Financial Market report

4 • 2006

- Insurance savings and fund investments have grown sharply in the new millennium
- No clear signs of competition in deposit rates
- Numbers of bank branches and employees on the rise in the EU countries
- Finnish bond market no longer expanding
- Market participants boost the efficiency of securities clearing and settlement
- Payment systems integration lacks legislative base

Bank of Finland

Financial Markets and Statistics

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1 Financial intermediation

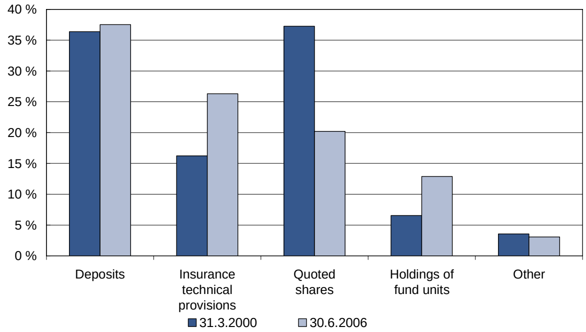
1.1 Insurance savings and fund investments have gained popularity in the new millennium

Laura Vajanne

Households' fund investments have increased rapidly in the current decade. Another saving channel which has rapidly gained popularity is personal life and pension insurance. By contrast, net purchases of equities have remained modest, and changes in equity wealth are mainly due to changes in share prices.

Households' financial assets[1] totalled EUR 151 billion at the end of June 2006. The majority of financial assets is still in bank deposits, and quoted shares account for about a fifth and mutual funds for 13% of financial assets. One-fourth of financial assets is in insurance technical provisions, of which individual life and pension insurance accounts for about a half, ie for slightly less than EUR 20 billion.

Chart 1. Breakdown of households' financial assets, %



Source: Bank of Finland.

The biggest changes in the structure of financial wealth in the current decade are due to changes in share prices. In June 2006, the value of quoted shares owned by households totalled EUR 30 billion (domestic shares: EUR 27 bn), down from EUR 44 billion (domestic: EUR 41 bn) in the first quarter of 2000, the peak of the IT boom. Net changes in equity investments have been small in the current decade. The number of shareholders has nevertheless fallen slightly in recent years.[2]

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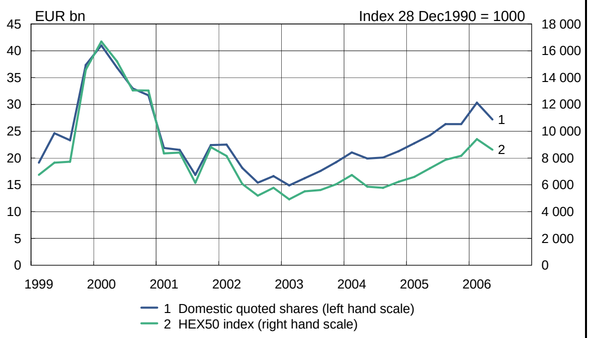
[1] Data are based on the Bank of Finland's/ ESCB's quarterly financial accounts. Bank of Finland data do not include unquoted shares and other equity or other accounts receivable. Nor are shares in housing corporations included in financial assets.

[2] At the end of September 2006, the book-entry system included over 730,000 accounts registered to households, whereas in the same period in 2003, the number was 796,000. See http://www.apk.fi/files/excel_0610.xls

Chart 2. Households' share holdings and the HEX Index

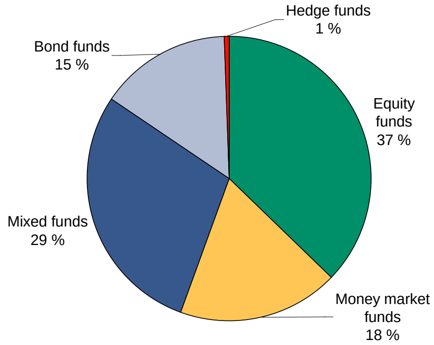


Source: Bank of Finland and Helsinki Stock Exchange.

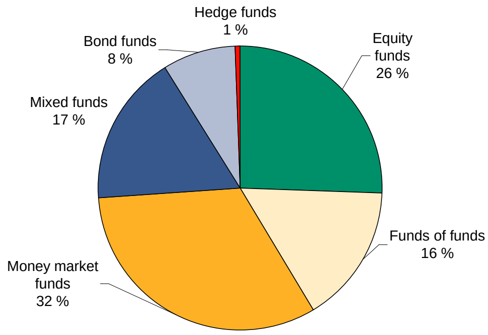
Deposits have usually moved more or less in line with income. In recent years, the stock of deposits has increased steadily, at 6% pa, while new forms of saving have grown considerably faster. Individual insurance savings (insurance savings and voluntary pension insurance) have doubled in the current decade, from EUR 10 to 20 billion. According to the Finnish Bankers' Association's latest Banking Barometer, households are expected to favour insurance savings and pension insurance products also in the near future.

Fund investments have also increased considerably in recent years. Households' fund investments totalled about EUR 19 billion in June 2006, up from EUR 7.5 billion at the end of 2000. Of the total, one-third was in money market funds, one-fourth in equity funds, and the rest in other funds, such as mixed funds, funds of funds, and bond funds.

Chart 3. Holdings of fund units



June 2001



June 2006

Source: Statistics Finland.

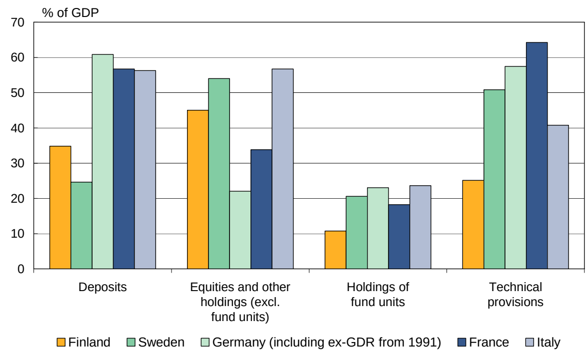
Money market funds in particular have increased in relative terms, while investments in mixed funds have decreased.

The popularity of new saving forms has been boosted by both supply and demand factors. Banks and insurance corporations have increased and diversified their product range, and they have actively marketed their new products. On the other hand, low interest rates on bank deposits have induced households to seek out savings vehicles offering higher returns. Discussions on the adequacy of pensions have also boosted interest in personal pension insurance saving.

Deposits-to-GDP ratio low in Finland compared to other euro area countries

By international comparison, the household deposits-to-GDP ratio is not especially high in Finland. In Sweden, the ratio is even lower.

Chart 4. Households' financial receivables in selected EU countries, 2005



Source: Eurostat.

Particularly in the large euro area countries, the deposit-to-GDP ratio is clearly higher than in Finland.[3]

In Finland, the level of shareholdings (incl. unquoted shares and holdings) is close to the international average. However, methods of compiling statistics on unquoted shares and holdings vary considerably between countries, which may explain eg the low level of shareholdings in Germany. As unquoted shares and holdings are mainly holdings in SMEs, the figures also reflect differences in company structure. Despite rapid growth in mutual fund investments, Finnish households still lag behind the other EU countries. In the euro area, the ratio of mutual fund investments to GDP is on average 20%. In Finland, the ratio at year-end 2005 was only 11%. Hence, to achieve the average level of fund investments in the euro area, Finnish households' fund investments should nearly double from the current level of EUR 19 billion.

In Finland, the insurance technical provisions-to-GDP ratio is fairly low compared to several other EU countries. It is however difficult to make international comparisons of insurance technical provisions because of the notable differences in pension systems. In Finland, the statutory and collective employee pension insurance system plays a key role, but funds formed in this system not included in household assets.[4] In contrast, funds created in other pension systems are included in household assets, which partly explains the considerable cross-country differences.

[3] International comparison is based on Eurostat data. The data deviate slightly from those published by the Bank of Finland.

[4] According to the Finnish Centre for Pensions, households' funded pension assets (that can be considered insurance technical provisions) amounted to about 65% of GDP at year-end 2005.

2 Banks and insurance corporations

2.1 Continued robust growth of banks' operating profits

Mervi Toivanen

As a result of positive developments in the domestic operating environment, banks' operating profits continued to increase in January–September 2006. Results were boosted particularly by the growth and expansion of business operations, several non-recurring items, and items measured at fair value in accordance with International Financial Reporting Standards (IFRS).

Banks' net interest income has improved, due to growth of lending stock and higher market interest rates. The volume of loans for house purchase continued to increase in 2006, albeit at a slightly slower pace. The positive impact of rising market interest rates is transmitted via two channels. Increases in the most common reference rates for loans – Euribor and Prime rates – have boosted interest income on loans, despite some resistance from narrowing interest rate margins. Secondly, banks benefit from sluggish deposit rates. Interest rates on deposits, which are the core of banks' funding, react to changing interest rates more slowly than the interest rates on loans. In other words, as interest rate rise, banks' interest expenses on funding increase less than interest income. On the other hand, as banks are increasingly resorting to market-based funding, their funding costs are increasing and the positive impact of rising market interest rates on net interest income has diminished.

Banks' other income has increased significantly. This is due to in particular, growth in net fee income and net income on items measured at fair value. Banks gain net fee income particularly from mutual funds and asset management, as a result of growth in customers and business volumes. Net income from items measured at fair value has grown due to favourable stock exchange and share price developments in 2006. Some banks have also received one-off capital gains from the sale of shares and investment properties.

Banks' expenses continue to rise. Higher staff expenses are due to wage increases and growth of performance-linked bonuses, as well as to recruiting. The growth in other expenses is mainly due to bank-specific factors – most commonly higher business volumes, increased focus on sales and marketing, and expansion of operations into new areas. In January–September 2006, banks recorded net loan loss recoveries.

On the whole, banks' cost efficiency and profitability have improved. Cost efficiency, measured by the expense-income ratio, was on average 52% in January–September 2006. In other words, banks receive EUR 1.92 of income for each euro they spend. Cost efficiency does vary greatly across banks. The weakest expense-income ratio was 100% and the strongest 41%. Banks' profitability, measured by return on equity, has also generally improved since the end of 2005. Banks' efficiency and profitability are currently clearly based on growth in income.

Table 1. Key items from banks' income statements, Jan–Sep 2006 (EUR m) and changes on year-earlier period

	Net interest income, EUR m		Other income, EUR m		Total expenses, EUR m		Operating profit, EUR m	
	1-9 2006	Change %	1-9 2006	Change %	1-9 2006	Change %	1-9 2006	Change %
Nordea Group	2 863	4.9 %	2 621	21.8 %	2 806	3.5 %	2 853	24.0 %
Retail banking	2 370	4.5 %	1 353	15.3 %	1 963	2.0 %	1 896	18.4 %
Retail banking in Finland	648	6.6 %	337	19.5 %	478	0.8 %	513	25.7 %
Sampo Group	252	10.0 %	4 235	-1.9 %	3 469	-2.1 %	1 019	1.2 %
Banking and investment services	276	8.2 %	329	19.6 %	325	6.2 %	279	21.8 %
Insurance services	-	-	3 883	-4.3 %	3 137	-3.3 %	747	-8.0 %
OP Bank Group *	642	7.2 %	796	89.5 %	834	47.9 %	598	32.3 %
Retail and corporate banking services	611	-	216	-	349	-	473	10.3 %
Non-life insurance services	-	-	-	-	-	-	58	-
OKO Bank Group *	73	-38.1 %	395	259.1 %	301	168.8 %	166	44.3 %
Savings banks (excl. Aktia), total	97	12.2 %	36	10.5 %	81	3.5 %	52	27.0 %
Aktia Savings Bank plc (Group)	63	5.2 %	42	36.5 %	61	10.2 %	46	34.1 %
Local cooperative banks, total	67	17.2 %	19	5.7 %	52	5.7 %	34	30.4 %
Bank of Åland plc (Group)	24	2.6 %	21	30.4 %	29	11.8 %	17	20.3 %
Evli Group	1	25.0 %	38	-8.0 %	37	4.9 %	2	-67.8 %
eQ Group	4	58.2 %	27	39.1 %	20	12.9 %	11	169.1 %
1. Finnish banking business (incl. Nordea retail banking Finland)	1 790	-	1 064	-	1 431	-	1 426	19.7 %
2. Finnish banking and financial groups (incl. Nordea retail banking in Finland)	1 821	7.7 %	1 644	45.0 %	1 916	19.4 %	1 551	27.8 %
3. Financial conglomerates operating in Finland	4 012	5.9 %	7 834	11.2 %	7 388	4.3 %	4 631	19.2 %

Other income includes net fee income, capital gains/losses from sale of tangible and intangible assets, and shares in profits/losses of associated companies.
Expenses include depreciation and write-downs on tangible and intangible assets.
The various items do not equal operating profit, as some profit and loss account items are not included in the table.
The change % was calculated on figures for 2005.
1. Includes savings banks, Aktia Savings Bank Plc Group, local cooperative banks, Bank of Åland plc Group, Evli Group, eQ Online Group, OP Bank Group's retail and corporate banking services, Sampo's banking and investment services and Nordea's retail banking activities in Finland.
2. Includes savings banks, Aktia Savings Bank Plc Group, local cooperative banks, Bank of Åland plc Group, Evli Group, eQ Online Group, OP Bank Group, Sampo's banking and investment services and Nordea's retail banking activities in Finland.
3. Includes Finnish banking and financial groups, Sampo Group and Nordea Group.

* OP Bank Group (and OKO Bank Group) income statement includes the result for Pohjola Group plc for January–September 2006. Pohjola's figures are not included in comparative data for 2005. In addition, the substantial change in the structure of OKO Bank Group as a consequence of the Pohjola deal has weakened the comparability of OP Bank Group and OKO Bank Group figures for 2006 and 2005.
Source: Banks' interim reports.

2.2 Are banks competing on deposit rates?

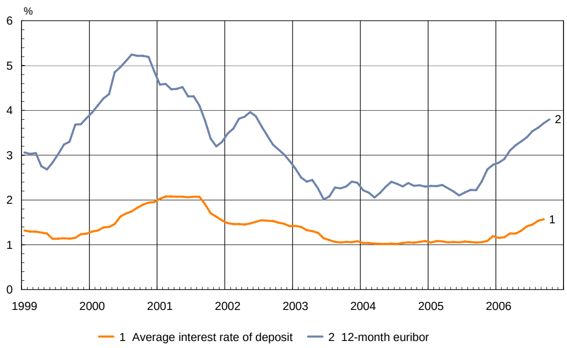
Mervi Toivanen

The average interest rate on the deposit stock rose in 2006. Statistics do not, however, clearly indicate that banks have started to compete in terms of deposit rates. Deposit rates are developing much as in the last period of rising market interest rates. In 2006, an increase in market interest rates led, in particular, to rises in the interest rates on non-financial corporations' deposits and on households' fixed-term deposits. In contrast, interest rates on households' most common transactions accounts have not risen.

For several years, banks have been quite actively competing via margins on loans for house purchase. Narrowing margins and historically low reference rates have led to an increase in banks' stock of lending. Growth in lending stock must however be financed via the financial markets or by attracting deposits from the public. In 2006, the average interest rate on the stock of deposits has risen gradually. Might this be an indication of increased competition also in the deposit market?

The interest rate on the stock of deposits tracks the rise in Euribor interest rates with a lag of about six months.[5] The last increase in the interest rate on the deposit stock took place in 2000. The relative change in Euribor and deposit interest rates was roughly the same in 2000 and 2006. Between June 1999 and September 2000, the Euribor rose by 2.38 percentage points and the average interest rate on the deposit stock rose by 0.55 percentage point. In January 2005–September 2006, the Euribor climbed by 1.61 percentage points and deposit interest rates by an average of 0.36 percentage point. In other words, in both the periods, about 22 to 23% of the change in market interest rates was passed on to deposit rates.

Chart 5. Average interest rate on stock of deposits of the general public in Finnish MFIs and 12-month Euribor

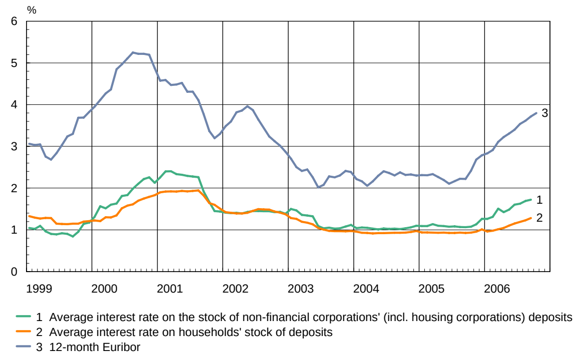


Source: Bank of Finland.

The majority of MFI deposits are made by non-financial corporations and households. Interest rates on non-financial corporation deposits are more sensitive to developments in market interest rates, whereas interest rates on household deposits change more slowly. Between September 2005 and September 2006 the interest rate on non-financial corporation deposits increased by 0.66 percentage point, while the interest rate on household deposits rose only by 0.36 percentage point. About three-fourths of non-financial corporation deposits are overnight deposits, ie deposits on transaction accounts. In September 2006, the average interest rate on non-financial corporation overnight deposits was 0.55 percentage point higher than in the corresponding period of 2005.

[5] Statistics on deposits of the general public in Finnish MFIs and deposit banks. Bank of Finland publication Financial Markets - Statistical Review.

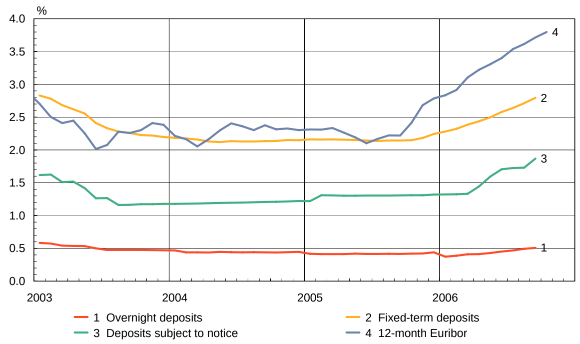
Chart 6. Average interest rate on stock of non-financial corporation and household deposits in Finnish MFIs and 12-month Euribor



Source: Bank of Finland.

At the end of September 2006, about 60% of household deposits were in transaction accounts, 25% in fixed-term deposits, and 16% in deposits subject to notice and other deposits. In the past year, the proportion of transaction accounts has decreased slightly and that of fixed-term deposits has increased.

Chart 7. Average interest rate on stock of household deposits in Finnish MFIs, by maturity and 12-month Euribor



Source: Bank of Finland.

The average interest rate on household transaction accounts has over the past four years remained close to 0.5%. Changes in interest rates on transaction accounts have been fairly small in recent years.

Household deposits in transaction accounts totalled about EUR 34 billion at the end of September 2006, ie about 42% of total euro-denominated MFI deposits. Due to the high proportion of household deposits in transaction accounts relative to the total stock of MFI deposits, changes in the interest rate on transaction accounts have a strong impact on banks' interest expenses and thereby on net interest income. Statistics indicate that in recent years, banks have not competed on interest rates on household transaction accounts.

Interest rates on household deposits subject to notice and fixed-term deposits[6] rose in 2006. Interest rates on deposits subject to notice are strongly affected by changes in banks' prime interest rates. By contrast, rates on fixed-term deposits follow market interest rates fairly closely, because the rates on new fixed-term deposits are based on market interest rates. In addition, recent offers on deposits have often focused on fixed-term deposits. Interest rates on fixed-term deposits seem not to vary greatly between banks. Since the beginning of 2003, the difference between the highest and the lowest interest rate has decreased slightly. However, as it is difficult to make a clear distinction between the impacts of competition and market interest rates, firm conclusions cannot be drawn solely on the basis of descriptive statisticals.

[6] Fixed-term deposits have a fixed term of maturity. Deposits subject to notice include deposits without the possibility of credit transfer and a debit card facility and which have to be repaid on demand, as well as high-yield investment and yield accounts (usually with a restricted number of monthly withdrawals).

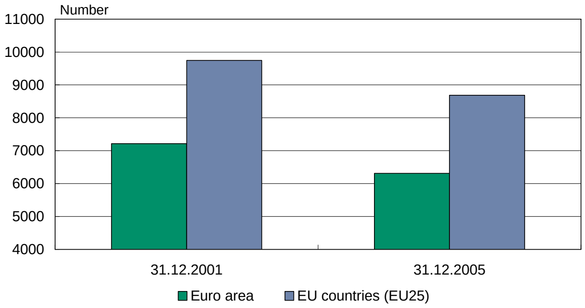
2.3 Is the protracted decline in the number of banks in EU countries coming to an end?

Sampo Alhonsuo and Jukka Vauhkonen

One of the key trends in the European banking sector in the past decade – the sharp decline in the number of banks and branches – seems to have ended in many EU countries.

The number of European credit institutions has been declining for several years. The number of euro area credit institutions fell in 2001–2005 by some 13%, from over 7,200 to slightly over 6,300. In the same period, the number of credit institutions in EU countries decreased by nearly 11%, to less than 8,700 (Chart 8). [7]

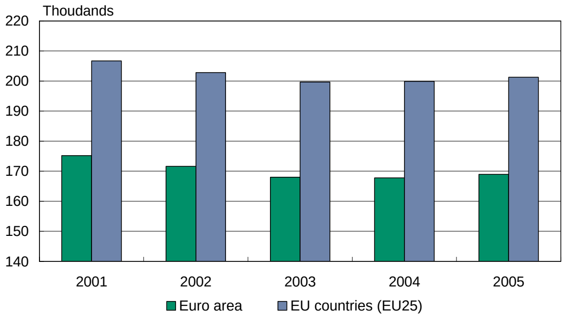
Chart 8. Number of credit institutions in euro area and EU countries (EU25), 2001 and 2005



Source: European Central Bank.

The process of consolidation and rationalisation in European banking, which began in the1990s and included sharp reductions in the numbers of banks, branches and staff, now seems to be winding down. In 2004–2005 the number of credit institutions increased or remained unchanged in 11 EU countries. However, the number of credit institutions continued to decline particularly in Germany, France and the Netherlands, which resulted in a further reduction in the total number of credit institutions in the EU countries. By contrast, the total number of EU credit institutions' branches and staff grew in 2005, for the first time since the ECB started compiling harmonised statistics (Chart 9).[8]

Chart 9. Number of credit institutions' branches in euro area and EU countries (EU25), 2001–2005



Source: European Central Bank.

Strong profitability in banking in recent years has attracted new banks into the market and induced banks already operating to expand operations.

As a result of changes in banks' operating environment in the past twenty years (eg development of banking technology and liberalisation and integration of financial markets), banking has become more efficient and banks have grown rapidly on average. Large banks in particular have grown at a more rapid pace than small ones. As a result, EU countries' national banking systems have become increasingly concentrated. Concentration can be

[7] For more information on structural developments in the European banking sector, see ECB (2006), 'EU Banking Structures 2005'.

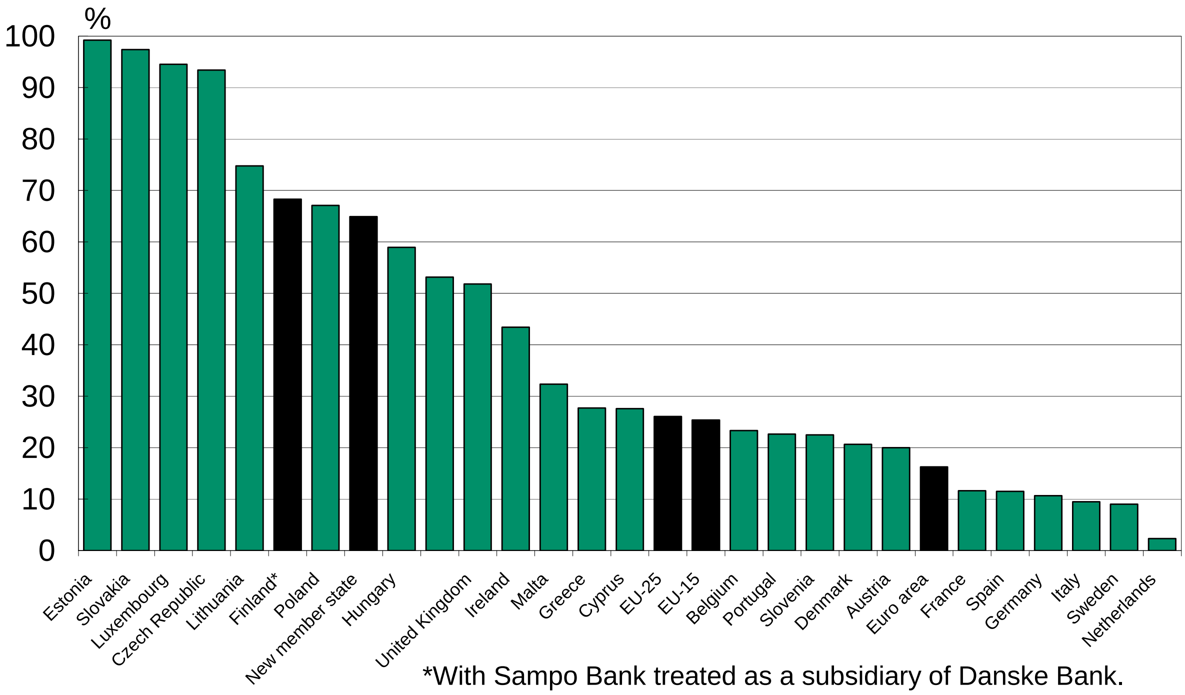
[8] The ECB has since 1997 compiled statistics on the number of credit institutions, credit institutions' branches and staff in the EU15, and since 2001 on the new EU member states.

measured eg by the proportion of the aggregate balance sheet total of a country's five largest credit institutions in the aggregate balance sheet total for all credit institutions in the country. In 2001–2005, the (weighted) average of this key financial ratio grew in the EU countries from 38% to 42%.

European banks have grown as a result of both increased overall business operations and mergers and acquisitions. In 2005, several major cross-border bank acquisitions were finalised in Europe, the most significant being those between Unicredit and HypoVereinsbank, ABN-Amro and Banca Antonveneta, and Swedbank and Hansabank. It is worth noting that the parties to these acquisitions are mainly retail banks. In previous years, banks focusing particularly on asset management and investment banking were the most active participants in European cross-border mergers and acquisitions.

Cross-border bank acquisitions have in recent years focused particularly on banks in the new EU member states. The market share of foreign banks is thus on average clearly higher in the new EU member states than in the old ones. With the finalisation of Danske Bank's acquisition of Sampo Bank, the market share of foreign banks in Finland will be the second highest in the euro area, after Luxembourg (Chart 10).

Chart 10. Share of aggregate total assets of foreign credit institutions' subsidiaries and branches in aggregate total assets of EU countries' credit institutions, 2005



*With Sampo Bank treated as a subsidiary of Danske Bank.

Source: ECB and Bank of Finland calculations.

In all the Nordic countries, with the exception of Iceland, the number of credit institutions and their staff has declined in recent years. At year-end 2005, the number of credit institutions in the Nordic countries totalled slightly over 1,000 and the number of staff totalled more than 140,000. In contrast, the number of branches has fallen in Denmark but increased slightly in Finland and Sweden (Table 2).

The causes and consequences of these developments are the same as in the other European countries. Banks' strong profitability and efficiency, as well as the favourable operating environment have supported the expansion of operations. The average size of Nordic banks has thus grown rapidly. In Finland, Sweden, Norway, and Denmark, credit institutions' average balance sheet has grown by 40 to 50% in the past few years. Finnish credit institutions account for over a third of the total number of Nordic credit institutions (ca 1,000), and Finnish credit institutions are on average clearly smaller than those in the other Nordic countries.

Table 2. Structural data on credit institutions in the Nordic countries

Credit institutions, number

	2002	2005	change, %
Finland	369	363	-2
Sweden	216	200	-7
Denmark	200	197	-2
Norway	219	209	-5
Island	38	38	0
Total	1 042	1 007	-3

Credit institutions, number of staff

	2002	2005	change, %
Finland	27 190	25 182	-7
Sweden	42 357	39 237	-7
Denmark	47 613	47 579	0
Norway	27 321	25 117	-8
Island	3 629	4 285	18
Total	148 110	141 400	-5

Credit institutions, number of branches (three countries)

	2002	2005	change, %
Finland	1 572	1 616	3
Sweden	1 904	1 910	0
Denmark	2 128	2 114	-1
Total	5 604	5 640	1

Average balance sheet, EUR m
(total assets/number of credit institutions)

	2002	2005	change, %
Finland	449	646	44
Sweden	2 198	3 266	49
Denmark	2 496	3 665	47
Norway	1 221	1 729	42
Island	341	2 174	-

Sources: EU Banking Structures report (Finland, Sweden and Denmark), and Nordic Banking Structures report (Norway and Iceland, see www.bof.fi)

3 Securities markets

3.1 Growth of the domestic bond market comes to a halt

Pertti Pylkkönen

The decline in government debt has led to a slight decrease in the stock of bonds. Issuance has increased only in the financial sector.

Growth of the domestic bond market has ended and the stock of bonds has remained quite stable in the last several years. As result of government debt retirement, there was even a slight downturn in the stock of domestic bonds in autumn 2006. In recent years, government borrowing has concentrated on a few benchmark bonds. The EUR 5 billon bond issue in spring 2006 was supplemented in December by an issue of EUR 1 billion. The bond is a fixed-rate benchmark bond that matures in 2017. Yield bond issues, targeted at private investors, have not been successful, and in 2006 they totalled only a few million euros. Government borrowing has focused on issues of long-term benchmark bonds. At the end of October, debt with a maturity of less than 1 year accounted for about 8% of total borrowing.

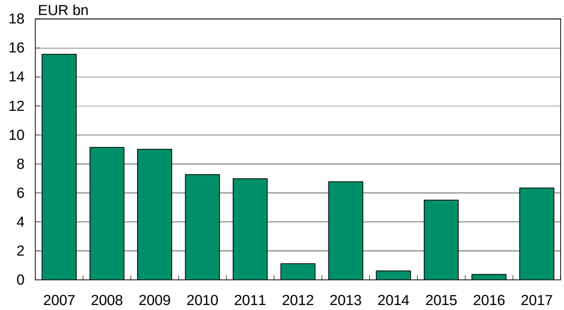
Government bonds are sold mainly to foreign investors. In June 2006, foreign investors held almost 90% of the total stock of government bonds (ca EUR 55 billion). The previous main investor group, Finnish employee pension insurers, have diversified their bond investments over the entire euro area and considerably reduced their investments in domestic government bonds. In June, employee pension insurers held Finnish government bonds amounting to only about EUR 2 billion, which was just 5% of their total holdings in debt instruments.

In June 2006, domestic money market and bond funds held Finnish government bonds worth over EUR 0.5 billion. The amount of government bonds held by households has dropped to a few hundred million euros, as a result of unsuccessful issues of yield bonds.

The secondary market for government benchmark bonds has now largely moved abroad. For example, trades between primary dealers take place mainly in the MTS Finland and EuroMTS marketplaces. The number of primary dealers currently stands at 14, only one of which is a Finnish bank.

In 2007, government debt retirement will amount to EUR 13.2 billion and interest payments to EUR 2.4 billion. Net borrowing will remain modest.

Chart 11. Government debt retirement and interest payments



Source: State Treasury Office.

Borrowing from the bond market by other public sector entities is minor. In 2006 bond issues by municipalities totalled only about EUR 100 million. Municipalities acquired debt financing mainly in the form of bank loans and via Municipality Finance, which they jointly own.

Gross issuance of corporate bonds declined in January–October 2006 on the same period of the previous year, even while the stock of corporate bonds continued to grow moderately, due to the small amount of amortisation. Companies currently acquire domestic long-term debt financing almost entirely from banks. The larger domestic companies have in the past year become more active in issuing bonds on the international market, and bond sales there have increased rapidly.

Financial institutions are the only group that has stepped up its bond issuance. Banks have been particularly active in bringing new products to the market. The majority of bonds issued by banks in the domestic market are various types of structured or index-linked bonds sold primarily to households. Banks' larger bond issues, sold on the wholesale market, are aimed at the international financial markets.

3.2 Continued growth in hedge funds

Pertti Pylkkönen

Hedge funds continue to grow in both international and domestic markets. Yield differentials between hedge funds and other investments have narrowed.

Difficulties confronting the Amaranth Advisors hedge fund in the early autumn of 2006 brought hedge funds back into the spotlight. The Amaranth fund was an exceptionally large hedge fund: in August, its assets totalled about USD 40 billion.

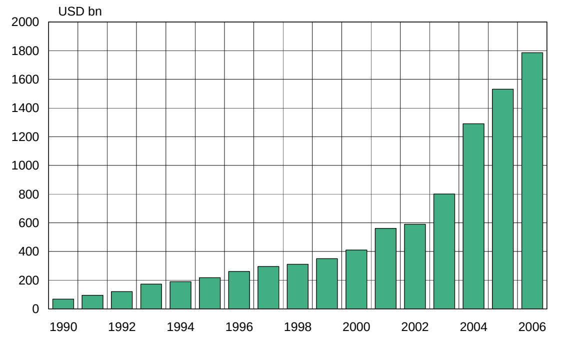
The fund invested in the commodities market, with a focus on natural gas futures. The fund's investment policy was based on the view that natural gas prices would continue to rise during the autumn. The view proved to be wrong. Natural gas prices dropped sharply, by about 40%, in September, and the fund suffered considerable losses.

The rise in the fund's losses ended when the fund transferred its natural gas portfolio to another hedge fund, Citadel, and the investment bank JP Morgan. At this point, the Amaranth's losses had mounted to over USD 6 billion, considerably larger than eg those of the Long-Term Capital Management fund in autumn 1998.

The total assets of Amaranth covered the losses, despite losing some two-thirds of its assets during the autumn turmoil. The problems did not spread further, as the fund was able to cover its losses with its own assets. For example, the fund's creditors did not suffer any loan losses. The overall stability of the investment environment was one reason why the markets did not react more strongly to the fund's problems. A decline in the prices of gas, oil and other energy products can on the whole be considered a positive development, for both the economy and the financial markets.

Despite the individual problems, hedge funds' global assets continue to grow rapidly. Fund assets are estimated to have reached about USD 1.8 trillion by September, and the number of hedge funds is estimated at about 9,000[9].

Chart 12. Hedge funds' total assets



Source: Van HedgeFund Advisors and HFN HedgeFund.

The growth of funds is however partly due to rapid growth of funds that invest in other funds. Many 'new investors' investing in hedge funds use these funds of funds to allocate risks, or because their investments are not large enough for direct investing. Moreover, it is often easier to withdraw from investments in funds of funds than from direct investments in hedge funds.

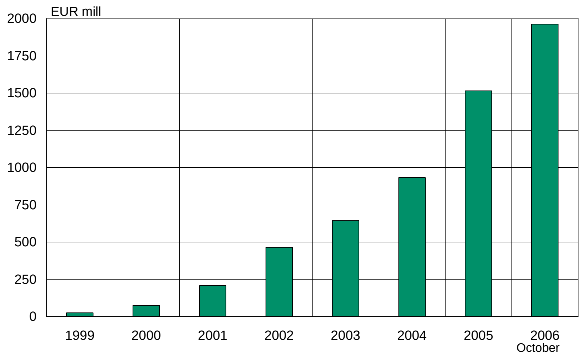
Hedge funds are usually quite small: the assets of the majority of funds, ie about two-thirds, total less than USD 100 million. The bulk of their investments is in funds with assets totalling USD 100 to 500 million[10].

Domestic hedge funds

Hedge funds sold in Finland are special mutual funds as referred to in the Mutual Funds Act. They are supervised mutual funds whose investment style differs from that of many international hedge funds. Finnish hedge funds, unlike unregulated funds, cannot eg obtain investment money via debt financing.

Hedge funds registered in Finland are currently sold by more than 10 management companies. The Helsinki Stock Exchange's list of mutual funds currently includes 23 various types of hedge funds. The funds are growing at a steady pace, and their assets total about EUR 2 billion[11]. In October 2006, hedge funds accounted for more than 3% of Finnish mutual funds' assets.

Chart 13. Domestic hedge funds (fund assets)



Sources: Financial Supervision Authority and Investment Research Finland.

Of the domestic institutional investors, insurance corporations, for example, have started to actively allocate their investments also to the hedge fund markets. In September, insurance corporations' investments in international and domestic hedge funds totalled about EUR 4.5 billion (pension insurers: EUR 3.3 bn, life insurers: slightly over EUR 1 bn). Non-life insurers have not actively invested in hedge funds.

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9 Source: HFN HedgeFund

10 Sources: TASS and ECB.

11 Sources: Financial Supervision Authority and Investment Research Finland.

4 Infrastructure

4.1 Payment Services Directive delayed – is there a lack of definite support for market development?

Päivi Heikkinen

Drafting of the Payment Services Directive continues in 2007. A Single Euro Payments Area needs support by a directive-based legal framework. Without it, we will not achieve harmonised pan-European rules on the transfer of customer payments.

The European internal market guarantees free movement of goods as well as people. The Services Directive, which covers movement of services, was finally adopted in mid-November 2006, after three years of preparations. Adoption of the Payment Services Directive, which will harmonise the rules on payment transfers, may also be prolonged, despite the fact that the creation of a Single Euro Payments Area (SEPA)[12] would require regulative support.

The European Commission began drafting the Payment Services Directive in 2003, and in November 2005 it presented its first draft for consultation.[13] Following comments and discussions in early 2006, expectations were high for the adoption of the directive during the Finnish Presidency. Despite strong efforts by the Presidency, national differences remain an obstacle to finalisation of the directive. The political message to the markets is ambiguous. On the one hand, the banking sector is required to create a Single Euro Payments Area, while on the other hand, the authorities are unable to agree on a harmonised legal framework for the payments area.

Why are the Single Euro Payments Area and the Payment Services Directive as its legal framework so important? Commitment to harmonised payment instruments and rules on payment transfers will remove one more barrier and uncertainty factor regarding intra-European trade. Harmonised payment instruments facilitate integration of payment transfer infrastructure, which will in turn raise the efficiency of operations and enable economies of scale. Differences in technology or national practices will no longer restrict competition,

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[12] SEPA refers to the processing of both pan-European payments and domestic payments under the same terms and conditions.

See eg http://www.pankkiyhdistys.fi/english/index.html, or http://www.europeanpaymentscouncil.eu/index.cfm, and http://www.bof.fi/eng/5_tilastot/5.2_Tilastojulkaisut/index.stm (Financial Market Report 4/2005).

[13] See http://www.epfsf.org/meetings/2006/briefings/briefing_21feb2006_more.htm

which will make it easier for both companies and private citizens to compare services and make choices. The Single Euro Payments Area is a political initiative to which banks are committed, on encouragement by the European Commission and the European Central Bank. However, the banking sector has focused on the standardisation of interbank payment transfers, whereas the Payment Services Directive would have harmonised practices concerning end-users, such as rules on payment transfers, execution times and data transmitted with the payment. Moreover, the banking sector had looked forward to the finalisation of the Payment Services Directive, to clarify the differences in existing services.[14]

The key problem area in drafting the Payment Services Directive has been the less strict requirements on new types of payment service providers[15]. These non-banks could transfer payments.

Further delay in the adoption of the Payment Services Directive will not as such prevent the creation of a Single Euro Payments Area, but it leaves us with a great deal of uncertainty. Since future services will be based on agreements on interbank operations, the uniformity of customer contracts and conditions on customer payments cannot be guaranteed. Hence the key objective of the Single Euro Payments Area – ie to enable all Europeans to use the same payment methods subject to the same terms and conditions – will remain unfulfilled. Moreover, banks will remain uncertain as to the final legal framework under which they will operate in future. In the worst case, market participants will be unwilling to implement single European payment services until a regulatory framework is in place.

[14] See http://www.europeanpaymentscouncil.eu/content.cfm?page=european_institutions

[15] See http://www.euractiv.com/en/financial-services/eu-ministers-undecided-single-payments-area/article-160099

4.2 A quick solution for regulation of clearing and settlement

Emilia Koivuniemi

The European Commission wants to support market participants' efforts to ensure increased efficiency of securities clearing and settlement. The Commission, together with market participants, have thus prepared a Code of Conduct, which is already being implemented.

An initiative for creating a Code of Conduct was put forward in July 2006 by Charlie McCreevy, the European Commissioner for Internal Market and Services[16]. His initiative called for increasing transparency and promoting competition in securities clearing and settlement. The purpose of the plan is to lower the high costs of cross-border clearing and settlement. Commissioner McCreevy favours market-based measures, which would make it unnecessary to resort to a directive.

The Federation of European Securities Exchanges (FESE), European Association of Central Counterparty Clearing Houses (EACH) and European Central Securities Depositories Association (ECSDA) prepared a Code of Conduct, with the help of the Commission.

[16] Charlie McCreevy (11 July 2006), 'Clearing and settlement: The way forward'.

The members of the organisations committed to implementing the Code on 7 November 2006[17].

The European Commission welcomes self-regulatory measures to increase efficiency of the post-trading process and to clarify services and their pricing.

The Code of Conduct includes a strict timetable for implementation. By the end of 2006 market participants were to introduce measures to increase the transparency of pricing. In practice, prices have to be service-specific. By the end of June 2007 market participants have to agree on measures to achieve interoperability of clearing and settlement systems and open access to services. Accounting separation must be implemented on central securities depositories' separately defined services by the end of 2007. After that, these services cannot be bundled for pricing purposes. The Code of Conduct will initially apply only to cash equities but will be gradually extended to include other financial instruments, such as bonds and derivatives. The Code does not apply to issuance services either.

The consultation involved representatives of all stakeholder groups, including the ECB and system users. Implementation of the Code will be closely monitored by a new ad hoc monitoring committee chaired by a representative of the Commission. Common standards are an integral part of the development of securities clearing and settlement. The Code of Conduct is a major achievement – but only a first step towards system harmonisation and M&A agreements between service providers. The Commissioner stressed that the Code will not replace ongoing parallel initiatives, such as removal of the Giovannini Barriers or the Target2-Securities initiative of the Eurosystem.[18]

Successful implementation of the Code of Conduct is also important for further regulation. If market participants implement the measures properly and on time, the Commission may also in future favour self-regulatory solutions, and consider proposals for a directive as just one alternative. From the perspective of the Commission, the Code of Conduct is useful because it enables quicker results than does the drafting of a directive.

The Commission and service users expressed the wish that integration of exchange trading infrastructure will improve the efficiency of clearing and settlement. This has proven to be more difficult than expected – hence the high expectations for implementation of the Code.

4.3 Interoperability should speed up market integration

Emilia Koivuniemi

A working group of the European Central Securities Depositories Association recently reported that improving links between central securities depositories promotes integration of securities markets – however, the proposition is not a new one.

Interoperability between securities services providers is essential for promoting market integration.

[17] European Commission (7 November 2006), 'European Code of Conduct for Clearing and Settlement'. See http://ec.europa.eu/internal_market/financial-markets/clearing/index_en.htm.

[18] The Bank of Finland assessed the current situation of the removal of the Giovannini Barriers in the Financial Stability Report published on 14 December 2006. See http://www.bof.fi.

Interoperability is also a central concept in the Code of Conduct of the field. A report by a working group of the European Central Securities Depositories (ECSDA) examines how links from electronic marketplaces, via central counterparty functions, to CSDs can improve clearing and settlement.[19]

It is commonly understood that even a fully integrated market should include several CSDs connected by highly efficient links to promote competition and cost-efficiency and to minimise systemic risk. Under the Directive on Markets in Financial Instruments[20] (MiFID), counterparties should be able to choose the system for settling transactions. The use of CSD links contributes to the achievement of these goals.

The report by the ECSDA working group redefines CSD links by making delivery-versus-payment (DVP) settlement a more definite part of linked transactions. This is mainly a technical reform which also outlines the role of links in the future TARGET2 system.

In its report, the working group identifies key functions to the operation of links. For example, an investor CSD needs a settlement control mechanism to be in place in the issuer CSD. Efficient payment solutions, such as links, also enable the management of securities issued in foreign countries as well as currencies issued by foreign central banks. CSD links should also have a direct routing and receipt of settlement instructions function. Other important functions include adequate custody and tax services, as well as standardised communication interfaces. Some of the functions will be realised with removal of the Giovannini Barriers.

Similar initiatives on harmonising the provision of infrastructure have been presented before. The Federation of European Securities Exchanges (FESE) proposed in early 2006 an agreement to increase interoperability between securities exchanges, central counterparties and central securities depositories. The new definition presented in the ECSDA report harmonises the use of central bank money in CSD link functions.

Interoperability promotes competition and thereby reduces costs to end users. The outcome of measures to increase efficiency depends first and foremost on whether market participants achieve progress in the introduction of common standards and approve principles for harmonisation. It is not yet known when the reforms proposed in the report will be implemented.

[19] ECSDA (27 November 2006),'Cross-border Clearing and Settlement Through CSD Links'. See www.ecsda.com

[20] European Commission, 'Markets in Financial Instruments Directive'. See http://ec.europa.eu/internal_market/securities/isd/index_en.htm

5 Key corporate arrangements and events in the financial sector

Date	Event and description
April 2006	Nasdaq purchases 16% of the shares in LSE. In May, it owned ca 25% of LSE's share capital.
	Sampo Bank announces it will acquire Profibanbk (Industry and Finance Bank) operating in St. Petersburg.
	The Australian Stock Exchange announces it will acquire the country's largest futures trading place, the Sydney Futures Exchange, for AUD 2.3 billion.
May 2006	Savings banks announce they will start co-operation with Fennia Life and start selling Fennia Life's endowment and pension insurance policies.
	The Government of Austria announces it will issue a framework guarantee in the amount of EUR 900 million to save the BAWAG PSK bank. In addition, a consortium of Austrian banks will grant an EUR 450 million loan to BAWAG.
	NYSE Group makes an EUR 8 billlion bid for Euronext. Deutsche Börse makes a competing bid of EUR 8.5 billion.
	FIM Group Corporation announces it will establish a subsidiary in Russia that will engage in asset management and mutual fund operations.
	If P&C Holding Ltd announces it is planning to establish a non-life insurance corporation in Russia. The company has had a representative office in St. Petersburg since 1995.
	OP Bank Group Central Cooperative announces it will purchase OP Bank Group Mortgage Bank plc shares held by OP Bank Group member banks.
June 2006	OMX launches the First North marketplace in Stockholm.
	The French group Axa announces it will acquire Winterthur, an insurance corporation owned by Credit Suisse.
	OP Bank Group and Kesko Corporation start cooperation in the development of payment cards.

Date	*Event and description*
	Nordea sells its stake in the Russian bank International Moscow Bank to HypoVereinsbank, a German subsidiary of Unicredit.
July 2006	*Spanish stock exchanges listed on the Madrid Stock Exchange.*
August 2006	*Sampo Bank plc concludes acquisition of Profibank, a bank based in St. Petersburg.*
	Banca Intesa announces it will acquire Sanpaolo IMI.
	The Finnish Bankers' Association and the Federation of Finnish Insurance Companies to merge at the start of the year 2007.
September 2006	*Nationwide Building Society and Portman Building Society announce their decision to merge.*
	OMX and the Icelandic stock exchanges announce the signing of a letter of intent on the acquisition of the Icelandic Stock Exchange by OMX.
	Helsinki Stock Exchange adopts round lot 1 trading.
	S&P's revises its outlook on OKO Bank plc from negative to stable. Short-term rating is A1+ and long-term AA-.
	Fitch Ratings rates Teollisuuden Voima Oyj for the first time. Ratings: short-term F2 and long-term A-.
	Moody's upgrades Metso's long-term rating from Ba1 to Baa3.
	Nordea will apply for a banking licence in China to open a branch in Shanghai.
October 2006	*OMX launches Nordic List.*
	Chicago Mercantile Exchange Holdings Inc. and CBOT Holdings Inc. announce agreement to merge.
	French company AXA announces agreement with the Greek Alpha Bank, to acquire its insurance subsidiary Alpha Insurance.
	Banca Popolare di Verona e Novara announces it will acquire Banca Popolare Italiana for EUR 8.2 billion, to create the fourth largest bank in Italy.
	Tapiola Bank and Bank of Åland announce they will establish a new payment card company.
November 2006	*Sampo Group announces it will sell all the companies that are part of Sampo Bank Group to Danske Bank, for EUR 4.05 billion.*

Date	*Event and description*
	Aktia annouces it will acquire Veritas Life Insurance Company Ltd and an 80% stake in Oy Fondex AB (Rahastotori Oy).
	Nordea announces it will acquire a 75% stake in the Russian bank JSB Orgresbanki, for USD 313.7 million.
	Icelandic Stock Exchange and Icelandic Securities Depository (ISD) are sold to OMX.
	Bank of America announces agreement to acquire U.S Trust Corporation from The Charles Schwab Corporation for USD 3.3 billion.
	Fitch and S&P confirm ratings for Finnish government bonds: Fitch: F1+ and AAA; S&P: A-1+/AAA.
	S&P upgrades Elisa Plc's short-term rating from A-3 to A-2.
	Moody's downgrades Stora Enso's ratings: short-term from P2 to P3 and long-term from Baa2 to Baa3.
	OMX finalises acquisition of Icelandic Stock Exchange (ICEX) and Icelandic Securities Depository (ISD).
December 2006	*The Bank of New York Company, Inc. and Mellon Financial Corporation agree to merge. Bank of New York will purchase Mellon for USD 16.5 billion.*
	OMX makes an offer to acquire the Ljubljana Stock Exchange.
	eQ Bank Ltd acquires the entire share capital of the investment firm Fides, for EUR 6.4 million.
	Life insurance company Duo is granted an operating licence. The company was established by the Savings Banks' Group and its 39 member banks, together with the insurance group Lähivakuutus and its associate companies Lähivakuutus Keskinäinen Yhtiö and 89 insurance associations. The company plans to commence operations in early 2007.