Financial Market Report

3 • 2008

- Banks' financial results weaker also in Finland – but the impact of the turbulence is still limited
- Crisis generating regulatory reforms in financial sector

Bank of Finland

Financial Markets and Statistics

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Project team

Laura Vajanne
Sampo Alhonsuo
Nina Björklund
Timo Iivarinen
Karlo Kauko
Marko Myller
Jarmo Pesola
Hanna Putkuri
Pertti Pylkkönen
Maija Salmela
Katja Taipalus
Mervi Toivanen
Hanne Viitala

Coordination

Kimmo Virolainen
Kari Korhonen
Jouni Timonen

ISSN

1796-931X

Postal address
PO Box 160
FI-00101 HELSINKI, FINLAND

Street address Snellmaninaukio
Phone +358 10 8311
Fax +358 9 174 872

Email
first name.surname@bof.fi
www.bof.fi

Swift SPFB FI HH
Business ID 0202248-1
Domicile Helsinki

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1 Financial intermediation

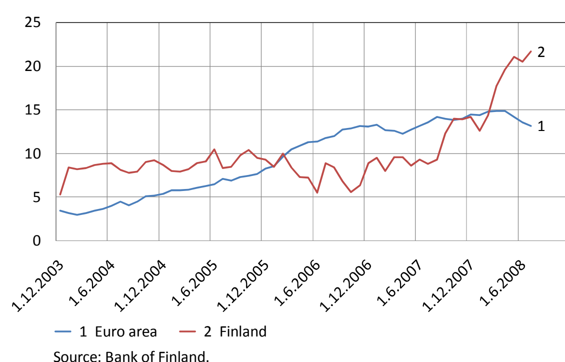
1.1 Recent developments in corporate loans in Finland

Karlo Kauko

For almost the entire period since the turn of the 21st century, household loans have grown faster than corporate loans in Finland. Recently, the situation has changed and the stock of corporate loans is expanding rapidly. Bank loans are being used to replace other sources of finance, but until recently there has also been an increasing need for finance.

In this decade until very recently, bank lending to households has grown notably faster than lending to companies. Now the situation has changed. If we compare July 2007 to July 2008, the stock of household loans grew by only about 10%, according to Bank of Finland statistics. In contrast, the stock of corporate loans grew by almost 20% to EUR 53.9 bn. This is an exceptionally high growth rate.

Chart 1. Annual growth of corporate loan stock, %



Source: Bank of Finland.

The largest proportion of bank lending to companies has been granted to domestic companies. Growth of the stock of loans to domestic companies is faster than growth of loans granted to foreign companies.

Growth of the corporate loan stock is not restricted to bank loans. According to Statistics Finland, the stock of loans granted by insurance institutions[1] to companies and own-account workers at the end of the first quarter of 2008 was about 31% larger than a year earlier, at about EUR 1.1 bn. In contrast, the stock of loans granted by general government had remained broadly unchanged.

The growth of corporate loans would hardly have been as rapid if there had been problems in the availability of loans. According to the SME barometer survey of spring 2008 by Finnvera Plc and the Federation of Finnish Enterprises, there were no signs of increased financing problems at the start of the year. Only about 7% of the companies considered financing problems the main obstacle for corporate development. The proportion was slightly lower than a year or two earlier. On the other hand, the result applies only to fairly small companies.

Growth of the loan stock may be due either to an increased need for financing or by banks and insurance institutions replacing other finance sources.

There are many reasons to believe that the growth of the corporate loan stock over past months has, at least partially, been the result of substitution for other types of finance. For example, corporate bond issues have been reduced materially, as a result of the

[1] Insurance institutions include life and property & casualty insurance companies but exclude employee pension insurers.

financial market turmoil. In early 2007, bonds issued in Finland by non-financial corporations amounted to over four billion euro. In July 2008, the stock had declined to about EUR 3.8 bn. In contrast, the stock of commercial paper organised by Finnish monetary financial institutions has not changed materially.

As regards the early part of the year, growth of corporate loans can be explained by the strength of investment demand. The figures describing developments in the balance of resources and expenditure of the national economy show that investment continued to grow fairly rapidly. In the first quarter of 2008, investments grew 7.7% on the year-earlier period. However, in the wake of a cyclical downturn, the situation may be changing. In the second quarter, a decline investment was observed. The contraction amounted to 3.3% y-o-y, and, based on the most recent barometer data, the situation is not improving materially.

Companies have also increased their deposits. These increased from July 2007 to July 2008 by over three billion euro.

The price of corporate loans is clearly rising, which is slowing down the growth of the loan stock. From July 2006 to July 2008, the average interest rate on new Euribor-linked corporate loans increased by about 1.3 percentage points.

According to the June Bank Barometer of the Federation of Finnish Financial Services, bank managers' near-term expectations regarding corporate loans were not particularly exceptional. The faith in corporate loan growth was strongest in early 2008, when 42% of bank managers believed the amount of corporate loans would be higher than a year earlier. In the second quarter, the proportion dropped to 27%, which is a more-or-less average figure relative to the past. The shift in loan stock growth in favour of corporate loans does not strengthen banks' net interest income, since the average interest rate on corporate loans is lower than the rate on household loans. In July, according to Bank of Finland statistics, the average rate on the household loan stock was 5.80% and the average rate on corporate loans was 5.45%.

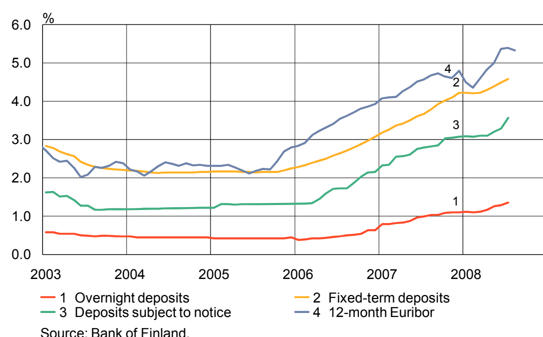
1.2 A decline in real interest rate on fixed-term deposits

Mervi Toivanen

Banks advertise their offerings of fixed-term deposits with attractive interest rates. They promise to pay attractive interest on deposits held for long periods. But rising inflation lowers the real yield on fixed-term deposits.

Interest rates on Finnish households' fixed-term deposits have risen steadily since early 2006 (Chart 2). This has been accompanied by a rise in the interest rate on households' deposits subject to notice and transaction accounts. In January 2006–July 2008, the interest rate increased for fixed-term deposits (from 2.28% to 4.58%), deposits subject to notice (from 1.32% to 3.57%) and transaction accounts (from 0.37% to 1.36%).

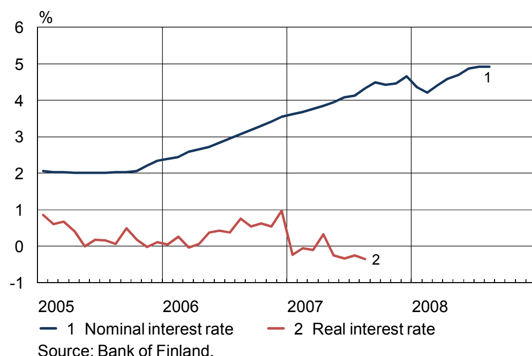
Chart 2. Households' deposits in Finnish MFIs by maturity; average interest rate on stock of deposits and 12-month Euribor



Source: Bank of Finland.

Even though nominal interest rates on deposits have risen, the interest rate on households' fixed-term deposits has decreased in real terms (Chart 3). The real interest rate[2] in 2005 was on average 0.31% and in 2006 on average 0.42%. In early 2007, the real interest rate however turned negative as a result of rising inflation. In August 2007, the real interest rate on fixed-term deposits stood at -0.34%. In real terms, households' deposits did not maintain their purchasing power, nor did they generate yield, despite the lucrative offers. Despite their low yield, from households' perspective, deposits are a less risky form of investment than market-based instruments.

Chart 3. Nominal and real interest rate on households' new fixed-term deposits

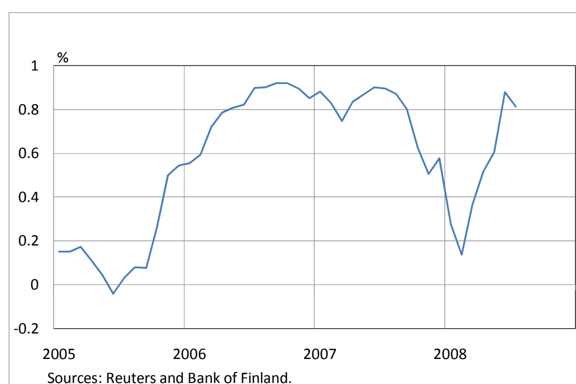


Source: Bank of Finland.

Rising interest rates and increasing uncertainty in the markets boosted the growth of households' fixed-term deposits. In August 2008, the annual growth rate of fixed-term deposits was 48.7%. Deposit growth has also been boosted by the current market situation, as the outlook for and yield on market-based investments are weakening.

From banks' perspective, the growth in fixed-term deposits is favourable because they are an alternative to the increasingly expensive market-based funding. Banks' margin on fixed-term deposits, ie the difference between the 12-month Euribor and the interest rate on fixed-term deposits, has in recent years been ca 0.8% (Chart 4). The narrowing of the margin can be considered an indicator of tightening competition. The margin narrowed at the end of 2007, but in early 2008 it widened again to ca 0.8%. The widening was however mainly due to a rapid rise in the Euribor rate stemming from the current market turbulence.

Chart 4. 12-month Euribor less interest rate on households' fixed-term deposits



Sources: Reuters and Bank of Finland.

[2] The real interest rate is the interest rate on new fixed-term deposits less the actual rate of inflation in 12 months time. For example, the interest rate promised in January 2005 is reduced by the inflation realised in January 2006.

2 Banks and insurance corporations

2.1 Weak results in the US and European banking sectors

Sampo Alhonsuo

The financial market turbulence which has lasted for over a year has weakened banking sectors' results significantly, both in the United States and in Europe. The earnings and performance outlook is bleak. Capital adequacy ratios have however remained high overall.

Write-downs on banks' investment portfolios since the third quarter of 2007 are almost USD 600 billion, USD 100 billion of which are write-downs by European banks[3]. UK and Swiss banks have also booked massive losses. Banks have acquired equity in the amount of ca USD 440 billion. US and European authorities have been forced to take exceptional measures, and large institutions have to adjust to a situation of losses, lack of confidence and liquidity problems.

In the United States, the performance of the banking sector has weakened rapidly. The total operating profit of commercial and savings banks supervised by the FDIC[4] decreased in the first half of 2008 by 67%, to USD 24 billion, year-on-year. Weaker results are largely due to rapid growth of recorded loan losses. The proportion of nonperforming loans in the lending stock has increased in the past year, from just under 1% to 2%. The authorities' list of problem banks included117 banks at the end of the second quarter 2008. So far in 2008, 13 banks have been closed down[5]. Large US investment banks have posted highly mixed results.

Table 1. Pre-tax profits of large US investment banks, USD million

	Q407	Q108	Q208	Q308
Morgan Stanley	-5,804	2,214	1,446	1,948
Goldman Sachs	5,055	2,143	2,832	960
Merrill Lynch	-14,920	-3,301	-8,111	-
Lehman Brothers	1,230	663	-4,087	-5,824

Sources: Published interim reports. Note: Q308 ended on 31 August.

Of the four large investment banks, Lehman Brothers, which filed for bankruptcy, and Merrill Lynch, which was forced to merge, have recorded by far the largerst losses. The weak performance and losses are due to generally weak market developments and realisations of major risks.

In Europe, data available on the banking sector's performance in the first half of 2008 indicate a general weakening, even though banks have posted positive results, with the exception of a couple of banks. Weaker results are mainly due to the impact of the financial market crisis on earnings performance. Market risks have been realised in the past year. For example, the aggregate profits of 16 large European financial groups in January–June shrank to nearly one-

[3] Source: Bloomberg.

[4] Federal Deposit Insurance Corporation is a federal government body that insures deposits in over 8,400 commercial and savings banks in the USA and manages the closures of problem banks. See the FDIC Quarterly Banking Profile.

[5] The biggest banks that have been closed down are Washington Mutual Bank and IndyMac Bank, specialised in housing finance.

third compared to the year-earlier period. The groups' performance has been highly mixed.

Major bank mergers are taking place in Europe, at least in the United Kingdom and Germany. Weak earnings performance as a result of the financial turbulence is the major factor behind the mergers.

Table 2. 16 large European financial groups, pre-tax profits, EUR million

	2008, January - June	2007, January - June	Change, %	Capital adequacy, tier 1 % 30.6.2008
Grupo Santander, Spain	6,288	6,206	1%	7.9
BNP Paribas Group, France	4,749	6,752	-30%	7.6
BBVA Group, Spain	4,490	4,701	-4%	7.7
UniCredit Group, Italy	4,378	6,465	-32%	6.3
ING Group, Netherlands	4,257	5,508	-23%	8.2
Barclays Group, United Kingdom	3,476	5,176	-33%	7.9
Societe Generale Group, France	3,069	2,664	15%	8.1
Fortis, Benelux	1,638	2,782	-41%	9.1
AIB Group, Ireland	1,279	1,318	-3%	7.7
Crédit Agricole S.A, France	1,217	3,378	-64%	8.9
Commerzbank Group, Germany	894	1,983	-55%	7.4
Lloyds TSB Group, United Kingdom	756	2,516	-70%	8.6
Credit Suisse Group, Switzerland	623	4,772	-87%	10.2
Deutsche Bank Group, Germany	388	5,862	-93%	9.3
RBS Group, United Kingdom	-872	6,456	-	8.6
UBS Group, Switzerland	-8,796	6,360	-	11.6
Total	27,834	72,899	-62%	
Average				8.4

Sources: Interim reports published in August 2008.
Exchange rates: GBP and CHF at 30 June, in the banks of the countries concerned.

In the United States and in Europe, banks are attempting to acquire equity capital to build up buffers against risk. The capital adequacy ratios of large banks and financial groups have remained stable and high overall. The near-term outlook depends largely on the interbank market situation, cyclical developments and the macroeconomic environment. The earnings outlook has weakened. Banks' funding costs are not likely to decrease, at least in the short term.

A good example of the force and swiftness of the market turbulence is the partial nationalisation of Fortis, a financial conglomerate operating in the Benelux countries, at the end of September. The group posted a positive result for the first half of 2008; result was nevertheless down by over 40% on the previous year. The group's financial ratios were also good. Fortis was nationalised because markets lost confidence in its ability to finance its share of the acquisition of Dutch bank ABN AMRO.

2.2 Market developments have a negative impact on Nordic banks

Mervi Toivanen

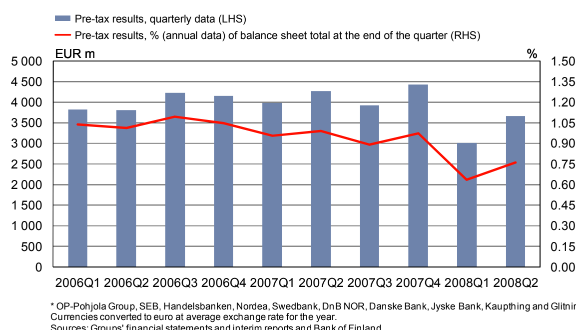
Large Nordic financial groups' results and market values have deteriorated as a result of the financial market turbulence. The decrease in market value was most pronounced for Swedbank, SEB and the Icelandic financial groups.

In the first half of 2008, the market turbulence had a negative impact on the financial results of large Nordic financial groups (Chart 5). Their results for January–June 2008 deteriorated by 20% on average, on the corresponding period of 2007. Most of the results declined by a fourth or a third, but Kaupthing's pre-tax results nearly halved from the previous year.

Weaker results are due to lower income and higher expenses. Banks' net interest income continued to increase as a result of rising interest rates. In contrast, net fee income and income from trading and investment plummeted. Developments in other income items were also negative. This was accompanied by an increase in expenses.

Quarter-on-quarter results for most groups turned positive in April–June 2008. Net interest income continues to grow, and banks posted positive results in trading and investment activities in the second quarter of 2008. Net fee income also rose at some banks, while expenses increased further.

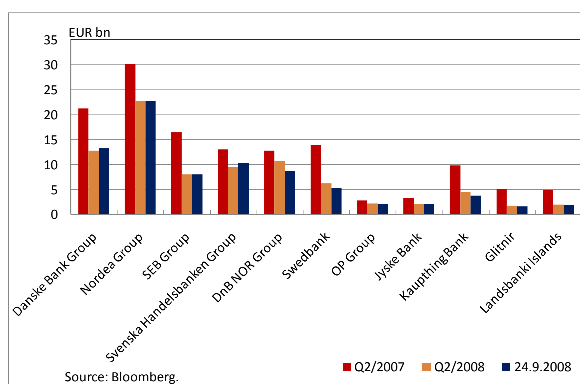
Chart 5. Large Nordic financial groups'* pre-tax results, quarterly



* OP-Pohjola Group, SEB, Handelsbanken, Nordea, Swedbank, DnB NOR, Danske Bank, Jyske Bank, Kaupthing and Glitnir. Currencies converted to euro at average exchange rate for the year.
Sources: Groups' financial statements and interim reports and Bank of Finland.

The market turbulence is not only reflected in banks' income from trading but also in their market value (Chart 6). In the past year, the market values of all the large Nordic financial groups have decreased. In the period June 2007–June 2008, the largest decline was in the share prices of Swedbank and SEB, and the smallest in the share prices of OP Group and DnB NOR. Icelandic financial groups' share prices also fell considerably.[6]

Chart 6. Market value of large Nordic financial groups



Source: Bloomberg.

For Swedbank and SEB, investment services and asset management account for a larger proportion of the income than is the case for OP Group and DnB NOR, which focus on traditional banking. Moreover, the future of Swedbank and SEB is clouded by the economic downturn in the Baltic countries because both are major players in the Baltic banking market. The banks' latest interim reports[7] however show that the quality of the lending stock of both the banks remains good and that the banks have not yet recorded major loan losses.

According to the stability reviews of the Baltic central banks[8], the Baltic banking sector is not in immediate difficulties. Although the banking sectors' aggregate nonperforming assets and write-downs on loans are increasing, they are still at a very modest level. Moreover, according to the Bank of Estonia, two-thirds of the nonperforming assets are on the balance sheets of small local banks. Bank of Lithuania reports that the banks have already covered the majority of nonperforming assets with loan loss provisions. The central banks also point out that stress tests indicate that banks operating in the Baltic banking market have good buffers against risks and that the capital adequacy ratios are high enough to withstand possible losses.

US investment bank Lehman Brothers filed for Chapter 11 in mid-September, which resulted in a further loss of confidence in the financial markets. There were however only minor changes in the market values of large Nordic financial groups in the period between end-June 2008 and 24 September 2008. The steepest fall in market value was witnessed by DnB NOR and Swedbanken. The future of both banks was clouded by possible credit risks related to Lehman.

The financial market turbulence has made it difficult for banks to acquire market funding. Because of the liquidity situation, the Icelandic government gave Glitnir bank (which was dependent on market

[6] The Icelandic bank Glitnir was nationalised on 29 September 2008 when the Icelandic government gave the bank a capital injection of EUR 600 million.

[7] Interim reports for January–June 2008.

[8] Bank of Estonia Financial Stability Review 1/2008 and Lietuvos Bankas Financial Stability Review 2008.

funding) a EUR 600 million capital injection on 29 September 2008. As a result, the Icelandic government now has a 75% stake in Glitnir

2.3 Finnish banks' profitability and capital adequacy remain mainly good

Hanna Putkuri

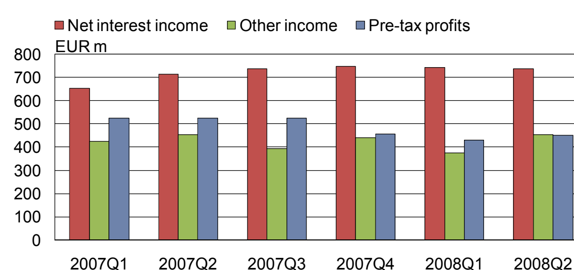
Developments in traditional banking have been favourable in Finland, as reflected in the steady development of net interest income. In contrast, banks' other income has suffered from the weakening investment situation. The overall impact of the turbulence has remained limited.

The aggregate pre-tax profits of Finnish banking operations for January–June was EUR 883 million, down 16% on the year-earlier period (see Table 3). In the second quarter, the pre-tax profits were up by 5% on the previous quarter. Results for the first half of the year are mainly good, considering developments in the operating environment and the record-high results in the reference period.

Banks' income developments were mixed in the first half of the year. Net interest income grew, while other income shrank compared to the corresponding period in 2007. Net interest income has remained stable since the start of the turmoil, whereas other income has fluctuated (Chart 7). The impact of the market situation was most adverse for fee income and income from banks' trading and investment activities.

The brisk growth in net interest income compared to the year-earlier period was based on strong growth in the volume of lending and deposits. At the end of June, the stock of loans to the public was 12.9% higher and the stock of deposits 16.7% higher than a year earlier. As a result of the sharp rise in deposit rates, the interest rate margin between lending and deposit funding has narrowed by 0.2 percentage point, to 2.5 percentage points in the past twelve months.[9]

Chart 7. Income and pre-tax profits for Finnish banking, quarterly data*



* Nordea's Nordic Banking Finland, Danske Bank's banking operations in Finland, OP-Pohjola Group's banking and investment services, Aktia Savings Bank's retail banking, other savings banks, local cooperative banks, Bank of Åland, Evli Bank and eQ.
Sources: Banks' interim reports and financial statements.

Expenses on banking operations were clearly higher in the first half of 2008 than in the year-earlier period. This was due to higher staff expenses and increases in other expenses in connection with business expansion and restructuring.

Impairment losses on loans and other receivables grew on the year-earlier period. The impact of loan losses on profit however remained minor, and their ratio to lending stock remained small. According to the Financial Supervision Authority (FIN-FSA), Finnish deposit banks' nonperforming assets totalled EUR 639 million (ca 0.4% of lending stock) at the end of July 2008.

The profitability of Finnish banks and banks operating in Finland deteriorated in the first half of the year but remained good for the majority of banks (Table 4). The capital adequacy ratios of all the banks were clearly above required levels.

[9] Finnish MFIs euro-denominated deposit and loans vis-à-vis euro area residents, see http://www.bof.fi/en/tilastot/tase_ja_korko/taulukot.htm

The financial crisis in the United States has thus far had only a minor direct impact on Finnish banks. According to data compiled by FIN-FSA, Finnish banks do not have such exposures in the Lehman Brothers group (entered liquidation) and in the insurance corporation AIG (taken over by the US federal government) and in the mortgage banks (Fannie Mae and Freddie Mac) as would be material relative to their capital adequacy and size[10].

Table 4. Profitability and capital adequacy of banks operating in Finland

	Return on equity (ROE), %		Expense-to-income, %		Capital adequacy ratio, %		Tier 1 capital adequacy, %	
	1-6/ 2008	1-12/ 2007	1-6/ 2008	1-12/ 2007	30.6. 2008	31.12. 2007	30.6. 2008	31.12. 2007
Nordea	16.0	19.1	54	52	9.3	9.1	7.0	7.0
Nordea Bank Finland	12.9	11.2	35	35	14.2	15.3	12.8	13.7
Danske Bank	11.2	15.1	59	56	14.1	9.3*	10.0	6.4*
Sampo Bank	9.4	44.8	71	37	10.9	15.1*	8.8	12.9*
OP-Pohjola Group	9.4	13.7	51	49	12.3	13.8*	12.3	12.6*
Pohjola Bank	-2.4	9.3	46	46	10.9	10.9*	8.5	9.0*
Savings banks (excl. Aktia)	..	..	62	56	21.6	22.8	20.2	20.4
Aktia Savings Bank	14.6	17.9	69	67	12.8	15.4	10.1	10.9
Local cooperative banks	..	..	57	55	21.5	22.1	..	..
Bank of Åland	13.0	16.4	68	61	12.1	12.8	8.2	8.6
Evli Bank	0.7	18.5	100	83	..	..	13.8	15.3
eQ	-1.3	14.4	102	70	13.1	12.0	13.1	12.0

..= data not available
* Basel I
Sources: Banks' interim reports and financial statements.

Table 3. Key items from banks' income statements, January–June 2008, and changes on year-earlier period

	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	2 411	18 %	1 542	-14 %	2 128	6 %	57	..	1 768	-6 %
Nordic Banking	1 993	14 %	1 144	-2 %	1 555	5 %	28	..	1 554	2 %
Nordic Banking Finland	550	8 %	312	-6 %	385	5 %	8	..	469	-9 %
*Nordea Bank Finland Group	855	15 %	539	24 %	484	7 %	26	..	884	-84 %
Danske Bank Group	1 730	9 %	1 196	-17 %	1 734	3 %	149	..	1 043	-23 %
Banking	1 710	8 %	744	-2 %	1 473	4 %	147	..	834	-10 %
Banking in Finland	214	24 %	87	1 %	296	47 %	-1	..	6	-89 %
*Sampo Bank Group	257	40 %	142	-21 %	285	26 %	-1	..	115	-80 %
OP-Pohjola Group	568	12 %	484	-26 %	683	8 %	9	..	359	-31 %
Banking and investment services	527	6 %	315	4 %	510	13 %	11	..	320	-7 %
*Pohjola Bank	75	29 %	227	-32 %	235	3 %	-3	..	71	-57 %
Savings banks (excl Aktia)	80.3	4 %	23.7	-38 %	64.4	8 %	-0.6	..	40.2	-28 %
Aktia Savings Bank plc (Group)	49.1	17 %	94.7	1 %	114.6	23 %	-0.8	..	29.9	-29 %
Retail banking	30.9	1 %	17.8	12 %	42.7	18 %	0.0	..	6.0	-42 %
Local cooperative banks	54.0	3 %	12.3	-18 %	37.2	3 %	0.2	..	28.8	-6 %
Bank of Åland plc (Group)	20.9	11 %	16.4	-14 %	25.3	14 %	0.2	..	11.8	-24 %
Evli Bank Group	-0.5	.	31.2	-28 %	29.9	-13 %	0.0	..	0.7	-93 %
eQ Group	3.1	-14 %	13.1	-42 %	16.5	-11 %	0.0	..	-0.3	.
1. Finnish banking	1 480	8 %	829	-5 %	1 407	15 %	18	..	883	-16 %
2. Finnish financial groups	1 886	16 %	1 356	-9 %	1 739	11 %	33	..	1 469	-27 %
3. Financial groups operating in Finland	4 916	13 %	3 414	-17 %	4 833	6 %	214	..	3 281	-16 %

Other income includes eg net fee income, capital gains/losses from sale of tangible and intangible assets, capital gains from sale of wound-up operations, and shares in profit/losses of associated companies. Expenses include depreciations and write-downs on tangible and intangible assets, refunds to shareholders and profit distribution to staff. Negative loan losses: recoveries exceed new write-offs.

1. Savings banks, Aktia Savings Bank Group's retail banking, local cooperative banks, Bank of Åland Group, Evli Bank Group, eQ Group, OP-Pohjola Group's banking and investment services, Danske Bank Group's banking operations in Finland and Nordea Group's banking operations in Finland.
2. Savings banks, Aktia Savings Bank Group, local cooperative banks, Bank of Åland Group, Evli Bank Group, eQ Group, OP-Pohjola Group, Sampo Bank Group and Nordea Bank Finland Group.
3. Nordea Group, Danske Bank Group and Finnish financial groups (excl. Sampo Bank and Nordea Bank Finland).
Sources: Banks' interim reports.

[10] See the online publication FIN-FSA Newsline 7/2008.

2.4 Insurance corporations' solvency buffers shrinking

Pertti Pylkkönen

Insurance corporations' exposures to problem banks are minor, but persistent decline in equity prices is eroding solvency.

The ongoing turbulence in the financial markets and particularly the downturn in the equity market have also weakened Finnish insurance corporations' profitability and solvency.

When the financial market turmoil began, Finnish insurance corporations' solvency was generally good and so the sector's solvency buffers have been large enough to withstand the losses in their trading portfolios.

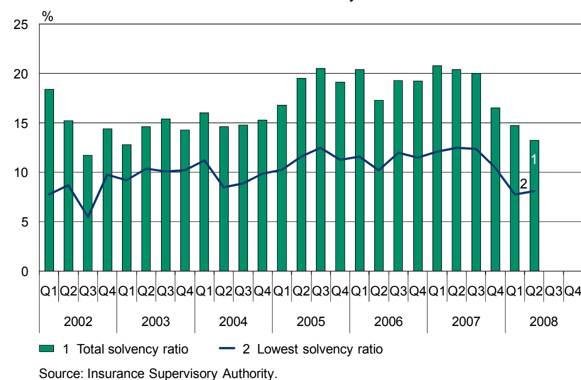
Of insurance corporations, non-life insurers have suffered least from the decline in equity prices. Due to the nature of non-life insurers' operations, equities account for a smaller share of the investment portfolio than is the case for life and pension insurers. Non-life insurers' liquidity needs may change rapidly eg as a result of major catastrophes. Fixed-income instruments, which account for a considerable share of non-life insurers' investments, have had only a minor impact on the decline in the solvency capital.

Non-life insurers' premium income usually develops in parallel with real economic growth, and hence premium income has also increased. Insurance operations of the largest non-life insurers have remained profitable, and the combined ratio is below one hundred. For the entire insurance sector, the ratio is close to one hundred. The sector as a whole is thus not particularly profitable eg by European standards.

In the life insurance sector, developments in profitability and solvency have been significantly weaker than in the non-life insurance sector. The growth of life insurers' premium has slowed on 2007 and their investment income has declined, due to the higher share of equities in their investment portfolio. Growth of premium income has slowed particularly for endowment insurance. Premium income on voluntary pension insurance and particularly on group pension insurance has continued to develop favourably.

As a result of the fall in equity prices, life insurance savings have decreased slightly in 2008. The fall in equity prices also resulted in a drastic decrease in life insurers' solvency capital, and their solvency ratio – solvency capital relative to technical provisions – has fallen to just over 13%, from nearly 20% a couple of years ago[11].

Chart 8. Life insurers' solvency ratio

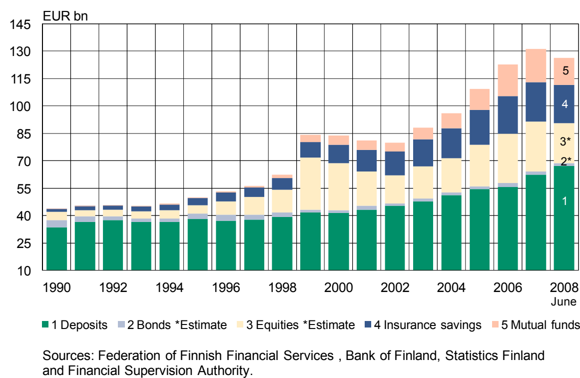


Source: Insurance Supervisory Authority.

The proportion of insurance savings in households' financial assets, after a long period of growth, has begun to decrease slightly, as has the proportion of equity investments. The importance of deposits in households' savings has grown significantly as a result of rising interest rates on deposits and uncertainties in the investment market.

[11] Solvency of insurance corporations and pension funds as at 30 June 2008. Insurance Supervisory Authority.

Chart 2. Finnish households' financial assets



Sources: Federation of Finnish Financial Services , Bank of Finland, Statistics Finland and Financial Supervision Authority.

Of the aggregate investment portfolio of employee pension insurers (over EUR 75 billion), equities and fund shares accounted for ca 41% at the end of June. These investments include capital investments and investments in hedge funds. Capital investments totalled over EUR 2 billion and investments in hedge funds totalled EUR 5.8 billion. As a result of the new regulations on investments which entered into force in 2007, pension insurers increased their equity investments slightly. In 2008, pension insurers' net purchases of equities have been virtually nil.

Of pension insurers' investments, over half are in various types of fixed-income investments, mainly bond investments. Investments in the short-term money market, ie in certificates of deposit issued by banks and commercial paper, nevertheless totalled nearly EUR 5 billion at the end of June. Lending by employee pension insurers has been subdued in recent years. For example, premium loans totalled just EUR 0.5 billion in June 2008. However, the demand for loans granted by employee pension insurers seems to be increasing slightly as a result of the financial turmoil. The rise in interest rates on variable-interest-rate bank loans for non-financial corporations has boosted the competitive position of loans granted by employee pension insurers. Their position should improve further as banks tighten their lending criteria.

The proportion of investments in Finland began to increase in 2006, and in June 2008, they accounted for ca 38% of total investments (at its lowest, the proportion was just over 30%).

The fall in equity prices has eroded employee pension insurers' solvency capital, and their solvency ratio has decreased. However, employee pension insurers had managed to boost their solvency capital in previous years, when the investment environment was more favourable. Employee pension insurers have built up their solvency capital to make provisions for possible impairments. Employee pension insurers posted an operating loss of EUR 4.7 billion for the first half of 2008, in contrast to the first half of 2007, when they posted an operating profit of EUR 2.3 billion[12].

[12] Employee pension insurers' interim reports.

3 Securities markets

3.1 Developments in trading facilities

Marko Myller

Multilateral trading facilities (MTFs) have arrived in Europe. As competition heightens, the focus of attention is on the most traded shares on stock exchanges. Will there be a redistribution of trading volumes? The future of one of the new players already looks unsure.

The Directive on Markets in Financial Instruments (MiFID), which was issued a year ago in November, has triggered a wave of new MTFs in Europe. The first multilateral trading facility Chi-X Europe[13], was launched in spring 2008; in August, trading commenced on the trading platform Turquoise[14], which was established by a group of global banks, and in September, Nasdaq-OMX Europe[15] entered the market. November will see the launch of BATS Trading Europe[16], and possibly also the Octopus project of NYSE-Euronext.

In 2009, even more new players will enter the market. Detailed information on these projects has not yet been published. The Swedish initiative Burgundy[17], an MTF for Nordic securities, is set for launch in the first half of 2009.

[13] http://www.chi-x.com

[14] http://www.tradeturquoise.com

[15] http://www.nasdaqomxeurope.com

[16] http://www.batstrading.co.uk

[17] http://www.burgundy.se

The financial market turmoil has brought dark clouds also over MTFs: the bankruptcy proceedings of Lehman Brothers are casting a shadow over Baikal MTF[18], a joint initiative between Lehman Brothers and the London Stock Exchange (LSE).

Nordic players are entering the field

Burgundy, which is a trading platform specifically for Nordic securities, is the latest newcomer MTF. It was established by Carnegie, SEB, Handelsbanken, Neonet, Nordnet, Öhman, Kaupthing, Avanza, Swedbank, and Evli. The trading platform is also open to investors. The founding members of the trading facility accounted for 44% of securities trades on the Stockholm Stock Exchange in August[19]. Instruments listed on the Stockholm, Oslo, Copenhagen and Helsinki stock exchanges will be traded on the Burgundy platform. Trading is set to commence in the first half of 2009.

Competition intensifies – lower trading cost for investors?

Heightening competition puts pressure on traditional exchanges in terms of pricing and forces them to specialise and create services that generate higher added values for customers. Competition also puts pressure on the other links in the trading chain. Consequently, central counterparties (CCPs), for example, are in the middle of a beauty contest, competing aggressively on pricing by eg scrutinising

[18] http://www.finextra.com/fullstory.asp?id=18984

[19] http://omxnordicexchange.com/

each others' pricing principles[20]. The results vary depending on the party making the comparison. Clearing costs are also under pressure. For example Clearstream[21] will update its pricing policy in autumn 2008.

In the past six months, 19 new multilateral trading facilities have commenced operations in the EEA[22]. Time will tell whether they all gain a foothold in the market and who will win the competition for volumes. Tightening competition should affect also investors' trading costs, and not only the fees that trading facilities levy on brokers.

[20] http://www.euroccp.co.uk/docs/cost_comparison_study.pdf, and http://www.euroccp.co.uk/docs/cost_comparison_chart.pdf

[21] Press release 11 September 2008.

[22] http://mifiddatabase.cesr.eu

4 Infrastructure

4.1 Risks of FX trade under scrutiny

Timo Iivarinen

The less stable the economic situation, the higher the risks in the settlement of foreign exchange trades in the traditional manner. New settlement methods for foreign exchange trades reduce the risks, but according to a study by the BIS[23] and central banks, there is still much room for improvement. Furthermore, more incentives must be found to steer individual banks towards adopting best practices of the industry.

The risks involved in the settlement of foreign exchange trades have long been known to be significant. Already in the 1970s, many banks suffered large losses when the German bank Bankhaus Herstatt, which was active in the foreign exchange markets, went bankrupt. The banks that suffered losses had agreed on foreign exchange trades with Bankhaus Herstatt and delivered the agreed currency to it but did not receive payment before the bank was closed down. There are many similar cases in the 80s and 90s.

Today, the risks are clearly higher than in previous decades due to the increases in international trade and speculative foreign exchange trading. For example in spring 2007, the daily volume of foreign exchange trades totalled about USD 3,200 bn. However, the risks have not grown as much as foreign exchange trade in relative terms. Joint efforts by authorities and banks to reduce the risks have made a difference.

The results of a joint study[24] by the central banks and Bank for International Settlement were published in the summer. In respect of Finland, the study included the major banks engaging in foreign exchange trade. According to the study, banks have adopted improved methods in the settlement of foreign exchange trades, but there is still a need for substantial efforts in the reduction of risks. The significance of foreign exchange trading for banks is well illustrated by the fact that, according to the study, the short-term risk of the average bank still amounts to about a half of its total capital.

The main improvement in risk reduction was the establishment of an international CLS bank. The risk of foreign exchange trades settled by the bank has been largely eliminated by the payment-against-payment principle. At present, a little over half of foreign exchange trades (55%) are settled through this organisation.[25] A total of 32% of the trades are settled via traditional correspondent bank networks and 8% through mutual netting.[26]

The use of correspondent banks is the traditional way of settling foreign exchange trades. Particularly in times of economic uncertainty, it involves the risk that an individual bank goes bankrupt as other market participants lose trust in its financial position and

[23] Bank for International Settlement.

[24] "Progress in reducing foreign exchange settlement risk", BIS, May 2008

[25] For more information on the CLS, see: www.cls-group.com

[26] "Reducing foreign exchange settlement risk", Robert Lindley BIS Quarterly Review, September 2008

tighten their foreign exchange trading limits to the extent that the bank concerned becomes unable to operate. Partly for this reason, it would be better to use the services of e.g. the CLS bank to ensure that currencies exchange hands simultaneously, in which case such distrust would not affect the bank's liquidity position.

The BIS study arrived at the conclusion that the risk reduction services are not yet at a sufficient level. This means primarily that in addition to SPOT trading (value date of a transaction is two days later) also foreign exchange trades made at the same day value should be included in the services of the CLS bank. Furthermore, the number of currencies that can be delivered through the CLS bank should be increased.

Another and perhaps even more important conclusion is that incentives should be increased for individual banks to adopt the best practices of the industry. According to the study, it seems that banks are not eager to do so in the absence of clear incentives, since eg the use of the CLS bank is more expensive to the banks than traditional solutions. It is indeed difficult to price risks in advance. The common interest (riskless FX trades) and the interests of the individual bank (minimal costs of FX trades) are at odds. Therefore, the reduction of risks in FX trading requires more active efforts by authorities to spotlight the common interest.

Some of the banks operating in Finland participate in the CLS, either directly or indirectly through another bank. Therefore the risks are relatively well under control. However, the conclusions of the study are significant also from the Finnish perspective.

5 Key regulatory and supervisory initiatives

5.1 Financial market turbulence leading to regulatory reform

Katja Taipalus

Regulatory projects generated by the financial market crisis focus on enhancement of market operations, reporting transparency and accounting reform.

The financial market turbulence has caused major writedowns of assets of financial market participants, underlined the problems of unregulated markets in crisis situations and uncovered a network of contagion channels. The turbulence has provoked the fall of major actors and led to banking sector mergers that had been considered unlikely a short time ago.

Even though the turbulence is probably not yet winding down, it is clear that a critical assessment will lead to significant regulatory reform. A number of projects are currently under way in various fora in the United States and Europe. Such projects relate eg to accounting reform, reporting and its content, as well as closer monitoring of the activities of market participants. It would seem to be a widely shared view that we will see tighter regulation and supervision in the future.

Regulation concerning market operations

The first big reform of market operations is likely to concern off-exchange-traded credit derivatives, whose volumes have swollen to an estimated USD 54,600 billion.[27] In spring 2008, following the difficulties of Bear Sterns, counterparty risks in this unregulated market came up for discussion, and in the United States the cases involving Fannie Mae and Freddie Mac, Lehman Brothers and the insurance company AIG spotlighted the need to create a centralised settlement counterparty. Meanwhile, greater transparency is required for the derivatives market.

The turbulence has also led to wide-ranging discussion of the position of rating agencies, and not solely because existing regulation assigns an important role to ratings. Ratings also have an established position among investors as criteria for comparisons between investment alternatives. Accordingly, in Europe, the Committee of European Securities Regulators (CESR) recommends to the European Commission that a new organisation be established to develop, and monitor compliance with, standards for credit rating activity. At the end of July, the European Commission submitted policy proposals concerning the activities of rating agencies for public consultation, open for comments until the start of September. The proposals would significantly tighten supervision compared with the present situation. In the United

[27] The latest publication of ISDA (International Swaps and Derivatives Association) for the first half of 2008 (previous volume USD 62,000 bn).

States, the Securities and Exchange Commission (SEC) in early July submitted for public comment a regulatory reform agenda aimed at increasing the transparency of the rating process and adjusting the regulatory use of ratings so as not to impair investors' incentives to make their own risk assessments of investment alternatives.

Accounting reform and reporting enhancement

Reform initiatives related to accounting practices are under way in both the United States and Europe. Many accounting reforms concern price determination for various securities. CESR, CEBS and CEIOPS[28] have together explored the 'fair valuation' method used by financial institutions in the valuation of investment instruments.[29] The need for such clarification became evident amid the ongoing market turbulence. As regards accounting standards, the Financial Stability Forum (FSF) has also asked the International Accounting Standard Board (IASB) to enhance its standards to enable a clear identification and presentation of the methodologies used in the valuation of instruments and related uncertainties. At the same time, the FSF has instructed the IASB to improve financial disclosure requirements concerning off-balance sheet items and to develop guidance for the valuation of illiquid market instruments in accounting. Moreover, the FSF has requested that the International Auditing and Assurance Standards Board (IAASB) enhance guidance given by the relevant national supervisors in respect of accounting practices applied to complex and illiquid instruments. In addition to the above, there were FSF recommendations for strengthened prudential oversight of capital, liquidity and risk management, enhancement of transparency and valuation, changes in the role and uses of credit ratings, greater supervisory responsibility for issues concerning risks and development of sufficiently robust official arrangements to meet financial market stress situations.

The Basel Committee on Banking Supervision has taken account of accounting issues and risk management in two proposals submitted for public comment. One deals with capital requirements for incremental risk in the trading book in the case of a decline in instrument value. The other introduces improvements to Basel II internal value-at-risk models.

As regards reporting and reporting transparency, the Senior Supervisors Group (SSG)[30], for example, has published two reports, one of which addresses disclosure of structured instruments that are at the core of the turbulence while the other analyses risk management practices followed during the turbulence. According to the first report, disclosure can be strengthened within the existing framework. In the latter report, the SSG provides an interesting description of visible differences in risk management practices between firms that weathered the financial market turmoil fairly well and firms that performed more poorly.

Other ongoing projects deal with transparency and simplicity regarding the IAS39 accounting standard. One of the most important accounting initiatives on the agenda of both the Financial Accounting Standards

[28] CESR =Committee of European Securities Regulators, CEBS = Committee of European Banking Supervisors, CEIOPS = Committee of European Insurance and Occupational Pensions Supervisors

[29] Their interpretation particularly in respect of illiquid and other instruments for which no market value can be obtained.

[30] The group consists of supervisors of five countries (France, Germany, Switzerland, the UK and the United States).

Board (FASB) and the IASB concerns reform of accounting standards dealing with consolidation in parent company balance sheets of special purpose entities used in structured credit products. FASB's current proposal could mean consolidation of several existing special purpose entities in parent company balance sheets.

US federal banking authorities are currently assessing the effects of proposed amendments on the country's banking system.

5.2 Changes in Eurosystem's collateral framework

Jarmo Pesola

In September, the European Central Bank announced a change in its counterparty risk control framework for Eurosystem credit operations, with effect from the start of February 2009. The changes concern asset-backed securities and uncovered credit institution debt instruments used as collateral.

Main features of the collateral framework

The Eurosystem's liquidity-providing monetary policy operations are usually conducted as reverse transactions under repurchase agreements between Eurosystem national central banks and counterparty banks. Central banks also extend intraday credit for payment system purposes. All Eurosystem credit operations must be based on adequate collateral. Consequently, depending on the legal nature of the credit involved, the underlying assets are provided by the counterparty in the form of the transfer of ownership of the assets or in the form of a pledge, an assignment or a charge granted over the assets.

Eurosystem central banks accept assets as collateral on the basis of uniform eligibility criteria. The entire pool of eligible assets is called the Single List. The List provides a breakdown of assets into marketable (debt instruments) and non-marketable (credit claims and non-marketable retail mortgage-backed debt instruments).[31]

Eligible marketable and non-marketable assets are subject to specified eligibility criteria. In addition to other eligibility criteria, the assets must meet certain credit standards. For the asset issuer's or debtor's probability of default (PD) over a one-year horizon of 0.1% is defined as the minimum requirement for high credit standards (equivalent to a single A credit assessment).

The Eurosystem applies two risk control measures for assets underlying its credit operations: valuation haircuts and variation margins (marking to market). Harmonised risk control measures ensure non-discriminatory conditions for any type of eligible asset at all euro area central banks.

To determine the haircut percentage, eligible marketable assets are allocated to liquidity categories, based on issuer classification and asset type. Eligible assets are subject to daily valuation. If, after valuation, the asset requirement proves to be inadequate, the central bank may require additional collateral. In the opposite case, the central bank may return excess assets.

Changes coming in February 2009

On 4 September, the ECB made an announcement of changes to risk control measures in Eurosystem credit operations following decisions taken in connection

[31] The list of marketable eligible assets is published on the ECB's website.

with the regular review of risk control. The changes reflect improvements in the methodological framework, the assessment of market and liquidity risk characteristics of eligible assets, the actual use of eligible assets by counterparties and new developments in financial instruments. These changes, which moderately tighten collateral policy, will become effective on 1 February 2009.

The most important of the changes concerns the levels of valuation haircuts, which depend on liquidity category. A new liquidity category for marketable assets will be introduced, which increases the number of liquidity categories from four to five. The present category IV, which is made up of the least liquid assets, will be renamed category V. Its content will remain unchanged, consisting of asset-backed securities (ABS). The new category IV will include uncovered credit institution debt instruments, which were previously included in category III (see Table).

The valuation haircuts for liquidity categories I-III will remain unchanged, but those for the new category IV will be set fairly high. Accordingly, in February 2009, the haircuts applied to uncovered credit institution debt instruments will rise by 5 percentage points, across the board, for all sub-categories of residual maturity and coupon structure. The haircut will thus range from 6.5% to 20% (see Table). The valuation haircut for liquidity category V, ie the haircut for asset-backed securities, will be 12 as from the start of February. In the absence of a market price for an asset-backed security, the valuation haircut will be raised by another 4.4 percentage points.

Other changes relate to the extension of the definition of ‘close links’ and the requirement for greater transparency in credit assessments issued by external credit assessment institutions.

Eurosystem counterparty banks have not been allowed to use as collateral any assets issued or owed by entities with which they have close links. So far, close links have been defined on the basis of direct or indirect ownership. Close links will now be defined as to include situations in which a Eurosystem counterparty enters into a currency hedge with the issuer or guarantor of the asset-backed security or provides liquidity support of at least 20% of the nominal value of the asset-backed security.

In addition, from the start of February, all credit assessments issued by eligible external credit assessment institutions (ECAIs) and utilised in the Eurosystem Credit Assessment Framework must be based on public ratings. Particularly in the case of asset-backed securities (ABS), ratings must be explained in a detailed publicly available credit-rating report. ECAIs must publish a rating review for each asset-backed security at least on a quarterly basis. These reviews should contain an update eg of the composition of the collateral pool, ABS transaction participants and capital structure, and performance data.

Table 5. Levels of valuation haircuts applied to eligible marketable assets in relation to fixed coupon and zero coupon instruments as from February 2009, %

Residual maturity (years)	Liquidity categories								
	Category I		Category II		Category III		Category IV		Category V
	Fixed-coupon	Zero-coupon	Fixed - coupon	Fixed - coupon	Fixed - coupon	Zero - coupon	Fixed - coupon	Zero - coupon	Fixed - or zero - coupon
0-1	0,5	0,5	1	1	1,5	1,5	6,5	6,5	
1-3	1,5	1,5	2,5	2,5	3	3	8	8	
3-5	2,5	3	3,5	4	4,5	5	9.5	10	12*
5-7	3	3,5	4,5	5	5,5	6	10.5	11	
7-10	4	4,5	5,5	6,5	6,5	8	11.5	13	
>10	5,5	8,5	7,5	12	9	15	14	20	

*Assets priced in the absence of theoretical market values will be subject to an additional haircut of 4.4 percentage points.

Source*: European Central Bank.*

Liquidity category I includes central government debt instruments and debt instruments issued by central banks.

Liquidity category II includes local and regional government debt instruments, Jumbo covered bank bonds and agency debt instruments and supranational debt instruments.

Liquidity category III includes traditional covered bank bonds and debt instruments issued by corporations.

Liquidity category IV includes uncovered credit institution debt instruments.

This category also includes certificates of deposit issued by Finnish banks.

Liquidity category V includes asset-backed securities.

6 Key corporate arrangements and events in the financial sector

Date	*Event and description*
April 2008	*Aktia Savings Bank plc and Veritas Mutual Non-Life Insurance Company announced plans to merge.*
	The Association of German Banks takes over Düsseldorfer Hypothekenbank.
	Moody's affirms Finland's ratings of P-1 and Aaa. Outlook remains stable.
	S&P lowers Stora Enso's long-term rating from BBB to BBB-.
	Moody's lowers Stora Enso's credit ratings as follows: short-term from P-3 to NP, and long-term from Baa3 to Ba1. Rating outlook stable.
	Multilateral trading facility Chi-X announces it will start trading the OMX Helsinki 25 component stocks.
May 2008	*Moody's lowers Iceland's long-term rating from Aaa to Aa1.*
	Fitch affirms Teollisuuden Voima Oyj's ratings; short-term: F2; long-term A-. Rrating outlook remains stable.
	Fitch affirms Nordea's credit ratings; short-term: F1+; long-term AA-. Rating outlook remains stable.
July 2008	*Spanish Banco Santander makes a takeover bid for British mortgage bank Alliance & Leicester.*
August 2008	*German insurance corporation Allianz sells Dresdner Bank to Commerzbank for EUR 9.8 billion.*
	US private equity firm Lone Star acquires German lender IKB Deutsche Industriebank.
	Trading platform Turquoise commences operations.

Date	*Event and description*
August 2008	*Norwegian fund management company Odin Forvaltning purchases mutual fund unit brokerage firm Rahastotori and its parent company Fondex.*
	Insurance corporation Sampo Life changes name to Mandatum Life Insurance Company Limited.
September 2008	*US mortgage banks Fannie Mae and Freddie Mac taken over by federal government.*
	Investment bank Lehman Brothers files for bankruptcy.
	Nomura Holdings to purchase Lehman's Asian operations.
	Barclays acquires Lehman Brothers' North American investment banking business for USD 1.75 billion.
	Federal government rescues US insurance giant AIG with a USD 85 billion loan.
	US Treasury announces USD 50 billion guarantee program for the US money market mutual fund industry.
	Lloyds TSB announces it will buy HBOS for GBP 12.2 billion.
	Bank of America announces it will buy Merrill Lynch for USD 50 billion.
	Danish Ebh Bank runs into liquidity problems. Danish central bank and several commercial banks announce they will guarantee Ebh's liquidity.
	Mitsubishi UFJ buys a 21% stake in Morgan Stanley.
	Deutsche Bank acquires a 29.75% stake in the German Postbank for EUR 2.8 billion.
	FDIC closes down Washington Mutual, the largest savings bank in the USA, and sells its assets and part of its liabilities to JPMorgan Chase for USD 1.9 billion. Washington Mutual was the 13th bank to be closed down in the United States this year.
	Citicorp Inc to acquire Wachovian Corporation's deposit stock and branch network.
	Investment banks Goldman Sachs and Morgan Stanley become commercial banks supervised by the Federal Reserve.

Date	*Event and description*
September 2008	*Nationwide takes over two mortgage banks, Derbyshire Building Society and Cheshire Building Society.* *British mortgage bank Bradford & Bingley taken over by UK government. Deposit stock and branch network sold to Abbey National, a subsidiary of Banco Santander.* *German authorities and financial sector arrange a EUR 35 billion plan to rescue Hypo Real Estate. Rescue was triggered by liquidity problems encountered by Depfa Bank, a subsidiary of Hypo Real Estate.* *Belgian, Dutch and Luxembourg authorities invest EUR 11.2 billion in the financial group Fortis. In return, each government will obtain a 49% stake in a Fortis subsidiary in its own country.* *Belgian, Luxemburg and French authorities and former shareholders announce they will increase Dexia's share capital by EUR 6.4 billion.* *Nordea announces it will sell to Municipality Finance Plc a EUR 600-million portfolio of loans granted to municipalities and municipally-owned companies.* *Nordea acquires 9 branch offices of the Danish bank Roskilde Bank. Spar Nord purchases 7 branch offices and Arbejdernes Landsbank 5 branch offices* *Ireland's government announces it will guarantee Irish banks' deposits and debts for two years.* *Aktia Savings Bank plc's banking operations transferred to Aktia Bank plc. Moodys keeps Aktia's ratings unchanged: short-term P-1, and long-term A1.* *Government of Iceland buys Glitnir Bank hf's shares worth EUR 600. In return it acquires a 75 % stake in the bank.* *Iceland's credit ratings lowered. S&P: short-term A-1 →A-2; long-term A →A-; outlook for long-term rating negative. Fitch: short-term F1 → F2; long-term A+ → A-; rating outlook negative. Moody's places long-term rating (Aa1) on watch for possible downgrading.* *Glitnir's ratings lowered. S&P short-term A-2 → A-3; long-term BBB+ →BBB; rating outlook negative. Fitch: short-term F2 → F; long-term; A- → BBB-; rating outlook negative. Moody's: short-term P-1 → P-2; long-term A1 → Baa2.*

Date	*Event and description*
September 2008	*Fitch lowers Kauphing Bank's ratings. Short-term F2 →F3; long-term A- → BBB. Ratings outlook negative. Moody's places short-term rating (P-1) and long-term rating (A1) on watch for possible downgrading.* *Fitch lowers Landsbanki Island hf's ratings. Short-term F1 → F3; long-term A → BBB. Ratings outlook negative. Moody's places short-term rating (P-1) and long-term rating (A2) on watch for possible downgrading.* *Fitch lowers Straumur-Burdaras Investment Bank's ratings. Short-term F3 → B; long-term BBB- → BB+.*