ratio also improved in 2009. The solvency of the largest non-life insurers was also supported by strong technical profitability. The number of loss occurrences and the costs incurred were not high enough to threaten the solvency of non-life insurers.

## 3 Securities markets

### 3.1 CDS markets criticised

**Jyrki Haajanen and Pertti Pykkönen**

**CDS markets related to governments' exposures have recently faced heavy criticism. Criticism of derivatives markets is understandable following the financial crisis, but demands for restrictions, or prohibitions, on trading in certain products require thorough analysis.**

A CDS (credit default swap) is a derivative contract in which one party to a contract buys protection against default by the issuer or other specified event, and the other party (eg bank or insurance corporation) issues, for a premium payment, a guarantee against default. CDS contracts based on the debt of an individual country are highly standardised.

CDS compensation can be triggered not only by default but also by the debtor's inability to make interest or principal payments. The weakening of the preferred status of the debt or extension of the repayment period are also events that may result in compensation.

CDS markets have grown robustly in recent years, but they still account for only a small share (ca 10%) of the total market for OTC derivatives.<sup>10</sup>

The majority of CDS contracts are USD or euro-denominated, but contracts are also denominated in pounds sterling, Swiss francs or Japanese yen.

CDS markets, particularly those for credit exposures of governments, have been heavily

criticised recently. The markets have been characterised as complex and non-transparent. Moreover, it has been claimed that trading in CDSs steers the pricing of sovereign debt instruments, and in some cases even (intentionally) increases the borrowing costs of a country in a weak economic position. Restrictions have been demanded on the operations of CDS markets, and even the total prohibition of "naked short CDS"<sup>11</sup> contracts. CDS contracts on Greece's credit exposures, in particular, have faced criticism.

Criticism of derivative markets and all the more complex products is understandable in light of the financial crisis. However, the notions of CDS complexity and of the impact of CDS markets on interest rates on government debt securities are faulty and are not wholly based on facts.

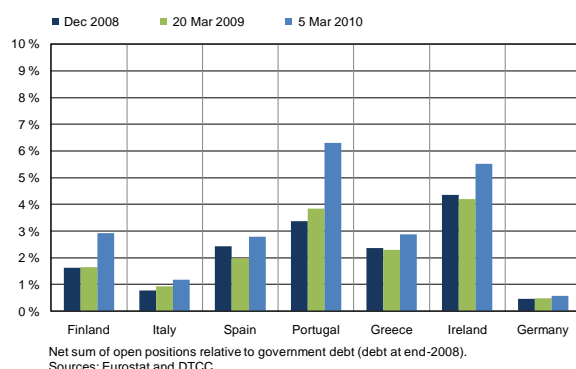
A CDS is a fairly simple instrument, which resembles the interest rate and currency swaps routinely used in the financial markets. The net volume of CDS markets is fairly small relative to the underlying assets, ie government debt securities.<sup>12</sup>

<sup>11</sup> A CDS contract is signed without the buyer holding the underlying debt instrument.

<sup>12</sup> Eg the Greek government has issued debt securities worth ca USD 400 bn. The net value of CDS contracts on Greek government's exposures is ca USD 9 bn. The ratio of government debt instruments to CDS contracts is in Greece more or less the same as in the other EU countries. Source: Depository Trust & Clearing Corporation and Barclays Capital.

<sup>10</sup> BIS Quarterly Review, March 2010.

Chart 9. Open CDS positions relative to government debt



A CDS is a financial instrument similar to other derivatives. Purchasing or selling a CDS does not require holding the underlying asset. Hence the transaction does not tie up a huge amount of capital.

Companies use CDS contracts in various ways in their business operations. For example, a bank can be the purchaser or seller of a CDS contract, depending of the area of banking. CDS contracts on government exposures are used mainly to hedge against exposures in other business operations. CDS contracts are not usually used to protect against the individual underlying debt security; instead the protection is part of a bank's total risk management. Studies thus far indicate that the majority of CDS contracts are made to buy protection and not for purely speculative reasons. It is also noteworthy that the same result can be achieved using a combination of other financial instruments, instead of a CDS. The use of CDS contracts promotes and facilitates the achievement of the goal, like derivatives in general.

Large banks do not usually require collateral on interest rate or currency swaps with governments. This creates a significant credit exposure in the banks' balance sheets. Banks can try to synthetically cover the created credit risk with products that correlate with the government's credit profile. A CDS with short maturity, for example, may be suitable for this

purpose. CDS markets are however quite illiquid, and strong demand may temporarily boost prices.

Moreover, market prices tend to temporarily overreact to changes in the economy. This is believed to have happened eg in the case of Greece and Portugal, which have been the focus of attention.

Banks (and investors) can use CDS contracts also to cover some of the country risk related to corporate loans (and other investments). Banks can also reduce the daily market and liquidity risks of their portfolios by using uncorrelated macro-protection. One way of constructing this type of macro-protection is to purchase a CDS contract with short maturity.

The transparency and collateral requirements for trading in CDS markets must be developed because CDS markets do not fulfil all the requirements of financial market regulation and supervision.

More fundamental demands for the prohibition of certain types of contracts or trading strategies however still require thorough analysis. This is an issue of such importance that all aspects must be thoroughly assessed before any action is taken.

## 3.2 Continued fragmentation in equities trading

**Marko Myller**

**The fragmentation of cash equity trading continues in Europe. Some of the multilateral trading facilities now play a major role alongside traditional stock exchanges.**

Multilateral trading facilities (MTFs<sup>13</sup>) have captured market share from traditional stock exchanges. The London Stock Exchange (LSE) has faced especially fierce competition; already over 40% of the share trading in the FTSE100 index<sup>14</sup> takes place in other trading venues. The largest proportion of the trading volume has been taken over by Chi-X<sup>15</sup>, which already accounts for over 25%<sup>16</sup> of share trading in the FTSE100.

Multilateral trading facilities have not been marginalized, but have instead become major players in trading, in some cases even topping the stock exchanges. Thus far the most successful MTF, in terms of volume and value of trades, seems to be Chi-X. According to data<sup>17</sup> from the Federation of European Securities Exchanges (FESE), it is the third largest European trading facility, in terms of euro-denominated turnover, right after the London Stock Exchange and NYSE-Euronext. FESE data also show

<sup>13</sup> See MiFID, Article 4.

<sup>14</sup> FTSE 100 constituents, see <http://www.londonstockexchange.com/exchange/prices-and-news/stocks/indices/constituents-indices.html?index=UKX>

<sup>15</sup> An MTF on which European equities are traded, <http://www.chi-x.com>

<sup>16</sup> Source: Fidessa Fragmentation Index.

<sup>17</sup> Source: FESE, European Equity Market Report, 02/2010.

that in number of trades, Chi-X is the largest European trading venue, 3.5 times bigger than Nasdaq-OMX Nordic.

The first step in the consolidation process was taken when the shareholders of Turquoise<sup>18</sup> decided to sell a 60% stake to the London Stock Exchange. As a result, LSE gained a foothold in Europe, as equities from nearly all the European countries are traded on Turquoise.

Establishing an MTF is relatively easy technically, but initial efforts have not brought huge successes. As for the Swedish trading venue Burgundy<sup>19</sup>, launched in summer 2009 and specialising in Nordic equities, the volume of trades in Finnish equities has been moderate. The launch of an MTF focusing on the Baltic markets seems to be delayed.

### Market share of Helsinki stock exchange in slow decline

Not even the Helsinki stock exchange has been saved from the revamping of market shares in the evolving markets. The fiercest competition between trading venues has focused on the most traded equities. Helsinki stock exchange's market share in share trading in the OMXH25 has declined to ca 75%<sup>20</sup>, depending on source and metric. In terms of the value of trading in Nokia shares, its market share is ca 65%. Similar developments are evident in the turnover and total market capitalization of shares traded on the Helsinki stock exchange (Chart 10) in 2009. The market capitalization of listed companies has

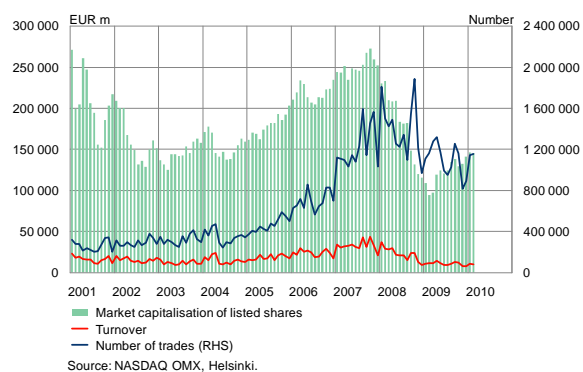
<sup>18</sup> An MTF on which European equities are traded, <http://www.tradeturquoise.com/>

<sup>19</sup> An MTF on which European equities are traded, <http://www.burgundy.se/>

<sup>20</sup> Source: Fidessa Fragmentation Index; market shares are based on data for the week of Monday, 15 March. Data on equities trading are published on the Internet by FESE, Fidessa and Thomson Reuters.

increased, whereas developments in turnover and number of trades differ from the previous years.

Chart 10. Helsinki stock exchange: turnover and market capitalisation



Although trading takes place on an increasing number of MTFs, listing takes place on stock exchanges.

Glimmers of light are evident also in Helsinki in terms of listings, but an increase in listings activity would be important for the development and survival of the markets.

## 4 Infrastructure

### 4.1 Remittances from abroad – significant income source for low-income earners in developing countries, a challenge for supervisors and legislators

**Maija Salmela**

**The largest remittance flows go to the Oceania–Asia area and the area of Latin America and the Caribbean. Some estimates of remittances from Finland amount to EUR 20–266 million annually.**

A remittance is usually a money transfer by a migrant to his or her home country. Many of these migrants have left their home country in hopes of a job and a better livelihood. Migrants from developing countries in particular send part of their income to relatives and friends in the home country.

Remittances are made via official and unofficial channels. An official channel is a regulated and supervised company operating openly in both the remitter's and recipient's country, eg a bank or credit cooperative. Unofficial channels include mail, networks of acquaintances, grocery shops, etc.

Unofficial channels based on trust between the members of a network include the hawala system, which is part of the Islamic banking system, fei ch'ien in China, and hundi in Pakistan and Bangladesh.

In developing countries, remittances are a significant source of income, often used for covering the cost of living, creating security by preparing for an emergency and making small acquisitions. In a crisis or conflict situation and in a natural catastrophe, remittances can be a quick and efficient means of helping victims and refugees, as the money is usually transferred outside the conventional banking system. The official banking system often does not function in a country that is unstable or unsafe.

The World Bank estimates that remittances in 2008 totalled ca USD 444 billion, ie ca EUR 302 billion. Remittance flows are forecast to fall to ca USD 420 billion in 2009, due to the recession (Table 4). Newly available data however show that the recession has not reduced remittance flows as much as expected in earlier projections.

According to the International Fund for Agricultural Development (IFAD) and the World Bank, the largest remittance flows go to the Oceania–Asia area, and the second largest remittance flows go to the area of Latin America and the Caribbean. In Europe, remittance flows are particularly important for Albania, Poland, Moldova, Romania and Ukraine. In Europe, the total value of a migrant remittance is on average USD

Table 4. World Bank estimates and forecast on remittance flows in 2006–2011

USD billion	2006	2007	2008	2009f	2010f	2011f
East Asia and Pacific	58	71	86	85	85	89
Europe and Central Asia	37	51	58	49	51	53
Latin America and Caribbean	59	63	65	58	59	61
Middle-East and North Africa	26	31	35	32	33	34
South Asia	43	54	73	72	73	76
Sub-Saharan Africa	13	19	21	21	21	22
World	317	385	444	420	425	441

f = forecast

Source: World Bank, Migration and Development Brief 11.

1,619 (EUR 1,161) annually.

Despite the estimates and forecasts, detailed statistics are not available on remittance flows. All figures are based on estimates and available data on eg the amount of migrants in various countries. For statistical purposes, one must resort to extrapolation based on insufficient and unreliable data.

Statistics Finland estimates remittance flows based on the number of foreigners living in Finland, their employment rate and the average size of a monthly remittance. Based on such calculations, the remittance flows from Finland are estimated at EUR 20 million in 2008 and EUR 18 million in 2009. The difficulty of assessing remittance flows is reflected in the fact that the World Bank has estimated remittance flows from Finland in 2008 at USD 392 million, ie ca EUR 266 million. According to Statistics Finland, the majority of remittances are transferred by migrants from Russia and Estonia. Russians and Estonians are also the largest groups of foreigners in Finland.

According to IFAD estimates, remittance flows in 2006 consisted of over 150 billion payment transactions. The payments are typically small (ca USD 100–300). The aim is for these payments to be

executed on the same principles as other small cross-border payments<sup>21</sup>.

The challenge for legislators and supervisors is to find ways to increase the efficiency of remittances, so as to enable the prevention of money laundering and terrorism financing. For example, the European Economic and Social Committee proposes in its opinion ‘Migration and development: opportunities and challenges’<sup>22</sup> measures to increase the efficiency and enhance the benefits of remittances.

<sup>21</sup> General principles for international remittance services (2007), BIS and World Bank, <http://www.bis.org/publ/cpss76.htm>

<sup>22</sup> <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:120:0082:0088:EN:PDF>



## 4.2 SEPA credit transfer to replace domestic credit transfer – are you ready?

**Marianne Palva**

**The Single Euro Payments Area (SEPA) has been the topic of discussion since the introduction of the euro and changeover to euro cash. Now SEPA finally seems set to become a reality also for other payment instruments.**

In Finland, the transitional period for the domestic credit transfer ends on 31 December 2010. The domestic credit transfer can, however, be provided as special services until 30 October 2011. Thereafter all credit transfers must be furnished with the payee's International Bank Account Number (IBAN) and comply with ISO20022 XML standards. This is made clear in the updated SEPA migration plan<sup>23</sup> published by the Federation of Finnish Financial Services in February. The document also outlines other details on the realisation of SEPA in Finland.

The SEPA credit transfer was introduced in January 2008. Initially its use was very limited; it was mainly used in individual cross-border transfers in the euro area. The slow start was mainly due to the fact that banks were unable to receive bulk payments as batch transfers in the form of SEPA credit transfer until the fourth quarter of 2009. The use of SEPA credit transfers also requires an update of companies' software. Some companies and government institutions have already made the required updates, in

<sup>23</sup> [http://www.fkl.fi/www/page/fk\\_www\\_4538](http://www.fkl.fi/www/page/fk_www_4538) (updated migration plan available in Finnish only).

most the process is ongoing. Time is running out for those who have not yet started the updates.

In Finland, the use of SEPA credit transfers increased considerably towards the end of the year, but their share in the total number of credit transfers remained modest. The number of SEPA credit transfers is expected to increase sharply in early 2010, after companies have completed the software updates and start using SEPA credit transfers in bulk payments.

The migration plan also covers SEPA direct debit and SEPA payment cards. SEPA-compliant payment cards have been issued in Finland since the start of 2008, and they are already used fairly extensively. The aim is to achieve 100% usage by the end of 2010.

The SEPA direct debit was officially introduced in November 2009. Thus far, its usage is minor throughout SEPA, and in Finland banks do not yet provide SEPA direct debit services. By 1 November, banks will however provide SEPA direct debit services, in accordance with the EU regulation. The provision of invoicing services is voluntary. Banks operating in Finland have not yet published their plans and timetables on SEPA direct debit. They generally recommend replacing the domestic direct debit with services based on e-invoice and SEPA credit transfer. Most banks indeed already provide online banking customers with an automated payment service that is based on the e-invoice. For their customers not using online-banking, banks are currently developing an automated payment service that resembles direct debit and is based on e-invoice and SEPA credit transfer. The aim is to stop providing domestic direct debit by the end of 2013. The European Parliament resolution adopted in March may however change the situation. It calls on the European Commission to set "a clear, appropriate and binding end-date, which should be no

later than 31 December 2012, for migrating to SEPA instruments, after which all payments in euros must be made using the SEPA standards”.<sup>24</sup>

E-invoice is undergoing major development, and its usage has expanded considerably. Many companies and public authorities, including the Bank of Finland, have announced a date after which they will no longer accept paper invoices. E-invoice is the first step in the development of financial administration processes and procedures. Together with the ISO20022 standards used in SEPA payments they create a foundation for electronic real-time financial administration.

Similar developments are taking place in the EU. The Expert Group on Electronic Invoicing set up by the EU Commission published its report at the end of 2009. The report defines the framework for European electronic invoicing. The Expert Group’s aim is ambitious: e-invoicing is expected to become the predominant invoicing method in 5 to 8 years, in some countries even sooner.

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<sup>24</sup> <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+MOTION+B7-2010-0132+0+DOC+XML+V0//EN>

## 5 Key regulatory and supervisory initiatives

### 5.1 Tasks of the European Systemic Risk Board

Laura Vajanne

**The financial crisis has taught us in a concrete way that the financial system must be assessed as a unified entity that is affected by the functioning of the macro economy, financial institutions and infrastructure. The financial system requires also a cross-country supervisory system, due to the integration of markets and globalisation.**

In Europe, one of the major consequences of the crisis was the decision to establish a European Systemic Risk Board (ESRB). The ESRB will be responsible for macroprudential oversight of the EU financial system. Its objective is to prevent the creation and spreading of systemic risks and thereby contribute to ensuring that the financial sector functions smoothly and does not pose a threat to the stability of the economy. The ESRB will have a General Board, Steering Committee and Secretariat. The ESRB will be closely linked to the European System of Central Banks, as the governors of the national central banks of the 27 countries of the European System of Central Banks and the President of the ECB will be members of the General Board with voting rights. Representatives of the new European System of Financial Supervisors and representatives of national

supervisory authorities will also participate in the work of the General Board. The Secretariat will operate under the auspices of the ECB. This close connection to the ECB will bring synergy benefits, as the expertise of the ECB will be available to the new institution. Moreover, the operations of the new institution will gain credibility and influence because it is backed by the entire European System of Central Banks.

The legislative proposals on the establishment of the ESRB are currently being discussed by the European Parliament.<sup>25</sup> The hope is that the European Parliament will adopt the legislative reforms by summer so that the new legislation can take effect at the start of 2011 and the ESRB can start operating.

The ESRB will have the following tasks: continuous monitoring and analysis of risks and assessment of the macro-prudential situation and issuing risk warnings where systemic risks are deemed significant, and issuing recommendations for remedial action.

#### Monitoring, analysis and assessment of risks

Monitoring and analysing risks and the assessment of the macroprudential situation are traditionally part of

<sup>25</sup> The European Commission published in autumn 2009 legislative proposals which were adopted by the European Council meeting of heads of government in December 2009. The European Commission's legislative package consists of a proposal for a regulation on establishing a European Systemic Risk Board and the related decision entrusting the European Central Bank with specific tasks concerning then functioning of the European Systemic Risk Board.

central banks' macroprudential oversight of the financial system. The financial crisis has however shown that the authorities did not pay enough attention to identifying and mitigating vulnerabilities threatening the stability of the financial system. Moreover, the perspective in the analysis of stability threats was clearly national. Moreover, not enough resources were devoted to cross-border cooperation in the supervision of large banking groups with global operations.

Risks threatening the financial system are created eg as a result of changes in economic conditions. In an upturn, households, financial institutions and non-financial corporations tend to take on debt and excessive risks, and in a downturn, they are overly risk-avoiding.

Another significant factor creating systemic risks are contagion risks between banks. An individual bank may not sufficiently consider the impact of its operations on the risks to other financial institutions and the entire financial system. For example, the bankruptcy of a large financial institution may cause serious problems for other financial institutions, due to bilateral business and concerns about reputation, or panic. The work of the future ESRB is thus underlined by the need to expand the macroprudential analysis and systematise and sharpen the analysis of interlinkages between the various parts of the financial system.

In the identification of potential systemic risks, attention must be paid particularly to identifying hidden vulnerabilities and creating risk scenarios, and testing them against possible shocks. The objective is also to create forward-looking and early-warning stability indicators. It is also intended to construct a data base for risk monitoring and analysis with the help of existing data. Data on banks will be complemented with data on the insurance sector and other parts of the financial sector.

### Risk warnings and policy recommendations

A particular objective of establishing the ESRB is to create value added through risk warnings and possible recommendations for remedial action. First, with every risk that is deemed to be significant, the ESRB must decide whether a risk warning should be issued. Issuing a risk warning is a heavy measure, and therefore the decision must be based on an assessment based on the monitoring and analysis of the risks which shows that the risk identified is a major systemic risk. The criteria for issuing warnings depend largely on the discretion of the ESRB.

After the ESRB has decided to issue a warning it must decide on issuing recommendations for remedial action where appropriate. Various types of recommendations for remedial action may be issued, eg large-scale initiatives for reforming EU regulation or other financial system structures. On the national level, remedial action may be recommended to restrain growth in problem loans. Recommendations may also focus on the discretionary elements of the regulatory mechanisms (countercyclicality, adequacy of liquidity or bank indebtedness). Even *ad hoc* recommendations may be issued if necessary.

The recommendations for action are not legally binding, but the ESRB will monitor the follow-up to the recommendations. The party to which a recommendation is addressed is required to submit a response within a specific time if the recommendation has not been followed.

The ESRB may also make its warnings or recommendations public. It is evident that a public debate is more effective in terms of macroprudential policy, and at the same time it promotes system accountability. The timing of a warning also warrants careful consideration so as to achieve the maximum impact.

## 5.2 Tighter regulations on banks' capital adequacy and liquidity

Jyrki Haajanen and Jukka Vauhkonen

**Banks will be required to have more and higher-quality capital and liquid assets in the future. The aim is to dampen the pronounced cyclicity of lending by requiring banks to maintain in normal circumstances capital buffers that exceed minimum capital requirements and by setting limits on the growth of banks' balance sheets and indebtedness. The liquidity of EU banks' foreign branches will in future be supervised by the financial supervisor of the bank's home country.**

The current financial and economic crisis has in many ways been unique, and it has had exceptionally far-reaching consequences. The severity of the crisis is due to several factors, the most important being banks' insufficient capital buffers and inadequate liquidity risk management.

In the majority of developing countries, capital adequacy regulations for banks are based on the Basel II framework adopted by the Basel Committee on Banking Supervision in 2004. The Basel Committee in December 2009 published two consultative documents<sup>26</sup> that include proposals for enhancing capital adequacy and liquidity regulations for banks,

<sup>26</sup> "Strengthening the resilience of the banking sector" and "International framework for liquidity risk measurement, standards and monitoring".

strengthening the resilience of the banking sector and promoting the stability of the financial system.

The Basel Committee is expected to finalise its recommendations in 2010. The aim is to implement the reform package by end-2012. The EU's capital requirements directive is based mainly on recommendations by the Basel Committee. The directive will be amended in roughly the same timetable as the Basel framework.<sup>27</sup>

The Basel Committee's recommendations consist of five elements. **Banks will be required to increase the quality and quantity of the regulatory capital base.** Prior to the current economic crisis, a large part of banks' regulatory capital classified as high-quality was not able to absorb large losses. The Committee considers raising the quality of the capital base as one of its key objectives and aims to raise particularly the requirements on the quality of the highest-quality capital component (Tier 1). Harmonising and tightening the quality requirements for the capital base are important to ensure that capital buffers are effectively available to absorb losses in a crisis situation. The Committee will calibrate the minimum requirements for the overall level of capital in the course of 2010.

The proposal to strengthen **capital requirements for counterparty credit risk**<sup>28</sup> arising from eg derivatives contracts would move trading to exchanges and central counterparties. Of derivatives trading, over 90% takes place outside of the exchanges and central counterparty system. Moving a larger proportion of derivatives trading to supervised systems would

<sup>27</sup> Commission Services Staff Working Document. Possible further changes to the capital requirements directive.

[http://ec.europa.eu/internal\\_market/bank/regcapital/index\\_en.htm](http://ec.europa.eu/internal_market/bank/regcapital/index_en.htm)

<sup>28</sup> Counterparty risk is the risk of a counterparty to an agreement defaulting before the cash flows of a transaction are settled with finality.

reduce counterparty risk and increase market transparency. But excessive regulation of derivatives trading entails the risk that an important part of the financial market and business will wither away.

To supplement the risk-based Basel II capital adequacy requirements currently limiting banks' risk exposure, the Committee proposes a new, non-risk-based **leverage ratio**.<sup>29</sup> This simple measure would help contain the build up of excessive balance sheets and leverage. In addition, the leverage ratio could serve as a 'backstop' to the risk-based requirement in case it gives a too-positive picture of banks exposures, particularly in an upturn. The appropriate calibration of the new leverage ratio is however a challenging task for the authorities, as an excessively high leverage ratio could hamper banks lending activity and a too-low leverage ratio would not contain the build up of banks' leverage and balance sheets.

A common concern already in the preparatory phase of the Basel II framework was that risk-based capital requirements might unnecessarily amplify the business cycle, as risk-based capital requirements are typically loosened in an upturn and tightened in a downturn. To reduce this procyclicality, the Committee proposes that banks in normal conditions maintain **capital buffers above the minimum requirement**, which can be drawn on in periods of stress to absorb losses. The Committee will define the target level of capital buffers. Banks whose capital buffers are below the required level have to build them up by eg reducing earnings distributions and staff bonus payments until the required level is achieved.

In addition, the Committee is considering a **requirement for countercyclical capital buffers**. The size of the required capital buffer would vary depending on the cyclical phase: in an upturn, the

required capital buffer would be larger and in a downturn smaller. The required size of the buffers could be based on certain macroeconomic variables (eg rate of growth of total lending-to-GDP ratio) or authorities' discretionary decisions. The Basel Committee will publish additional information on procyclical capital buffers after its meeting in July 2010.

The Committee's proposal to strengthen banks' liquidity consists of **two quantitative liquidity standards**. The previous liquidity framework was based solely on the definition of qualitative criteria. The Net Stable Funding Requirement standard would address the maturity mismatch of banks' assets and liabilities. The Liquidity Coverage Requirement standard would require banks to maintain an adequate stock of high-quality liquid assets to enable them to survive a 30-day liquidity crisis.

The Basel Committee is reviewing possible additional requirements for large systemically important financial institutions and capital requirements for debt finance that can be converted into share capital under certain conditions.

Proposals on changes to the capital requirements directive are based mainly on the recommendations of the Basel Committee. The Commission however proposes a significant change in supervisory responsibilities concerning banks' foreign branches by **proposing that the supervision of liquidity of credit institutions' branches be transferred to the banks' home country supervisor**. Currently the host country, in cooperation with the competent authorities of the home country, is responsible for supervising the liquidity of credit institutions' branches.

<sup>29</sup> Equity ratio = equity / non-risk-weighted assets

## 6 Key corporate arrangements and events in the financial sector

<i>Date</i>	<i>Event and description</i>
<b>June 2009</b>	<p><i>Department of Finance of the Irish government announces reform of the institutional structures for regulation of financial services in Ireland.</i></p> <p><i>Savings banks Hauhon Säästöpankki and Rengon Säästöpankki merge to form Kantasäästöpankki Oy.</i></p>
<b>July 2009</b>	<p><i>eQ Bank, a subsidiary of Nordnet Bank, sells the Advium corporate finance operations to its senior management.</i></p> <p><i>Fitch changes the outlook on Pohjola Bank's rating from stable to negative. The ratings are short-term: F1+ and long-term AA-.</i></p>
<b>August 2009</b>	<p><i>Fitch lowers UPM Kymmene's long-term rating from BB+ to BB-. Rating outlook negative.</i></p> <p><i>Fitch changes the outlook on Pohjola Bank's rating from stable to negative. The ratings are short-term: F1+ and long-term AA-.</i></p> <p><i>Moody's confirms Stora Enso's long-term rating (Ba2), following restructuring announcement.</i></p> <p><i>Moody's places Metso's long-term rating (Baa2) on watch for possible downgrading.</i></p> <p><i>Sampo plc announces it will submit an application to the Swedish Financial Supervisory Authority for a license to increase the holding in Nordea Bank AB above 20%.</i></p> <p><i>Nordea announces it will acquire the Danish bank Fionia Bank.</i></p>
<b>September 2009</b>	<p><i>Moody's downgrades Pohjola Bank's long-term rating from Aa1 to Aa2. Nordea's long-term rating is downgraded from Aa1 to Aa2.</i></p> <p><i>S&amp;P upgrades Fortum's long-term rating from A- to A. Rating outlook stable.</i></p> <p><i>The Finnish Association of Mutual Funds was merged with the Federation of Finnish Financial Services.</i></p>

<i>Date</i>	<i>Event and description</i>
<b>September 2009</b>	<p><i>Savings banks Kuortaneen Säästöpankki and Töysän Säästöpankki merge to form Oma Säästöpankki Oy.</i></p> <p><i>Remote broker Van Der Moolen Effecten B.V's operations at the Helsinki stock exchange cease as its parent company in the Netherlands is declared bankrupt.</i></p> <p><i>Aktia's shares listed on the Helsinki Stock Exchange.</i></p>
<b>October 2009</b>	<p><i>Evli Bank Plc acquires Carnegie's asset management operations in Finland and Erik Penser Fonder AB in Sweden.</i></p> <p><i>Moody's lowers Fingrid Oyj's long-term rating from Aa3 to A1. Rating outlook negative.</i></p> <p><i>Moody's lowers Nokia Plc's long-term rating from A1 to A2. Rating outlook stable.</i></p> <p><i>Dutch bank DSB Bank NV is declared bankrupt.</i></p> <p><i>Government of Iceland reaches agreement with the U.K. and the Netherlands on repaying depositors at Icesave. The agreement was also approved by the Parliament of Iceland.</i></p> <p><i>Swedish Financial Supervisory Authority grants Sampo plc a license to increase its holding in Nordea Bank AB beyond 20%. Sampo plc's ownership of shares in Nordea exceeded 20% in December.</i></p>
<b>November 2009</b>	<p><i>Ministry of Justice working group proposes reform of regulations on the provision of consumer credit. The objective is to transpose the new EU directive on consumer credit and to amend national legislation in line with the development of markets.</i></p> <p><i>Standard &amp; Poor's affirms the sovereign credit ratings for the Republic of Finland. Short-term A-1+ and long-term AAA. Rating outlook remains stable.</i></p> <p><i>Moody's confirms Metso Corporation's long-term rating Baa2. Rating outlook remains negative.</i></p> <p><i>Metso Corporation and Tamfelt Corporation sign a combination agreement.</i></p> <p><i>Moody's lowers Iceland's foreign and local currency bond ratings from Baa1 to Baa3. Rating outlook stable.</i></p> <p><i>Estonian bank BIGBANK opens a branch in Helsinki.</i></p>



<i>Date</i>	<i>Event and description</i>
<b>November 2009</b>	<p><i>Finnish State Treasury accepts Eurex Bonds as trading platform for Finnish government bonds.</i></p> <p><i>Cooperative banks Koillis-Savon Osuuspankki and Nilsian Osuuspankki announce plans to merge in autumn 2010.</i></p>
<b>December 2009</b>	<p><i>EU finance ministers reach an agreement at the Ecofin Council meeting to create new financial supervisory authorities (for securities markets, banking and insurance) by the end of 2010. The three authorities will cooperate with the European Systemic Risk Board to be established under the auspices of the European Central Bank.</i></p> <p><i>Société Générale takes full control of Credit Du Nord by paying EUR 676 million for Dexia's 20% stake in Credit Du Nord.</i></p> <p><i>Austrian government nationalises Hypo Group Alpe Adria.</i></p> <p><i>eQ Bank, a subsidiary of Nordnet Bank, announces it will sell its asset and fund management business to the current managers of the business and Fennogens Investments S.A.</i></p> <p><i>Fitch downgrades Greece's short-term foreign currency and local currency Issuer Default Ratings (IDR) from F1 to F2 and the long-term rating from A- to 'BBB+. Rating outlooks negative.</i></p> <p><i>Standard &amp; Poor's downgrades Greece's long-term credit rating from A- to BBB+. Rating outlooks negative. Short-term credit rating is A-3, rating outlook negative.</i></p> <p><i>Moody's downgrades Greece's government bond ratings from A1 to A2. Rating outlook remains negative.</i></p> <p><i>Standard &amp; Poor's revises the outlook for the Kingdom of Spain from stable to negative, and affirms Spain's sovereign credit rating: short-term A1+ and long-term AA+.</i></p> <p><i>Standard &amp; Poor's downgrades Danske Bank's long-term rating from A+ to A. Sampo Bank's long-term rating was also lowered. Rating outlooks negative.</i></p> <p><i>Fitch lowers Nokia's credit rating: short-term from F1 to F2 and long-term from A to A-. Rating outlooks stable.</i></p> <p><i>Citibank sells its consumer credit business in Finland to S-Bank. The ca EUR 200 million lending stock will be transferred to S-Bank in February.</i></p>

<i>Date</i>	<i>Event and description</i>
<b>December 2009</b>	<i>Finnish Parliament adopts act on government capital investments in deposit banks. Capital loans may be subscribed until 30 April 2010. Parliament also decides to extend to the end of 2010 the temporary guarantee for deposit banks and mortgage banks issued in December 2008; provided the Council of State, by 30 June 2010, establishes a need to grant new guarantees.</i>
<b>January 2010</b>	<i>Moody's confirms Aktia Bank's ratings: short P-1 and long A1.</i>  <i>Standard &amp; Poor's affirms M-Real's credit ratings C and CCC+. Rating outlook stable.</i>
<b>February 2010</b>	<i>Standard &amp; Poor's downgrades UPM-Kymmene's long-term rating from BB+ to BB.</i>  <i>Fitch affirms UPM-Kymmene's ratings B and BB-. Rating outlook stable.</i>
<b>March 2010</b>	<i>Eufex applies for a banking licence.</i>  <i>Representatives of the local cooperative banks of Iisalmi, Kuopio and Varkaus approve plans to merge the banks at the start of 2011. The boards of directors had already approved the merger.</i>  <i>Tikkurila Oyj's share is listed on the NASDAQ OMX Helsinki stock exchange and the shares of Julius Tallberg Real Estate Corporation are delisted from NASDAQ OMX Helsinki.</i>  <i>Financial Supervisory Authority (FIN-FSA) revokes Sofia Bank's authorisation. The bank's own funds fell below the minimum level for a credit institution.</i>  <i>Standard &amp; Poor's affirms the United Kingdom's long-term sovereign credit rating AAA, but the outlook is negative.</i>  <i>Fitch downgrades Portugal's long-term foreign and local currency issuer default ratings from AA to AA-. Rating outlook negative. Short-term foreign currency rating is affirmed at F1+</i>  <i>Standard &amp; Poor's revises the outlook for Greece's short-term and long-term sovereign credit ratings from negative to stable.</i>
<b>April 2010</b>	<i>Marketing of long-term pension savings accounts commences.</i>