



Financial Market Report

4 • 2007

- New banks boost competition for deposits
- Nordic banks – efficient and internationally oriented
- Subprime turbulence reflected in securities market restructuring
- TARGET2-Securities harmonises securities settlement
- Adequate liquidity in Finnish banks' payment systems



Bank of Finland

Financial Markets and Statistics

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1 Financial intermediation

1.1 Heightening competition in deposits

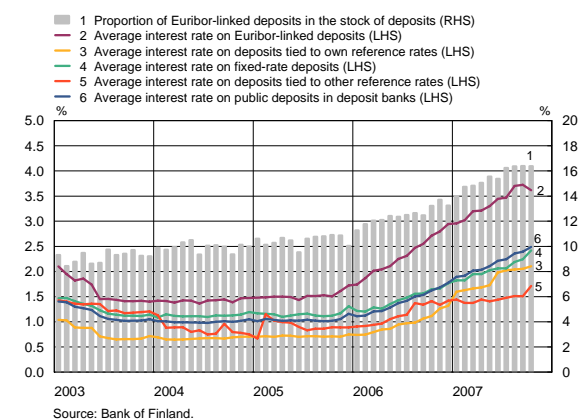
Kimmo Koskinen

The majority of deposits carry a fixed interest rate or are tied to banks' prime rates. The average rate on households' deposits is boosted by liquid investment and yield accounts. Uncertainty has raised the popularity of short-term fixed deposits.

New operators in the banking market and the increased price of funding in international money and capital markets have recently intensified competition particularly in households' deposits. In October 2007, the stock of euro-denominated public deposits in Finnish MFIs totalled EUR 90 billion, 70% of which was accounted for by households and 21% by non-financial corporations.

The average interest rate on non-MFI deposits has traditionally not risen as rapidly as market interest rates and interest rates on loans because nearly 84% of total deposits are tied to rates other than Euribor rates. The prime rates of the largest commercial banks have not changed since July 2007. Of non-MFI deposits, more than half are fixed-rate, and 27% are tied to banks' own reference rates, ca 16% to Euribor rates, and ca 6% to other reference rates.

Chart 1. Average interest rate on the stock of non-MFI deposits by interest rate linkage and Euribor-linked deposits as a proportion of total deposits



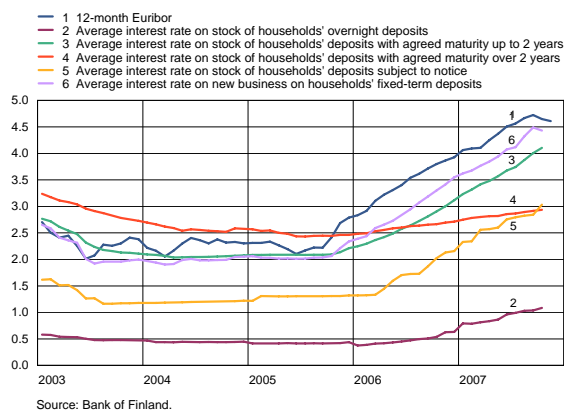
In addition to interest rate-linkage, deposit rates are affected by the type of deposit. The majority of households' deposits have traditionally been in transaction account-type overnight deposit accounts without agreed maturity or withdrawal limit; payments can be made from the accounts, and the interest rate is fixed and usually very low. In October 2007, the stock of households' overnight deposits totalled EUR 33.5 billion; the annual growth rate has been slowing, and in has at times been negative.

Competition in deposits has increased recently and some banks are already offering 2%-plus interest rates on transaction accounts. Several banks also offer various deposit accounts for short- and long-term savings, which are classified as overnight deposits. These accounts do not have agreed maturity or

withdrawal limits. However, some of the accounts cannot be used for payments, or linked to a credit or debit card. Interest rates on these types of savings accounts may have been several percentage points higher than that on a traditional transaction account.

In addition, interest rates on deposits change gradually, depending on the balance. Sometimes banks have offered above-market interest rates on savings account. These types of overnight deposit accounts for investment purposes have helped to raise the average interest rate on overnight deposits to over 1%. Thus far, the statistics do not differentiate between transaction accounts and other overnight deposits.

Chart 2. Interest rate on households' deposits by claim, and the 12-month Euribor



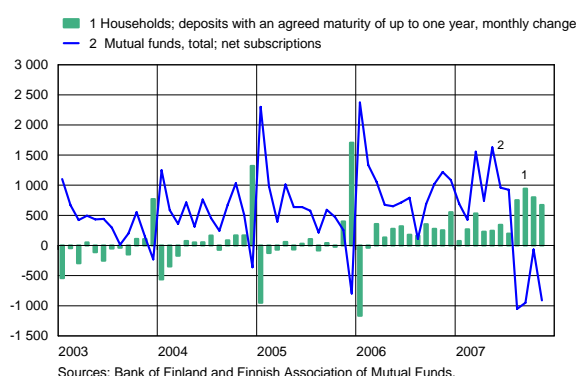
In deposit statistics, investment and yield accounts are included in deposits subject to notice. Accounts subject to notice, however, refer only to accounts with limited monthly withdrawals. The stock of households' deposits subject to notice has grown slightly in the past year. In October 2007, it totalled ca EUR 10 billion, up by ca EUR 900 million over the prior ten months. The average interest rate on deposits subject to notice was over 3% in October.

Households' short-term deposits with agreed maturity have gained considerably in popularity in recent months. This is probably due to households'

unwillingness to keep savings in mutual fund units which they consider increasingly uncertain.

The stock of households' fixed-term deposits totalled EUR 19.2 billion in October. Of this, ca EUR 14.6 billion was accounted for by deposits with agreed maturity up to one year; ca EUR 3.2 billion by deposits with agreed maturity of over one year up to two years, and ca EUR 1.4 billion by deposits with agreed maturity of over two years. The average interest rate on fixed-term deposits in October was 4.02% and the average interest rate on new business on fixed-term deposits was 4.43%.

Chart 3. Monthly flow of deposits with agreed maturity up to one year and net subscriptions in mutual funds



1.2 Non-financial corporations not shocked by the increase in interest rates

Jukka Vauhkonen

A survey shows that the more than doubling of market interest rates over the past two years has had virtually no impact on non-financial corporations' demand for credit. In addition, a relatively small proportion of non-financial corporations hedge or intend to hedge against a possible rise in interest rates.

As a result of rising market interest rates, the average rate on banks' new loans to non-financial corporations has risen by nearly two percentage points. The annual Survey on Business Finances by the Bank of Finland, Confederation of Finnish Industries and the Ministry of Trade and Industry studied the impact of the rise in interest rates on non-financial corporations' borrowing and intentions to borrow.¹

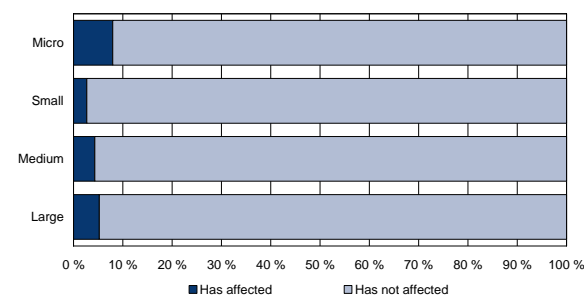
Rising interest rates do not seem to have cooled non-financial corporations' demand for credit: only ca 5% of non-financial corporations that had sought or considered seeking a loan reported that the increase in interest rates has affected the demand for loans (Chart 4). This result is consistent with the fact that the

¹ A total of 1,011 non-financial corporations, of various sizes and representing a variety of industries from all over Finland responded to the survey. The survey took place in the second half of August 2007, when market interest rates and rates on new loans to non-financial corporations were slightly lower than at the time of writing (December 2007). The survey is available on the Bank of Finland's website

(http://www.suomenpankki.fi/fi/julkaisut/selvitykset_ja_raportit/rahoituskyselyt/index.htm, in Finnish only).

growth of the stock of Finnish MFIs' loans to non-financial corporations has remained rapid, and accelerated further in autumn 2007.

Chart 4. Has the increase in interest rates affected your company's seeking of new loans in the past 24 months?



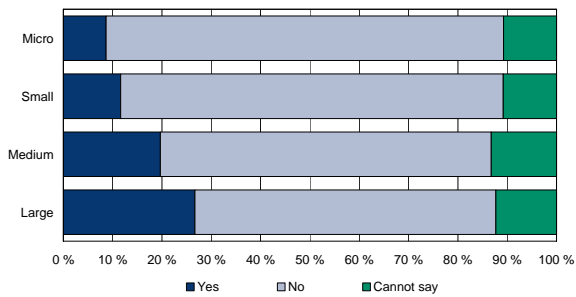
The minor impact of rising interest rates on the level of borrowing can be partly explained by the fact that the interest rates on corporate loans, though having moved up, are still fairly moderate by historical standards. The survey also showed that the average margin for new loans to non-financial corporations has declined, which for some of the non-financial corporations lowers the cost-effect of rising interest rates.

Continuing increases in interest rates may, however, have a larger effect on the demand for corporate credit. To determine this, the respondents were asked whether an additional percentage-point increase in the interest rate on new loans (compared to August 2007) would affect their future demand for credit. A fairly small proportion of the non-financial corporations (less than 13%) reported that a rise in interest rates would reduce their demand for credit. The survey shows that factors other than interest rates indeed have a larger impact on the financing of non-financial corporations (at least as long as interest rates fluctuate at levels witnessed in recent years).

The survey also studied whether non-financial corporations intend to or are considering hedging

against a possible rise in interest rates; ca 17% intend to hedge. Of the micro-sized companies, with staffs of less than ten, only one in ten intend to hedge, whereas over 25% of the large non-financial corporations intend to hedge (Chart 5).

Chart 5. Is your company intending or considering hedging against a possible rise in interest rates?



For medium-sized and large companies, the most important means of hedging are such instruments as interest rate derivatives, forward rate agreements and interest rate swaps. Particularly some of the micro- and small-sized companies intend to hedge by replacing variable-rate loans with fixed-rate loans and by speeding up the repayment of current debt.

2 Banks and insurance corporations

2.1 Slight hiccup in domestic banks' net income in the third quarter

Hanna Putkuri

Domestic banks' pre-tax results in January–September improved significantly on the previous year. Despite market turbulence, results remained good in the third quarter.

Domestic banks'² aggregate pre-tax results in January–September 2007 totalled ca EUR 2.5 billion. The results were up by over a fifth on the year-earlier period. Excluding the largest non-recurring capital gains in 2006–2007³, the January–September results

² Domestic deposit banks (parent companies, excl. subsidiaries) and their branches operating in Finland and abroad. Branches of foreign credit institutions engaged in deposit bank activities in Finland are not included in the figures; their aggregated pre-tax results in January–September totalled ca EUR 0.1 bn.

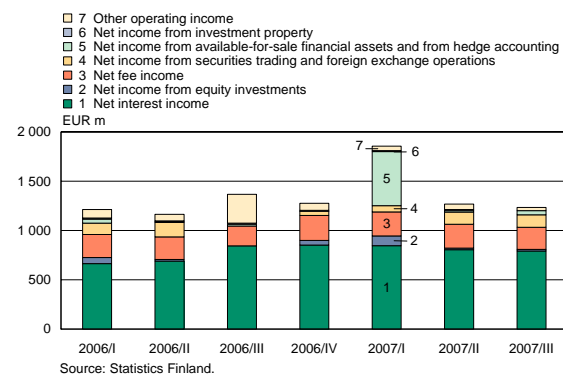
³ In the first quarter of 2007, Sampo Bank recorded a EUR 460.6 million capital gain linked to Danske Bank Group's internal restructuring, and it was booked in net income from available-for-sale financial assets. In the third quarter of 2006, Nordea Bank recorded a EUR 199 million capital gain on the sale of its Russian associated bank, and it was booked in other operating income.

were better by 10% on the year-earlier period. The comparable improvement was based mainly on an 11% increase in net interest income.

The third quarter was characterised by turbulence in the global financial markets, albeit with a fairly minor impact on Finnish banks. Combined net income declined by 3% on the previous quarter, while administrative and other expenses declined even more (8%). This and the recoveries of loan losses boosted pre-tax results in July–September by 4% on April–June.

The slight hiccup in net income compared to the second quarter was due to several items (Chart 6). Net interest income declined by EUR 12 million (1%) and net fee income by EUR 18 million (7%). Net income from equity investments declined by almost EUR 1 million (5%), net income from investment property

Chart 6. Domestic banks' net income



by EUR 12 million (120%), and other operating income by EUR 23 million (41%). By contrast, net income from securities trading and foreign exchange operations and from available-for-sale financial assets

grew by a total of EUR 29 million (21%) compared to the second quarter.

Favourable developments in insurance activities also boosted the January–September results of financial groups operating in Finland (Table 1).

Table 1. Key items from financial groups' income statements in January–September 2007

	Net interest income		Other income, net		Total expenses		Operating profit	
	EUR m	Change	EUR m	Change	EUR m	Change	EUR m	Change
Nordea Group**	3 139	10 %	2 605	8 %	2 993	7 %	2 805	6 %
Nordic banking	2 693	9 %	1 721	5 %	2 205	4 %	2 294	5 %
Banking in Finland	788	..	477	..	546	..	765	..
Life insurance	-	-	233	14 %	124	1 %	109	35 %
Danske Bank Group	2 417	10 %	2 125	5 %	2 483	12 %	2 025	-2 %
Banking	2 147	12 %	1 135	4 %	1 976	8 %	1 273	4 %
Banking in Finland***	293	4 %	139	4 %	322	41 %	96	-50 %
OP-Pohjola Group	771	20 %	895	13 %	826	5 %	757	27 %
Banking and investment services	761	17 %	444	2 %	576	2 %	545	15 %
Non-life insurance	-	-	341	29 %	217	5 %	125	114 %
Life insurance	-	-	132	38 %	42	-16 %	89	92 %
*OKO Bank Group	85	16 %	466	18 %	328	9 %	220	33 %
Savings banks (excl. Aktia)	118	22 %	47	33 %	87	8 %	78	50 %
Aktia Savings Bank plc (Group)	65	4 %	146	258 %	153	164 %	58	31 %
Retail banking	46	-2 %	24	17 %	53	13 %	17	-24 %
Life insurance	-	-	140	..	116	..	24	..
Local cooperative banks	80	19 %	21	11 %	53	2 %	46	36 %
Bank of Åland plc (Group)	29	20 %	26	23 %	33	17 %	21	23 %
Evli Bank Group	-0.3	.	61	63 %	37	6 %	13	753 %
eQ Group	5.4	47 %	31	14 %	26	27 %	11	-1 %
1. Finnish financial groups	1 068	19 %	1 227	26 %	1 215	14 %	984	30 %
2. Financial groups operating in Finland	6 624	11 %	5 958	10 %	6 691	10 %	5 813	6 %

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 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 (impairment losses, refunds to shareholders and customers and profit distributions to staff) are not included in the table figures.

** The percentage changes in Nordea Group's total figures and figures for banking were calculated on comparable data for 2006, excluding the EUR 199 million in capital gain from the sale of IMB. Nordea introduced new segment reporting in the January–September 2007 interim report; the January–September 2006 figures for banking in Finland are not comparable.

*** Includes Danske Bank Group's branch office in Helsinki, and Sampo Bank Group's banking business in Finland in February–September. The percentage changes were calculated on comparable (pro forma) figures for 2006.

1. Savings banks, Aktia Group, local cooperative banks, Bank of Åland Group, Evli Bank Group, eQ Group, OP-Pohjola Group.

2. Danske Bank Group, Nordea Group, and Finnish financial groups.

Source: Banks' interim reports.

2.2 Nordic banking sectors among the most efficient in the EU

Jarmo Pesola

A key factor behind the good productivity and efficiency ratios is the pro-technology atmosphere in the Nordic countries. Sparse population and long distances, together with the severe banking crisis in the early 1990s, provide the key incentives for development.

Structural indicators⁴ of the EU banking sector show that consolidation and efficiency developments continued in 2002–2006, albeit at a slightly slower pace in 2006. The average numbers of credit institutions and employees have declined over the same period in the EU. The number of branches has also been on the decline, except for a few countries.⁵ At the same time, the total assets of credit institutions have been increasing notably faster than GDP.

Bank branches increasingly offer sales and advisory services on the most complex products, whereas electronic channels and ATMs provide the less complex and standardised services.

Cross-country differences can be examined using the banking sector capacity indicators shown in Table 2. The indicators are published by the ECB. The table shows the indicators for the 14 key EU countries, in

⁴ EU banking structures, ECB, October 2007.

⁵ The most significant exception is France, where in 2005 a large number of postal offices were redesigned as bank branches. It should be noted that the establishment of the S Bank in 2007 will boost the number of bank branches in Finland.

ascending order by population density.⁶ Finland and Sweden have by far the lowest population density; the highest population density is found in the Benelux countries.

Productivity and efficiency indicators for banking include ratios that give the size of the population per credit institution employee, branch or ATM. The large cross-country differences in the indicators reflect differences in retail banking and business models, which are the result of different circumstances and history.

Finland and Sweden rank highest in population per credit institution employee. By contrast, the third Nordic country, Denmark, ranks only 12th.

If this very straightforward capacity indicator of banks' productivity is examined in terms of population density, the most sparsely populated EU countries rank very high, with a few exceptions (Chart 7).

Another productivity indicator is population per credit institution branch. Also in terms of this indicator, Finland and Sweden, as well as Denmark, rank high.

In contrast, ATM utilisation is a mixed indicator. Replacing bank branches with ATMs boosts productivity. But large number of ATMs may also indicate a widespread use of cash.

The latter argument is supported by the fact that the number of ATMs per inhabitant is particularly low in the Nordic countries. The frequency of cash payments is rather low in the Nordic countries due to the extensively increased automation of payments. As measured eg by the share of electronic credit transfers and use of payment terminals in total payments, the degree of payment automation is over 90% in the Nordic countries, with the exception of Denmark,

⁶ EU15, excl. Luxembourg (because it is an exception).

where it is 80%.⁷ Sparse population and long distances are probably among the drivers of automation.

Besides sparse population, there are other special factors affecting developments in the Nordic countries. The robust growth in productivity has been explained, particularly in Finland, Sweden and Norway, by the banking crisis in the early 1990s, which forced banks to considerably improve the efficiency of operations, by eg cutting the numbers of employees and bank branches.

Another and perhaps more fundamental reason is considered the positive attitudes towards the adoption of modern technology in the Nordic countries. This finding is supported by eg the Nordic Banking Structures report, and the survey by Eurostat, which shows that over 50% of Nordic and Dutch households used Internet banking at least to some extent in 2006 (Table 2).

Circumstances have thus been favourable for the general pricing policy of Nordic banks, which has steered customers to the use of automation.

⁷ Nordic Banking Structures report (28 August 2006). The report was prepared in cooperation between Danmarks Nationalbank, Bank of Finland, Seðlabanki Íslands, Norges Bank, and Sveriges Riksbank.

Chart 7. Population density and number of employees of credit institutions in EU14 (EU15 excl. Luxembourg), 2006

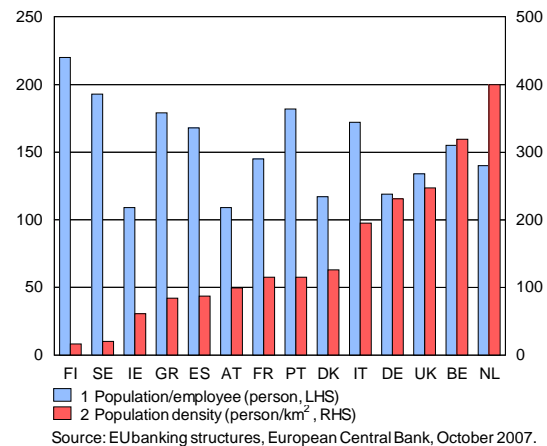


Table 2. EU banking sector capacity indicators and Internet banking in 2006, EU14* by population density

Country		Population					
		Population density pop./km2	per CI employee	Population per branch	Population per ATM	Assets per employee EUR m	Internet banking %**
Finland	FI	16	220	3296	1606	10651	63
Sweden	SE	20	193	4531	3235	16438	57
Ireland	IE	61	109	4549	1287	30090	21
Greece	GR	84	179	3005	1667	5068	2
Spain	ES	87	168	1009	762	9605	15
Austria	AT	99	109	1945	1037	10348	27
France	FR	115	145	1579	1322	13156	18
Portugal	PT	115	182	1889	663	6822	10
Denmark	DK	126	117	2536	1848	17726	57
Italy	IT	195	172	1813	1468	8218	9
Germany	DE	231	119	2045	1528	10286	32
United Kingdom	UK	247	134	4700	1002	21304	28
Belgium	BE	319	155	2306	1484	16509	28
Netherlands	NL	400	140	4728	2014	16078	59
	MU12	126	143	1744	1249	11338	24***
	EU25	116	152	2183	1355	12069	22

* EU14 = EU15 excl.Luxemburg

** percent of population (over 16) that has used Internet banking at least once in the preceeding 3 months

*** EU15

Source: EU banking structures, European Central Bank, October 2007.

2.3 Nordic financial groups – internationally oriented

Sampo Alhonsuo

Large Nordic financial groups' profits are based on a large number of countries. Finland weights heavily for Sampo Group and Nordea.

Large Nordic banking and financial groups are highly internationally-oriented and have been expanding their operations for quite some time. In recent years, particularly Icelandic banks have internationalised rapidly.

There are several reasons for the cross-border expansion of business: 1. limited growth opportunities and/or narrow price margins in the home country; 2. good growth potential and/or wider price margins abroad; 3. banks follow their customers abroad; and 4. economies of scale and scope in cross-border operations.

All the above factors have probably, to an extent, motivated Nordic banks' expansion of operations across geographic borders. The strategy has usually been to acquire a bank in the new country, but another strategy is to establish a branch office. Some groups are in the process of changing the status of their foreign subsidiaries to branch offices.

In the table below, Nordic financial groups' internationalisation is examined from two perspectives: the proportion of foreign operations of the group's (pre-tax) profits; and Finland's importance for the profits. Eight groups⁸ were examined; in five

⁸ The figures in this article are based on information published by the groups in connection with interim reports.

cases, foreign operations accounted for over 50% of the total profits.

Table 3. Nordic financial groups: proportion of foreign and Finnish operations of total profits

	Profits of the group's foreign operations 1-9/2007		Group's profits in Finland 1-9/2007	
	EUR m	% of group's total profits	EUR m	% of group's total profits
Sampo Group* (Finland)	2,601	70%	1,110	30%
Nordea**(Sweden)	1,614	76%	700	33%
Danske Bank (Denmark)	406	20%	96	5%
Handelsbanken (Sweden)	233	18%	46	4%
SEB (Sweden)	729	54%	40	3%
Swedbank (Sweden)	374	30%	-	-
Kaupthing*** (Iceland)	1,024	66%	15	2%
Glitnir (Iceland)	183	53%	-	-

*: premium income from non-life and life insurance 1-9/2007

** : operating profit of retail banking 1-9/2007

***: total earnings for the group 1-9/2007; for Finland: profit after tax 1-9/2007

The groups' foreign operations are very diverse. Sampo Group is the largest non-life insurance corporation in the Nordic countries via its ownership of If P&C Insurance. Nordea operates in all the Nordic countries and in the Baltic countries and Poland. In addition to the Nordic and Baltic countries, Danske Bank has expanded to Ireland and Northern Ireland; SEB has expanded to Germany, Poland and Ukraine; Handelsbanken to the United Kingdom, and Swedbank to Ukraine. Many of the groups also operate in eg Russia. The Baltic countries are particularly important for SEB and Swedbank – they account for 20–25% of the groups' profits, and for 10–20% of the groups' deposits and lending. The Baltic countries account for only 1–2% of Nordea Group's and Danske Bank Group's profits and business volume.

Finland accounts for ca 3–5% of the groups' profits, with the exception of Sampo Group and Nordea. The figures in the table refer to the operating profit of the various business units, without group eliminations. As to legal companies, Nordea Bank Finland Group's profit for January–June 2007 totalled EUR 743 million, ie 40% of Nordea Group's total profit.

Finland's importance in the operations of the two Icelandic financial groups is reflected in eg the following figures: in September, Finnish customers' funds managed by Kaupthing amounted to EUR 2.5 billion. Of deposits from the public, Kaupthing held EUR 285 million; or 0.3% of the total for Finland at the end of September. Finland accounted for ca 2% of total deposits in the Kaupthing Group, and for 0.6% of

its funding. Similarly Glitnir's stock of deposits in Finland totalled EUR 290 million at the start of October, which gave it a 0.3% market share for September–October, and amounted to 2% of the Group's total funding. Icelandic banks in Finland are expected to gain deposits in the last quarter of 2007 as a result of their aggressive pricing of deposits.

3 Securities markets

3.1 Rapid growth in sovereign wealth funds

Pertti Pylikkönen

While sovereign wealth funds have grown rapidly, their assets still account for only a small fraction of the international financial markets.

Rapid growth in sovereign wealth funds has sparked a major debate and concern over their impact on international financial markets. Their role has also often been discussed in connection with foreign investors' impact on national security matters.

Thus far there is no exact definition of a sovereign wealth fund. They can, however, be classified as investors with at least the following characteristics: (i) state-owned; (ii) debt-free; (iii) management separated from management of owner countries' foreign reserve assets; and (iv) investment policy differs from that concerning foreign reserve assets.

These funds are managed in very different ways. The following ways are the most typical: operates as an independent investment community (Singapore); managed by the ministry of finance (Russia); managed by the ministry of finance, but investment activities handled by the central bank (Norway); or in exceptional cases, the fund may be included in the central bank's assets (Saudi Arabia).

Assets held by sovereign wealth funds have grown rapidly in the past few years and are estimated at USD

2.5– 3 trillion. Most of the funds, however, do not publish information on their activities, and the exact amount of their asset holdings is not known. The assets account for only a small fraction of total assets in the international financial markets. For example, the global market capitalisation of exchanges was in September ca USD 63 trillion, and the amount of outstanding short- and long-term debt instruments was slightly higher. Global mutual fund assets totalled in June USD 24 trillion, and hedge fund assets ca USD 2 trillion.

The history of sovereign wealth funds goes back to the early 1950s. The first one was established in Kuwait in 1953. With the rise in oil prices in the 1970s, several oil producing states in the Middle East each established a sovereign wealth fund. The rapidly expanding returns generated assets that were invested to ensure the future. Of the non-oil producing countries, Singapore, for one, established its first sovereign wealth fund (Temasek) in 1974.

The rise in commodity prices and expanding current account surpluses of some countries set off a new wave of sovereign wealth funds around the start of the 1990s.

In addition to origin of assets, sovereign wealth funds are divided into two groups based on the scope of activities. Some of the funds are 'stabilisation funds', intended eg to stabilise the flow of income from fluctuating commodity prices. The purpose of the other sovereign wealth funds is to hold and invest assets for future use, eg when the country's raw material resources are running out. Some countries

have restrained the growth in foreign currency reserves by transferring assets to a sovereign wealth fund. This also enables more extensive investment and diversification of assets than is feasible in the investment of foreign reserve assets.

Sovereign wealth funds have sparked criticism due to eg the fact that most of the funds have not published information on their operations and that their investment motives are not well known. In addition, the rapid expansion of sovereign wealth funds underlines their importance in altering the financial markets and even as a threat to financial stability.

Most sovereign wealth funds are owned by countries with underdeveloped financial markets and a dearth of domestic investment instruments. This is the main reason why the sovereign wealth funds spread most of their assets among foreign investment instruments, in the markets of both the older industrialised countries and the emerging economies.

In 2007, sovereign wealth funds' investments in banks or other financial corporations in various countries totalled nearly USD 40 billion. Of the international banks, the growth in capital has been greatest for the US bank Citigroup and the Swiss bank UBS. In the Nordic countries, sovereign wealth funds have focused on trying to acquire ownership in the Nordic exchange OMX AB.

3.2 Turmoil in the markets for asset-backed securities

Katja Taipalus

Reports on market turbulence have focused mainly on losses on US subprime mortgages. The turbulence has far-reaching consequences in the markets for structured securities.

The subprime turbulence is widely reflected in the markets for structured securities; as more risk-based pricing, lower issuance volume, and in some cases lower ratings. In the third quarter of 2007, the volume of issues declined in both the USA and Europe⁹. Investors have become cautious and are focusing only on low-risk collateral and on securities with simple structure.

Investors are looking carefully for news on possible spreading of credit losses outside the subprime mortgage sector; to other sectors where credit risk has been spread across many investors via securitisation. Growing credit losses in new sectors would again bring uncertainty to the markets as to who will eventually bear the risk.

The larger the volume of securities issued, the larger the impact. Fannie Mae and Freddie Mac¹⁰ have

⁹ In Europe, the volume of new securitised issues decreased in the third quarter to EUR 89.5 billion, from EUR 164.8 billion in the second quarter; in the USA, a marked decrease took place in eg issues of asset-backed securities: the number of issues decreased by 60% in the third quarter, compared to the previous quarter.

¹⁰ These companies play a key role in housing finance in the USA. Their task is to promote the liquidity and stability of housing finance. This is done by purchasing mortgages from primary creditors, by keeping the mortgages on their balance sheets or by repackaging them into guaranteed securities for the secondary markets.

reported an increase in credit losses. Freddie Mac said in November that it needs to raise several billion dollars of new capital due to the growing credit losses which have chipped away its reserves. The mortgages accepted by these two institutions have traditionally met strict criteria, and the collateral for the securities issued by them has been considered high-quality and low-risk in the international securities markets. The amount of mortgage-backed securities guaranteed by Fannie Mae and Freddie Mac is a very high ca USD 3,200 billion. Credit losses have also increased in the household sector-driven credit card, home equity¹¹ and car credit markets in some US states.

In addition to increased credit losses, market developments in structured securities are threatened by the downgrading of 'monoline' bond insurers' credit rating. Monolines are insurance corporations that focus on offering insurance on the debt of borrowers with low credit ratings. The insurance obtained for the insurance premium boosts the rating of the issued debt and lowers the cost of funding.

The biggest concern in the market now is that compensation payments on insurance on structured securities will increase¹² enough to affect the insurers' capital, which traditionally provides fairly small buffers against losses. As a result, their credit ratings would recede from the best (AAA) category. The downgrading would, in turn, affect all the securities that are insured by the company in question. This would have a major impact on the market because insured issues are estimated to total trillions of dollars.

¹¹ A home equity credit is in principle a second credit on the value of a property. It is possible to acquire home equity credit when the value of the property is higher than the first credit (eg mortgage) tied to it.

¹² The growth in compensation is, in turn, due to expanding credit losses on the collateral for securitised items.

The amount of housing loans in Europe similar to US subprime credits is significant only in the United Kingdom. In 2006, these loans accounted for ca 7% of the stock of housing loans in the United Kingdom, compared to 16% in the United States. In the United Kingdom, the terms and conditions of loan agreements were never eased as much as in the United States. On the other hand, relative to disposable income, mortgage holders are currently more indebted in the United Kingdom than in the United States¹³. Moreover, housing prices have declined over the past months in the United Kingdom. The local financial supervisor, the Financial Services Authority (FSA) warned mortgage lenders of weakening conditions regarding both the availability of funding and the amounts of credit losses. A particular concern is the 1.4 million mortgage holders whose mortgage rates will be adjusted in 2008.

Also in Europe, part of the risk of property-backed credit has been allocated to the market via securitisation. In Europe, the majority of securitisations are residential mortgage backed securities (RMBS) or commercial mortgage backed securities (CMBS). The majority of the collateral originates from the United Kingdom; other significant sources include Spain, the Netherlands, and Italy. These countries are characterised by strong increases in property prices and amounts of housing loans in the past ten years. For example in Spain, the debt-to-disposable (gross) income ratio has increased from 45% in 1996, to ca 125% in mid-2007. In Spain, the majority of the growth in credit payment defaults is currently accounted for by mortgages – their total amount is nevertheless still relatively small.

¹³ In the United Kingdom, the last time quarterly figures for interest payments relative to income were on the same level was in 1992. The ratio was highest in the early 90s (over 27%); now it is 18.3%.

4 Infrastructure

4.1 TARGET2-Securities supports Nordic direct holding of securities

Marko Myller

The Eurosystem's TARGET2-Securities concept – aimed at harmonising the European settlement infrastructure – also supports the direct holding of securities. A public consultation has been launched; market participants should study the user requirements.

The TARGET2-Securities (T2S) project was prepared in the autumn in a transparent manner and in good cooperation with the various market participants. Although banks recognise potential benefits, the project has also raised criticism, partly due to its being a form of public intervention and the attention it has received among the various operators. The participants' comments will be taken into account in the further planning of the project wherever possible.

The European Central Bank's T2S Project Team and six technical groups, guided by the Advisory Group, have been drawing up the T2S user requirements over the past six months.¹⁴ In addition,

¹⁴ <http://www.ecb.int/paym/t2s/defining/html/index.en.html>

each euro area country has a national user group.¹⁵ The specification of user requirements focused on current needs of the markets and not on creating new requirements. This resulted in an 800-page documentation, which is the basis of the market consultation launched at the beginning of 2008. All participants should carefully study the solutions proposed for the T2S system in order to verify that they are appropriate.

The T2S concept promotes integration

The Eurosystem has called for a so-called lean concept aimed at harmonising market practices. Achieving the highest possible level of harmonisation of practices has been challenging. Such harmonisation is possible, but the differences in legislation require extensive cooperation and understanding of the other authorities.

A common view has, in principle, already been reached on eg the service level, data model, matching, and communication.¹⁶ Several opportunities for further harmonisation have also been identified, eg streamlining the handling of corporate actions and national central banks' collateral management procedures.¹⁷

¹⁵ The Finnish national user group (T2S FIN NUG) is headed by the Bank of Finland and includes representatives (ca 60) from a wide range of interest groups.

¹⁶ See T2S User Requirements, Annex 15, T2S Issue Note – Harmonised Features.

¹⁷ See T2S User Requirements, Annex 16, Issue Note – T2S Opportunities for further harmonisation.

Harmonisation will clearly bring benefits, but naturally all participants will not benefit to the same extent and the costs of adjusting may be higher for some markets. It will be interesting to see what the golden mean will be.

Direct holding – part of core services

In terms of the registration of holdings, the markets can be divided roughly into direct holding and multi-tier holding systems.¹⁸ Beyond the division into two types of models, the models for direct holding in particular have special national operational characteristics related to eg the settlement model and account structure.¹⁹

Neither of the models can however be seen as a special national characteristic. As a result of fruitful interaction between the market participants of various countries, solutions have been found to support both holding models as part of T2S core services. Nevertheless, difficult areas of harmonisation still lie ahead before that individual markets can adopt the proposed solution.

¹⁸ Legal differences in holding models are described in a publication by the Ministry of Finance 'Arvopaperien moniportainen hallinta' (Multi-tier holding of securities; in Finnish only) and at www.unidroit.org

¹⁹ T2S User Requirements, Annex 14, Issue note – settlement of direct holdings in T2S.

4.2 Changes in collateral framework have not affected the adequacy of payment system liquidity

Kristina Rantalainen

Since 1 January 2007, bank loans have been accepted as collateral for Eurosystem intraday credit and monetary policy operations. The eligibility criteria for banks' certificates of deposits changed on 1 June 2007. The changes have not reduced the Bank of Finland's payment system counterparties' liquidity adequacy.

Eurosystem central banks grant banks liquidity via monetary policy operations and as intraday credit in order to ensure smooth payment flows. On 1 January 2007, the Eurosystem collateral framework was revised with the introduction of a single list of collateral.

Changes in eligible collateral

In the new framework, assets eligible as collateral include bank loans ("credit claims") to non-financial corporations and other entities with a high credit ratings²⁰. For banks, bank loans are good collateral for central bank financing because they cannot be used as collateral for other purposes. On the other hand, in operational terms, their use is more difficult than the use of book-entry securities.

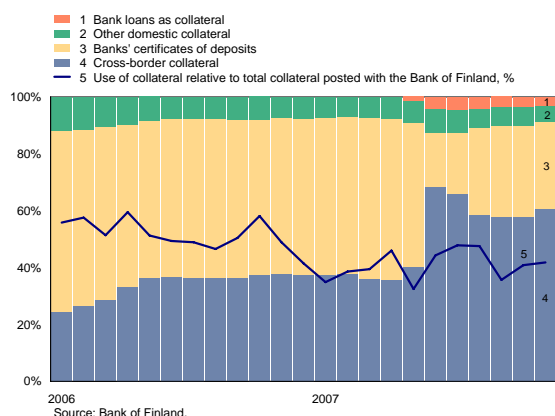
²⁰ Assets accepted as collateral and collateral management are described in Bank of Finland rules for counterparties and account holders, available on the Bank of Finland website http://www.bof.fi/en/julkaisut/ohjeet_ja_saannot/vastapuoli/index.htm

Another amendment, affecting particularly Finnish banks, involved the **eligibility criteria for banks' certificates of deposits**. As of 1 June 2007, debt securities issued by banks must be **listed on regulated markets**, eg on the Helsinki Stock Exchange. On the other hand an issue- or bond-specific credit assessment is not longer required; **an assessment of the issuer's credit standards** is sufficient.

Banks adapted successfully

In recent years, certificates of deposits issued by banks have accounted for more than half of the collateral posted with the Bank of Finland. As a result of the amendments to the eligibility criteria at the start of June, the share of certificates of deposits issued by banks in total collateral decreased to 12.5%; by the end of November, but it has since rebounded to 20% (Chart 8). Initially, banks replaced certificates of deposits mainly by increasing the use of cross-border collateral. Thus far the use of bank loans as collateral has been quite modest in Finland.

Chart 8. Collateral posted with the Bank of Finland and the use of collateral



In the Finnish banking system, the adequacy of collateral has been good since the start of stage three of the economic and monetary union. Harmonisation of the collateral framework in the Eurosystem has thus not affected the liquidity of payment systems.

The collateral management model applied by the Bank of Finland is so flexible that it is profitable for counterparties to keep their domestic eligible assets in a collateral account with the Bank of Finland. In 2007, on average ca two-thirds of the collateral posted with the Bank of Finland (Chart 8) was used as collateral for monetary policy operations or intraday credit. The proportion of banks' total collateral needs deriving from intraday credit connected with payment flows is much higher than that required for monetary policy operations.

4.3 Increased benefits from the single market – Commission launches new initiatives to increase competition in retail banking

Päivi Heikkinen

The European Commission aims to improve the realization of benefits of the single market. To this end, it prepared an extensive list of concrete initiatives for diverse areas of life, including retail banking.

The communication 'A single market for 21st century Europe'²¹ issued by the Commission in November discusses the realization of benefits gained from the single market, particularly from the viewpoint of citizens and small and medium-sized businesses: how

²¹ A single market for 21st century Europe (2007), http://ec.europa.eu/citizens_agenda/index_en.htm.

to improve services, prices and safety of goods and services, take advantage of the opportunities of globalisation, foster knowledge- and technology-based efficiency, and promote social and environmental wellbeing. Today, efficient banking services are essential for consumers and for the performance of the whole economy. Interbank competition improves the availability, quality and price of services. The Commission has published a background paper on initiatives to improve competition in retail banking.

If switching banks is easy, the customers can easily force the banks to compete. The Commission wants to prohibit the imposing closing fees in connection with switching banks. The Commission also requires that banks establish best practices to ensure that a customer's standing orders²² and direct debits will be redirected to the customer's new bank. At present, this is the responsibility of the customer.

The use of banking services should not be restricted based on customer's residence. If realised, this initiative would facilitate the opening of an account in a foreign bank. Opening an account however requires reliable customer identification methods. Currently, there are not many general online identification methods available which would enable the opening of an account without visiting the bank branch.

A bank may refuse to offer services if it cannot check the customer's credit data. The Commission paper thus proposes that customers 'carry' their credit data with them. This could be realized either by giving all credit institutions access to credit records or by enabling the customer to transfer credit data to the new service provider.

Many countries have various rules and regulations that restrict the provision of certain banking services to

customers. The Commission intends to examine whether we need separate 'European services' that could automatically be offered in all EU member states.

The Finnish Credit Institutions Act, enacted some years ago, includes provisions on citizens' right to basic banking services. The Commission wants all Europeans to have to this same basic right. For example in the United Kingdom, ca 2 million households do not have a bank account.²³

Many of the Commission's initiatives require regulation. The Commission is also prepared to act in this regard.

²² Eg wages and salaries and pensions.

²³ finextra (2005), <http://www.finextra.com/fullstory.asp?id=14295>

5 Key corporate arrangements and events in the financial sector

<i>Date</i>	<i>Event and description</i>
May 2007	<p><i>The Icelandic bank Straumur-Burdaras Investment Bank hf acquires a majority stake in eQ Corporation, for EUR 260 million.</i></p> <p><i>UniCredit SpA acquires Capitalia SpA for EUR 21.8 billion. The new bank will be the largest in Italy and the second largest in Europe.</i></p> <p><i>Banca Popolare di Milano acquires Banca Popolare dell'Emilia Romagna for EUR 5.7 billion.</i></p> <p><i>S&P raises Metso Corporation's short- and long-term credit rating by a grade. Short-term from A-3 to A-2 and long-term from BBB- to BBB.</i></p> <p><i>Royal Sun & Alliance Insurance Group offers DKK 6.4 billion for the remainder of shares in Codan A/S.</i></p> <p><i>The boards of directors of Nasdaq Stock Market Inc and OMX AB jointly announce that they have entered into an agreement to combine the two companies.</i></p> <p><i>E. Öhman J:or Securities Finland Ltd acquires Quorum Fund Management Company from its parent company Quorum Ltd. The new name of the fund management company is E. Öhman J:or Fund Management Finland Ltd.</i></p> <p><i>The US private equity firm Cerberus Capital Management acquires a 90% stake in the Austrian bank BAWAG.</i></p>
June 2007	<p><i>London Stock Exchange and Milan stock exchange (Borsa Italiana) announce plans to merge. The merger was completed at the beginning of October.</i></p>
July 2007	<p><i>Deutscher Sparkassen- und Giroverband purchases majority stake in Landesbank Berlin, for EUR 5.3 bn, as the City of Berlin sells its 81% stake.</i></p> <p><i>Deutsche Bank AG announces it will acquire Abbey Life Assurance Company Ltd from Lloyds TSB Group.</i></p> <p><i>S-Etuluotto Oy, established in 1999, merges with S-Bank Ltd.</i></p>

<i>Date</i>	<i>Event and description</i>
August 2007	<p><i>Landesbank Baden-Württemberg to buy Sachsen LB. Sachsen Finanzgruppe and the state of Saxony, the current owners of Sachsen LB, sell their stakes to LBBW and become joint owners of LBBW. Sachsen LB will be a subsidiary of LBBW.</i></p> <p><i>Lansbanki Islands opens branch in Helsinki.</i></p>
September 2007	<p><i>The name of OP Bank Group is changed to OP-Pohjola Group, and OKO Bank Plc will be changed to Pohjola Bank plc at the start of March 2008.</i></p> <p><i>Northern Rock forced to apply for emergency funding from the Bank of England due to liquidity problems.</i></p> <p><i>Norwegian financial services company Storebrand ASA announces it will acquire Handelsbanken's insurance subsidiary SPP, for EUR 1.9 bn.</i></p> <p><i>Aktia Corporate Finance Ltd starts operations.</i></p> <p><i>Kaupthing Finans opens a branch in Finland.</i></p> <p><i>Handelsbanken seeks permission of the Swedish financial supervision authority to merge Stadshypotek Bank with Handelsbanken.</i></p> <p><i>Moody's lowers M-Real Corporation's long-term credit rating from B2 to B3, and revises the rating outlook to negative in October.</i></p> <p><i>Metso Corporation delists from the New York Stock Exchange.</i></p>
October 2007	<p><i>S-Bank commences operations.</i></p> <p><i>Glitnir Bank (former FIM Securities Ltd) starts operations.</i></p> <p><i>The Financial Services Authority (FSA) of the United Kingdom increases the limit of Financial Service Compensation Scheme cover for deposits to 100% of the first GBP 35,000 of each depositor's claim. The previous cover for deposits was 100% of the first GBP 2,000 and 90% of the next GBP 33,000 of depositors' claim.</i></p> <p><i>Nasdaq announces it will acquire the Boston Stock Exchange.</i></p> <p><i>Nordea purchases ca 70 branches from Svensk Kassaservice, and will turn them into Nordea offices in 2008.</i></p> <p><i>ABN Amro completes sale of LaSalle Bank to Bank of America at the beginning of October.</i></p>

<i>Date</i>	<i>Event and description</i>
October 2007	<p><i>NetBank Inc. (established in 1996), the first US online bank, goes into liquidation. Ing Direct acquires NetBank's deposits of USD 1.4 bn for USD 14 million, and EverBank purchases NetBank's mortgages for USD 700 million.</i></p> <p><i>The Association of Local Cooperative Banks and its 42 members, and the Finnish Savings Banks' Association and its 39 members, together with Aktia Savings Bank, announce they will establish a new payment centre in Finland.</i></p> <p><i>Kaupthing Bank Luxembourg S.A announces it will acquire Robeco Bank Belgium.</i></p> <p><i>NYSE Euronext, BNP Paribas and HSBC announce they will launch a multilateral trading facility, SmartPool, for block trading of European listed shares, in line with provisions of the Markets in Financial Instruments Directive (MiFID).</i></p> <p><i>Moody's upgrades Metso Corporation's long-term credit rating by one grade, from Baa3 to Baa2.</i></p> <p><i>S&P lowers Fingrid Oyj's credit ratings by one grade, from A-1+ to A-1, and from AA- to A+.</i></p> <p><i>S&P lowers UPM-Kymmene Corporation's short-term rating from A-2 to A-3. Long-term rating remains unchanged, at BBB; but the outlook is negative.</i></p> <p><i>S&P lowers Stora Enso's long-term rating from BBB to BBB-; outlook negative. Short-term rating remains unchanged, at A-3.</i></p> <p><i>S&P lowers M-Real Corporation's long-term rating from B to B-; outlook stable.</i></p>
November 2007	<p><i>The Markets in Financial Instruments Directive (MiFID) takes effect on 1 November.</i></p> <p><i>Nasdaq to acquire the Philadelphia stock and derivatives exchange.</i></p> <p><i>OMX signs an agreement on acquisition of the Armenian Stock Exchange and the Central Depository of Armenia.</i></p> <p><i>Authorities approve merger between Oslo Stock Exchange and Norwegian Central Securities Depository.</i></p>
December 2007	<p><i>UPM-Kymmene delists from the New York Stock Exchange.</i></p> <p><i>The Deposit Guarantee Fund of Finland approves Kaupthing Bank Oyj as a member of the deposit guarantee fund. Kaupthing Bank Oyj will merge with its parent company Kaupthing Bank hf.</i></p>

<i>Date</i>	<i>Event and description</i>
<i>December 2007</i>	<i>Eirikuva Digital Image Oyj Abp is the first Finnish company listed on the First North marketplace.</i>
	<i>Fitch confirms Finland's long-term rating at AAA.</i>