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Finnish banking sector still sound, but financial market disruption is fuelling uncertainty

Origins of crisis in reckless mortgage lending

Going on for 20 years ago the Finnish banking sector was in crisis. The crisis was preceded by a strong increase in lending, which translated into rising lending rates, falling housing prices and borrowers' difficulties in servicing housing loans. The United States is now faced with a similar situation. The Finnish banking sector's problems of the early 1990s did not shake the global economy much, unlike those of the US banks currently. The problems originating in the US mortgage markets have driven global financial markets to great difficulties and the US economy close to recession, which is expected to lead to a fall in global economic growth.

From bold risk-taking to lack of trust

A year ago financial markets were still characterised by ample liquidity, the low price of liquidity, investors' appetite for risk and new complicated investment products that helped to diversify the risk broadly and out of sight. When the US subprime borrowers were no longer able to make their mortgage payments, the risk diversified throughout the markets surfaced, but its exact location and magnitude remained concealed.

Since banks were not able to assess the degree of risk in the investments other banks had made, they failed to trust one another and were therefore reluctant to lend money in the interbank money markets. Money markets dried up and so therefore did investment markets. The situation has been aggravated by the fact that banks have had to lay aside liquidity as a preparatory measure for their own needs, which means that they have cut lending in the money markets.

Several American and some European banks have had to record massive losses on securitised mortgages and mortgage derivatives. Increased risk premia and the drying up of some market segments have also led to writedowns on other investment instruments than just securitised mortgages. Losses due to writedowns have pushed some large commercial and investment banks deep into the red.

Finnish banking sector remains stable

The stability of the Finnish banking sector is not threatened. In the next few years banks are unlikely to reach past years' record results, but financial results will remain clearly positive. Supervisory assessments conducted by the FIN-FSA indicate that supervised entities' own funds are at a comfortable level, but there is scope for improvement in risk management.

The supervisory assessments reveal that banks' credit risk positions and strategic risk were mainly regarded as moderate and market risk positions low. However, financial conglomerates' market risk positions were considered passable. Wide investment activity in the insurance business constitutes a considerable risk factor for conglomerates, and the financial market disturbance has already partly made this risk tangible.

Owing to several uncertainties relating to the financial markets, the long-term outlook remains partly unclear. Factors supporting banking sector stability also raise cause for concern, which should not be taken lightly.

No major changes in credit risks reliant on economic development

Trust in the stability of the banking sector is underpinned by expectations that economic growth will not slow drastically in Europe. What lies ahead also in Finland is a period of weaker growth than observed in recent years, but still, expectations are that the economy will grow, employment will improve, earnings levels will rise and exports will develop at a reasonable pace. Under these conditions loan customers should generally be able to service their debt. Banks' own stress tests indicate that banks' own funds are at an adequate level and the whole sector would remain in profit even if GDP were to decrease for three consecutive years.

Increased market uncertainty has induced companies to resort to greater borrowing from banks. There is no specific sector that would constitute a clear problem due to nonperforming loans, but from capital intensive sectors, forest industry is exposed to several external factors. Should economic growth be considerably weaker than prospected, credit risk would manifest itself largely through corporate credit.

Nonperforming household credit is not expected to threaten banks' risk-bearing capacity in the next few years. Low activity in the US real estate markets and the surfacing of difficulties in Europe (the UK, Spain and Denmark) are factors that also contribute to higher uncertainty in Finland. Housing loans and prices have also been rising for a long time in Finland, which poses a risk for banks.

Heavy indebtedness and rising interest rates can cause problems for individual households. It is difficult to form a clear picture of households' debt servicing problems since banks grant payment-free periods relatively automatically if the customer is able to service at least the loan interest rates. Consequently, debt servicing problems can continue for a long time before they can be seen in an increase in nonperforming loans. This notwithstanding, there has been an upturn in the number of nonperforming loans, although their volume in relation to credit stock is still fairly small.

Relatively small investment writedowns for banking sector to date

Writedowns do not pose a threat to the banking sector stability in the short term either. Compared with many other countries, the problems of the global financial markets have generally caused relatively small writedowns on investments for Finnish banks. Finnish banks' direct investment in subprime financial instruments is very limited. Furthermore, the lower prices of bond investments due to increased credit risk premia do not put any particular strain on the banking sector's risk-bearing capacity either.

The financial market disturbance has led to the partial drying up of bond markets and markets for structured investment products as well as increased risk premia. Finnish banks have fairly little holdings in these investments on their balance sheets. Because of the liquidity crunch, it has not always been possible to find a public price quote for all investment products, which has made value determination difficult. Indeed, valuation of investments has been a topic for supervised entities and supervisors alike.

Unlike banks, insurance companies and consequently financial conglomerates have invested considerable amounts in bonds and structured products, both directly and indirectly eg through hedge funds. Insurance companies' investments are also, as a whole, riskier than investments in banks' liquidity reserves.

Banks' liquidity situation has remained good

The stability of the banking sector is also underpinned by banks' good liquidity position. Finnish banks have benefited from a sound reputation and increased deposits. Rising market interest rates, new competitors and higher price of market-based funding have had a major impact on the commencement of competition on deposits. At the same time, market uncertainty has contributed to the shift of investments from investment funds and equity to deposits.

Strong increase in deposits has kept banks partly overliquid, and so far banks have not had to resort to long-term and expensive market-based financing. On the other hand, the structure of financing has been dominated by short maturities. Finnish banks are generally regarded as reliable, which means that funding costs remain tolerable compared with several other countries. They are, however, clearly higher than before.

The FIN-FSA has long been concerned about the risk caused by narrow housing loan margins on profitability in a situation of rising funding costs. Unfortunately, the FIN-FSA's concern appears to be materialising now, since the price of both market and deposit funding has risen and net interest income is taking a downward trend.

Restoration of trust vital

A great deal of similarities can be detected in the Nordic banking crisis of the early 1990s and the US banks' current problems. It is therefore no wonder that the Nordic crisis is used as a benchmark for the current one.

It would be desirable for the global economy in general that financial markets calmed down and trust was restored among money market participants.

The ongoing financial market disruption is an example of how fast problems spread currently from one country to another. This underlines the importance of international supervisory cooperation further.

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Supervised entities' operating environment

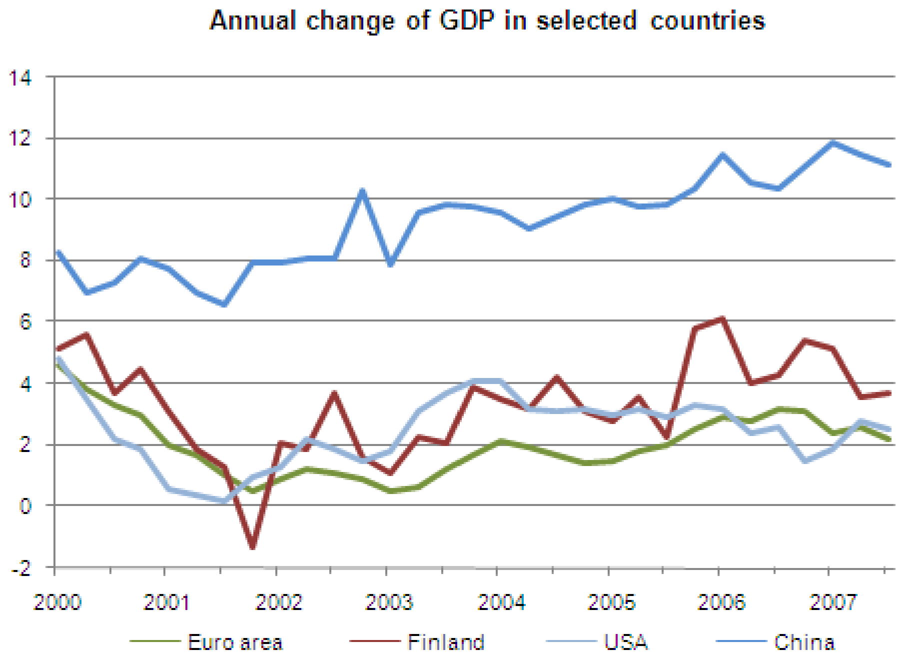
Impact of operating environment on supervised entities

The crisis that originated in the US housing and credit market has spread to global financial markets, and its implications are already reflected in real economic growth forecasts, even outside the US. In the Finnish financial markets, the situation is particularly felt as tighter liquidity conditions, wider credit risk margins and heightened nervousness in securities markets. Finnish banks' operating environment is still restrained, however, despite the deteriorating outlook.

World economic growth decelerating

Housing prices have fallen strongly in several US regions. This, together with troubles in the financial markets, has been reflected in the US real economy that is, if not already in recession, at least close to it.

The European mortgage markets appear to have suffered less overreaction than the US mortgage markets, but the risk of falling prices has nevertheless increased. The turbulence in the financial markets has also affected business confidence figures. They could also influence consumer consumption through the wealth effect. Higher inflation has weighed on private consumption.



Source: Bloomberg.

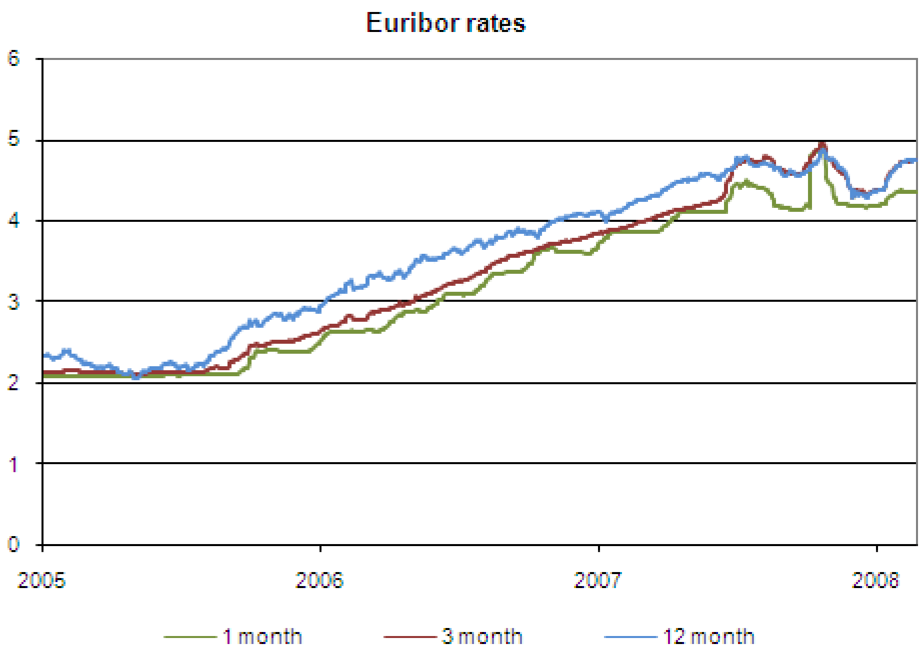
Moderation of world economic growth has diminished Finland's growth prospects

Economic growth in Finland was high in 2007, with GDP increasing by about 4 percentage points. Growth was fuelled by private consumption in particular. Favourable developments in the labour market continued, and consumers' confidence in their own economic situation remained strong. Besides a weaker global economic outlook, economic growth was overshadowed by the pickup in inflation in Finland towards the end of the year.

Economic growth is expected to slow in 2008, but there are, at least yet, no signs of a drastic change. Slackening global economic growth is expected to translate into declining exports. Construction investment is expected to continue developing along two diverging lines, with residential construction contracting and non-residential construction expanding.

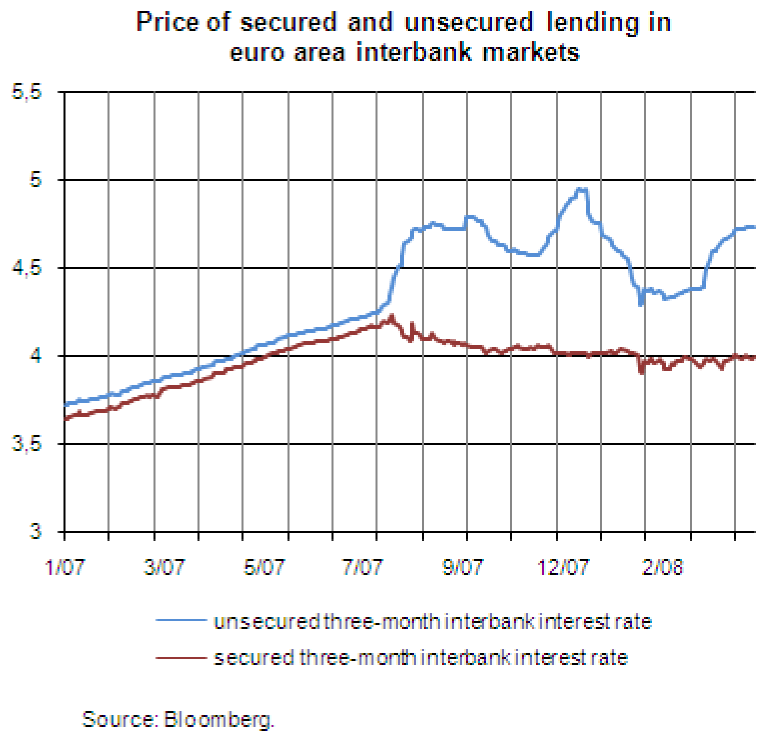
Strong liquidity disruptions in interest rate markets

Nervousness, originating in the US mortgage market has been reflected in interest rate markets, which have experienced some exceptionally strong occurrences. Until August 2007 money market rates were on a rising trend, but as unfavourable news on subprime accumulated, interest rate markets fell into turmoil on account of prevailing uncertainty.



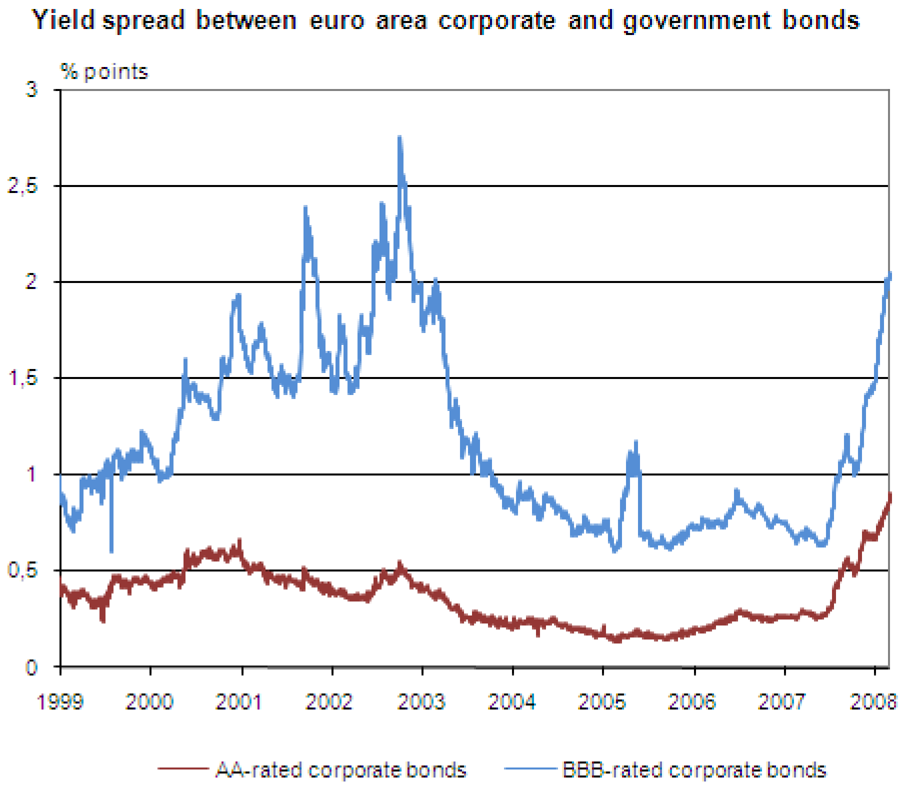
Source: Bank of Finland.

The Chart below shows how strongly interest rates on unsecured interbank lending reacted to the events of August 2007. While the spread between secured and unsecured lending had earlier been less than 10 basis points, it soared to 90 basis points at the turn of the year. The markets calmed down momentarily in January-February, as the normally less liquid period passed but owing to the continuation of uncertainty in March the spread has widened again rapidly.



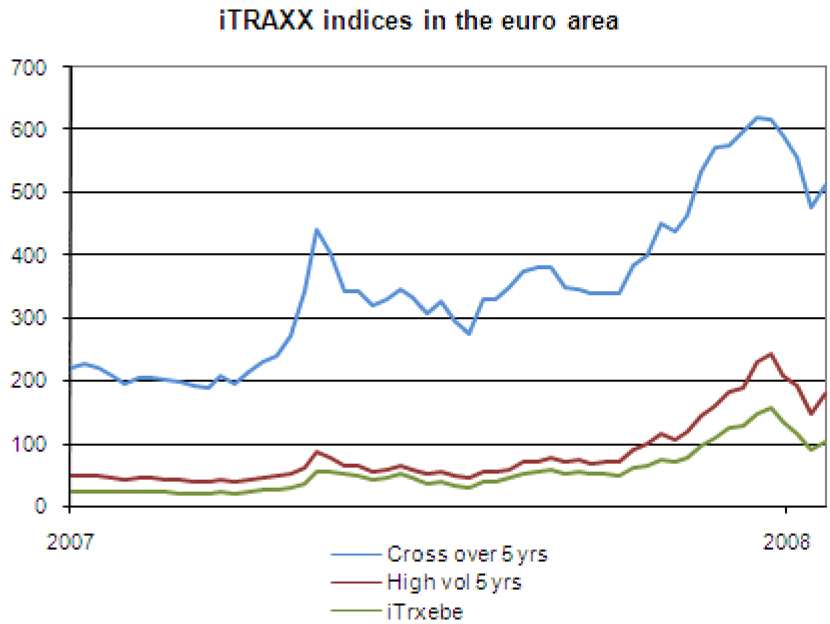
Nervousness in corporate bond markets

Risk premia increased strongly in corporate bond markets. The Chart below shows the yield spread between certain corporate bonds (AA and BBB rating) and government bonds. Yield spreads had been relatively narrow from the bursting of the IT bubble to early 2007, but interest rates on corporate bonds took a sharp upturn again in summer.



Sources: Bloomberg and JP Morgan.

CDS markets, used for pricing and transferring credit risk relating to investments between market participants, have received particular visibility during the year. Corporate credit risk premia priced in the euro area CDS markets have also increased since the turn of the year in particular. iTRAXX indices track credit risk margins calculated from CDSs of European companies operating in different sectors. The main index includes 125 investment grade companies from six different sectors. The Crossover index composed of low-rated companies (40 sub-investment grade companies) has risen strongly, which reflects the repricing of risks in the market.



Source: Bloomberg.

In terms of sectors, financials in particular have been traded actively in the CDS markets.

Money market rates expected to decrease

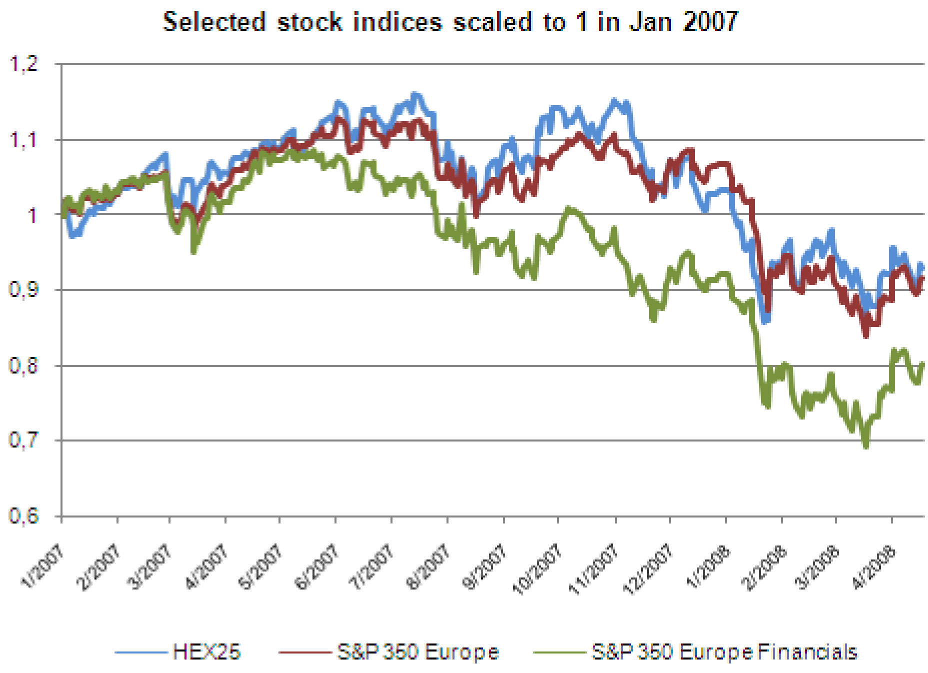
Interest rate expectations derived from market prices have recently fluctuated considerably in line with published data and market turbulence.

On 18 March the US Federal Open Market Committee cut the federal funds rate by 75 basis points to 2.25% and left the door open for possible further interest rate cuts. On the basis of market pricing, interest rates are expected to fall further.

For the time being, interest rates are clearly higher in the euro area, since the ECB minimum bid rate has been around 4% since June 2007. Unsecured interbank money market rates (Euribor rates) have remained well above this level (around 4.5–4.7%) on account of a lack of trust between banks.
On the basis of estimations derived from market interest rates, markets do not consider it probable that euro area short-term market rates (3-month Euribor rate) would rise to over 5% next year. Rather, markets expect interest rates to fall slightly. However, it is still wise to be prepared for other kinds of interest rate scenarios.

Some correction in the stock markets

Ample liquidity situation and investors' risk appetite have been reflected in growing numbers of capital investors and, in general, increased amount of high leverage buyouts. This development has fuelled stock prices in recent years. Stock prices have also benefited from strong improvements in corporate results; for instance in the US the share of profits to GDP jumped to record high.



Source: Bloomberg.

Volatility and risk awareness returned to the markets with the subprime crisis. Risk premia in particular were increased, and profit forecasts were reduced. Financial enterprises have naturally been hit hardest by the turbulences. The results of some of these enterprises have weakened considerably on account of writedowns.

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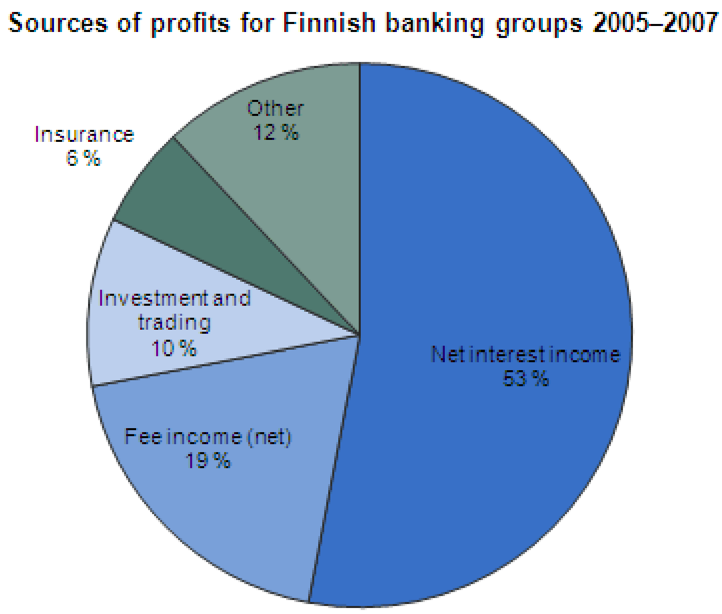
Bank profits hit records, but growth took a downturn

Profits increased by over one fourth - growth eased

Total operating profits for Finnish banking groups were record high in 2007. Income continued to grow at a solid pace and expense growth remained contained. Finnish banks had no subprime investments on their balance sheets. Without loan losses weakening the results, banks earned on average over double the amount for each euro spent.

Even so, operating profit growth faded during the year, leading to a slower overall growth compared with the previous year.



Source: Financial. Supervision Authority.

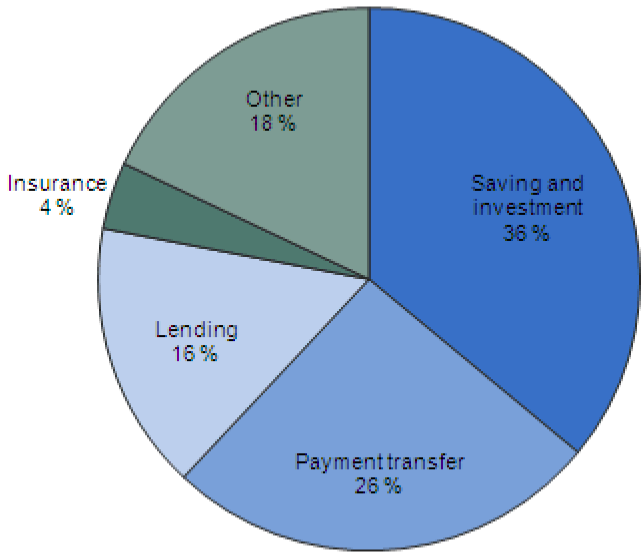
Financial crisis dims outlook for financial intermediation and investment services

Growth in fee, investment and other income moderated during the year for the majority of banking groups. Income from investment and trading even turned negative for some banks in the last two quarters of 2007. Fee income growth eased also in annual terms, but was higher than ever in the last quarter. Rapid growth in fee income on end-2006 resulted from strong growth in redemptions of securities and fund units by customers, fuelled by increased uncertainty about investment earnings amid continued financial crisis.

This profound change in customers' savings behaviour led to a rapid growth in bank's deposit stocks at the end of the year. Even though deposits facilitate acquisition of funding and liquidity management for banks, fee income losses easily weigh more over time than the advantages reaped from deposits. It is not yet clear how long the crisis will last, but market sentiment does not turn in a minute, nor is it easy to revive interest in investment. Public awareness of the cost of savings and investment products can also change if earnings prospects no longer reach levels observed in past years.

Loan losses again remained very small in relation to banks' results and the size of credit stock. However, there has been a trend increase in household loan writedowns in relation to credit stock in the past 2 to 3 years.

Sources of fee income for Finnish banking groups 2005–2007



Source: Financial Supervision Authority.

Although net interest income has accounted for a decreasing proportion of banks' profits in recent years, gradual moderation of net interest income growth was the main contributor to the downturn in income growth. The margin between average interest rates on lending and deposit stocks ceased to widen further already in early 2007 and began to narrow towards the end of the year. This development mainly mirrored a normal phenomenon during an upturn in the interest rate cycle, when interest expenses, rising with a time lag, begin to catch up with interest income growth. The financial crisis also contributed to the narrowing of the lending and deposit stock margins in the second half of 2007. The relative share of fixed-term deposits increased slightly, and their interest rates rose as well. In addition, the increase in the price of market-based financing (approx. 30% of lending is funded by market-based financing) was already reflected in rising interest expenses.

The volume of lending grew at a relatively even pace over the year. Growth moderated at the beginning of the year due to ongoing gradual weakening of development in the stock of credit to households. As a result of the financial crisis, interest rates on enterprises' own loan emissions rose fast, making bank lending a more profitable alternative. At the end of 2007 growth in credit to enterprises picked up, compensating the moderation of household loan markets.

Financial results hardly to improve this year

When interest rates began to rise two and a half years ago, bank's profits surged. The margin between deposit and lending stock widened. In addition, the cost of market-based funding remained relatively low, thanks to Finnish banks' good reputation and also of their mortgage banks. At the same time, the stock of household credit continued to expand strongly and demand for investment services increased.

The widening of the deposit and lending stock margin halted in 2007, already before the financial crisis started. This crisis will add to the uncertainty over funding costs and financial intermediation volumes in the near future. The profitability of lending to households in particular can weaken, although, on the other hand, banks could benefit from the recovery of credit to enterprises.

How profitable various saving and investment products are depends on the depth and length of the crisis. If the number of assignments falls and the value of assets under management does not soon rise to the level of summer 2007, fee income growth will also fade out. Weakening of return expectations can also affect public awareness of prices and competition in the savings product market.

Banks' profitability and efficiency have, nevertheless, become very high in recent years. Profit levels are also expected to remain clearly positive this year, even though it is probable that the former record results will not be topped.

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Finnish banks are financially sound

When comparing capital adequacy figures it has to be kept in mind that the 2006 figures for the entire sector were calculated on the basis of old capital adequacy regulations (Basel I). Of the large banks, OP-Pohjola Group and Sampo Bank still last year applied the old regulations. It is only this year that the entire sector applied the new regulations.

Banking sector dominated by a few operators

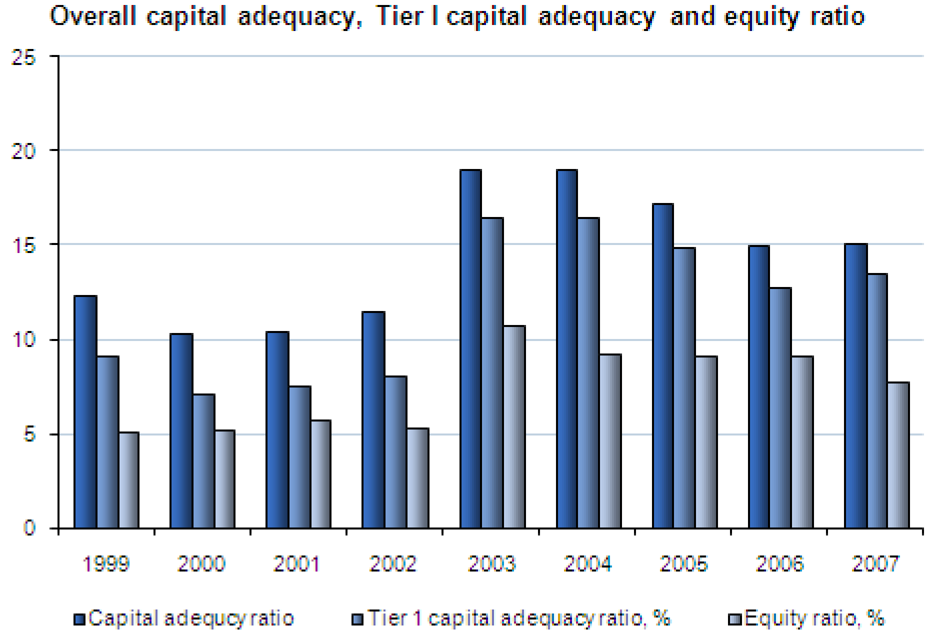
The capital adequacy figures for Finland include all domestic savings banks and the Finnish subsidiaries of foreign savings banks. In practice, Finnish figures are dominated by a small number of banking groups. For example, Nordea Bank Finland accounts for more than 50% of the banking sector's own funds and requirements for own funds. Moreover, the three biggest operators account for more than 90% of the banking sector's own funds and requirements for own funds.

Modest changes in banking sector capital adequacy

The switch to Basel II has not caused any major irregularities because the process is still under way and the regulations currently in force are so called floor provisions which exclude large decreases in capital adequacy for a period of three years (see FSA Newsline 4/2007). In the long run, the transition to Basel II should, in most cases, reduce the need for capital and thus improve key figures. On the other hand, the capital requirement for operational risk will be introduced as a completely new element. To facilitate comparison, Chart 1 also shows equity ratio, the calculation of which has not been changed because of the Basel II reform.

The recent market turbulence has not had any major adverse impact on Finnish banks' capital adequacy. Nearly all Finnish banks have avoided large write-downs in connection with the subprime crisis.

The capital adequacy ratio for the entire banking sector has hovered around 15.1%. Tier I capital adequacy ratio in turn rose from 12.8% to 13.5%. Accordingly, capital adequacy of the Finnish banking sector is still very good.

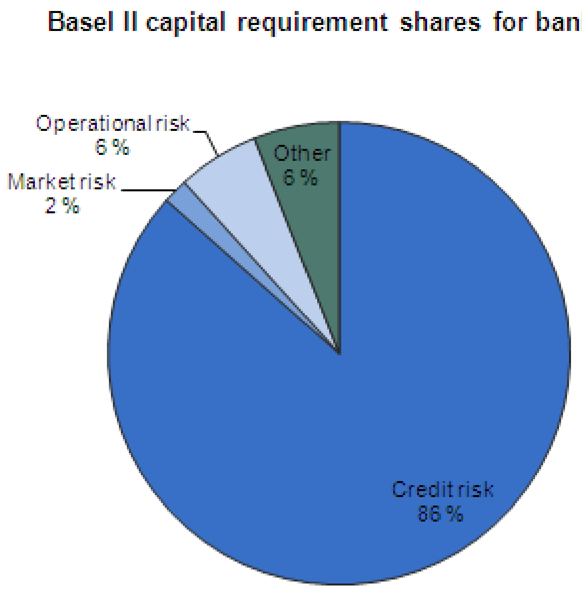


Source: Financial Supervision Authority.

Variations were observed in capital adequacy at the banking group and conglomerate level. Finnish banking conglomerates' capital adequacy is nevertheless sufficient, because it has not fallen below the conservative levels of 10% (for overall capital adequacy) and 6% (for Tier I capital adequacy). The minimum requirements are 8% and 4%, respectively.

Quality of own funds remained good

The quality of banks' own funds remained good. The majority of own funds are primary own funds and their share increased from last year.



Source: Financial Supervision Authority.

Capital requirement for credit risk fell

The minimum requirement for Basel II banks is dominated by the credit risk requirement that accounts for nearly 90%.

In 2007, large banks could not yet derive any significant benefit from the subsiding capital requirements on credit risk introduced in the wake of Basel II. Nordea Bank Finland was the only bank allowed to apply the internal ratings based approach (IBRA) to a part of its exposures. Small banks that primarily introduced the Basel II standard with effect from the beginning of 2007 only benefited from the lower capital requirement for mortgage-backed bonds (housing loans).

According to a survey conducted by the FIN-FSA in autumn 2007, banks have not yet introduced the techniques available in Basel II for the reduction of credit risk in capital adequacy calculation, except for mortgage-backed securities.

Capital requirements for market risk on a slight increase

The amount of own funds required to cover market risk has followed an uneven path but has for most been on the increase in 2007. Capital requirements for market risk are small in comparison to capital requirements for credit risk.

The requirement for own funds to cover exposure to market risk has accounted for less than 2% of own funds for banks actively engaged in trading. For banks engaged in investment service, the capital requirement for market risk is proportionately higher relative to deposit banks, because there is less lending. Whether a requirement is divided into a requirement for credit risk or a requirement for market risk is also affected by whether relatively large liquidity buffers for debt securities are entered under financial activities or trading stock.

Application of capital regulations for operational risk can be supervised

The capital requirement for operational risk is derived by applying a weigh of 0.15 to the average of balance-sheet items from three previous financial reports included in the so-called yield indicator. Depending on the size and nature of the supervised entity's business, the relative share of the capital requirement for operational risk out of the total requirement varies greatly In one deposit bank, the capital requirement for operational risk was approximately EUR 504 million and total capital requirement some EUR 5,330 million, compared to EUR 10 million and EUR 20 million, respectively, in a supervised entity with a much smaller volume of business.

The introduction of new capital adequacy requirements has been smooth in supervised entities. The FIN-FSA has not had to take any material corrective action with respect to capital adequacy calculations, and there have been no major interpretation problems of the regulations. However, the FIN-FSA does pay continuous attention to the improvement of the capital adequacy management process at supervised entities.

Financial and insurance conglomerates dominated by the banking business

The end-of-year 2007 figures for the financial and insurance conglomerates include OP-Pohjola Group and Aktia. In 2008, Tapiola General insurance company reported capital adequacy data broken down into financing and insurance. Tapiola General is insurance-dominated and increases the insurance business of the conglomerates' aggregate capital adequacy requirement.

At the end of last year, Finnish conglomerates were largely dominated by banking, while the credit institution business accounted for some 89% of the total requirement for own funds. In the insurance business, 6% of the total requirement for own funds came from life insurance and 5% from non-life insurance. The capital adequacy of the conglomerates was sufficient, with the capital adequacy ratio for the entire sector being 1.51 (minimum requirement 1).

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Lending growth exceeds the 2006 level, non-financial corporations' and households' problems loans on the increase

Lending growth exceeds the level in 2006

Total demand for credit in 2007 slightly exceeded the growth rate in 2006, to stand at 11.7% (11.5% in 12/06) at the end of the year. Demand for housing loans and consumer credit continued to grow, albeit at a slower rate than in its peak in 2005–2006. Household credit grew by 11.2%, year-on-year. In contrast, the rate of growth in corporate credit accelerated towards the end of the year, and the annual growth rate reached 12.9%. At the end of the year, households accounted for approximately 61% of MFI lending (EUR 141.5 bn). The proportion of corporate credit has grown slightly, to 34%.

Increasing uncertainty in the housing market

Continuing low interest rates, despite the rise in interest rates, and long maturities on housing loans have in the past few years boosted households' activity in the housing market, which has fuelled demand and driven up housing prices. Demand for housing was further boosted by sustained favourable developments in households' income and employment.

There is however growing uncertainty in the housing market. The rise in interest rates and housing prices has already slowed the growth in the demand for housing loans. House buyers have become increasingly price conscious and cautious, which has slowed the rise in prices and extended the average selling period. The slowdown in the housing market is also reflected in the lower asking prices and sales prices in some areas and unsold new housing in growth centres. Buyers' behaviour may also be affected by the growing impact of the US housing market crisis and the slowing growth rates in the stock market.

Slowing demand for household credit

At the end of 2007, housing loans again accounted for a record proportion (EUR 62.2 billion) of the stock of household lending (EUR 86.6 billion). Households raised EUR 1.7 billion worth of new housing loans in February 2008, which is EUR 0.2 billion more than a year earlier.[1] The annual growth in the stock of housing loans decelerated in 2007 to only 12.4%, from 14% in the previous year. The annual growth in consumer credit eased off by three percentage points on 2006, nevertheless still standing at 7.9% in December.

1 Bank of Finland.

Non-financial corporations' and households' problem loans on the increase

Growth in past due items accelerated, the share of nonperforming assets in the lending stock still low

The amount of banks' past due items (loans overdue for 30–90 days) grew in 2007 by approximately 38%. Their share of the lending stock also increased and was at the end of 2007 on average 0.58% (0.48% in 12/06). Growth in the amount of past due items in the last couple of years anticipates increasing financial difficulties for credit customers and has led banks to adjust their loan repayment programmes. Despite the growth in past due items, nonperforming assets[2] accounted for only 0.28% (0.26% in 12/2006) of the stock of lending at the end of 2007. In euro terms, nonperforming assets grew by 24%, year-on-year.

2 Nonperforming assets = nonperforming assets (overdue for more than 90 days) + guarantee claims + zero-interest assets outside the group.

Upward turn in impairment losses

Net impairment losses weakened banks' results in 2007 by approximately EUR 64 million, whereas at the end of the previous year, impairments were still EUR 52 million positive, due to refunds and reversals. Gross impairment losses (EUR 244 million) represented only 0.16% (0.13% and EUR 175 million in 12/06) of the stock of lending.

Corporate sectors' past due and nonperforming loans on the increase

Banks' claims on non-financial corporations in connection with overdue and nonperforming assets increased on the previous year. At the end of the year, overdue credit accounted for 0.51% (0.38% in 12/06) and nonperforming loans for 0.28% (0.26% in 12/06) of the stock of corporate credit. Measured in terms of nonperforming assets, the stock of corporate credit is still in good condition.
The corporate sector's impairment losses in gross terms were 25% smaller than at the end of 2006, despite the growth in nonperforming assets. Impairment losses (gross) accounted for only 0.17% (0.26% in 12/2006) of the stock of corporate credit.

Real estate financing exposures a major risk

A survey undertaken by the FIN-FSA in summer 2007 showed that the largest Finnish banking groups have significant real estate liabilities. This is reflected in the large amount of liabilities and their large proportion of the banking groups' own funds and exposures. The qualitative risks of real estate financing do not differ from the qualitative risks of other corporate lending, but the size of the exposures, together with real estate collateral and banks' real estate holdings, constitute a considerable risk. Moreover, the real estate sector is tied to the construction sector, which increases the risks. At the end of 2007, the real estate sector accounted for approximately 28% of banks' stock of corporate lending.

Growing number of bankruptcies

In January–February 2008, the number of bankruptcy proceedings initiated increased by approximately 14% on the year-earlier period. The biggest increase, 32%, was witnessed in the trade sector.[3]

Continued growth in payment defaults, number of overdue instant loans has increased

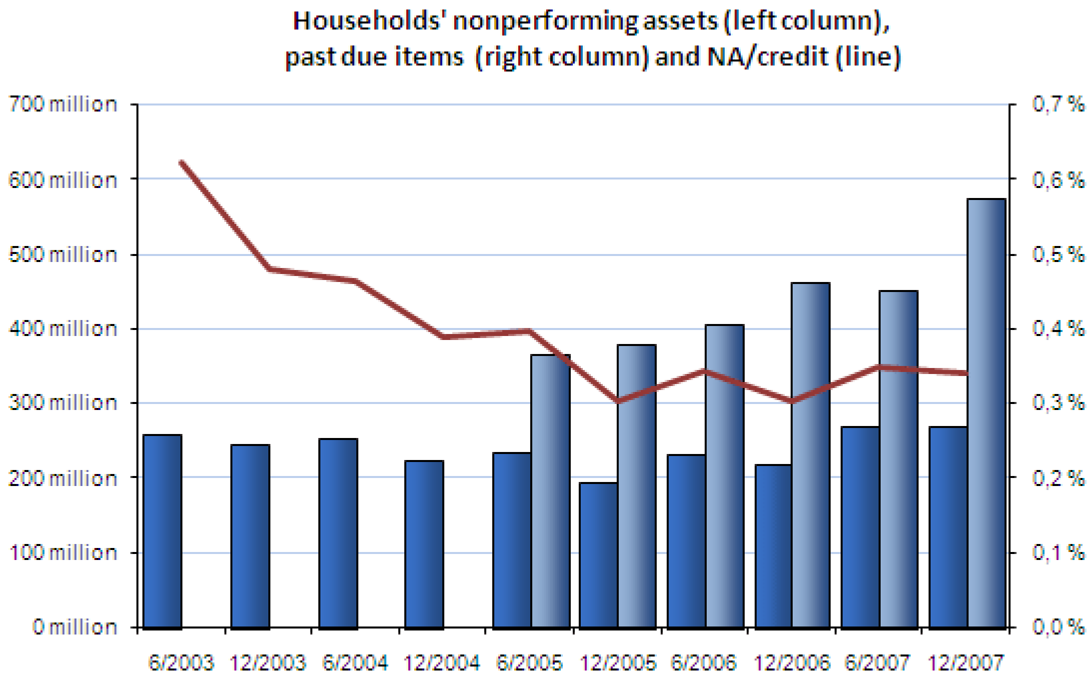
The number of registered new payment defaults by private individuals and non-financial corporations increased in 2007 by one fifth, compared to the previous year.[4] Payment problems are concentrated on the same persons. Although private individuals' payment defaults increased by over 20%, the number of defaulting private individuals increased by less than 1%. The majority of demand-for-payment rulings on running accounts, one-off credits and financial company claims of less than EUR 300 were due to overdue instant credit. Registered new payment defaults by non-financial corporations turned up last year, to a nearly 8% increase, and the number of defaulting non-financial corporations was approximately 5% higher than in 2006.

3 Statistics Finland, press release, 31 March 2008.
4 Suomen Asiakastieto Oy, February 2008.

Household sector's problem loans continue to increase

Households' problem loans have increased for already two years, compared to the turn of the year 2006. In euro-terms, problem loans increased in 2007 by approximately 24%, year-on year. The proportion of past due items in the sector's stock of credit increased to 0.72% (0.64% in 12/06). Nonperforming loans accounted for 0.34% (0.30% in 12/06) of the stock of household credit.

Households' loan servicing capacity does not yet cause considerable problems, measured by the ratio of problem loans and the credit stock. Growth in past due items is however an indication of households' loan servicing problems. At the end of 2007, the household sector accounted for 65% of banks' past due items.



Source: Financial Supervision Authority.

Banks' impairment losses in gross terms due to the household sector increased by one fifth on the previous year, but relative to the stock of household credit, their amount was small, ie 0.08% (0.07% in 12/06).

Household indebtedness record high

Favourable development of the economy has boosted households' confidence in their own economic situation. By the end of 2007, the average debt of a household had however already risen to over 100% of annual disposable income. In the years prior to the most recent recession in the early 1990s, households' debt ratio was 80–90%. As a result of the increase in indebtedness, households' savings ratio turned 3.8% negative, which is record low relative to disposable income.[5]

Despite the rapid rise in the debt ratio, Finnish households' debt ratio is not exceptionally high compared to other countries. Indebtedness is concentrated on young households with a large housing loan.

5 Statistic Finland, press release, 29 February 2008.

Households' loan servicing problems concentrated

Large housing loans and rising interest rates have caused excess indebtedness and loan servicing problems for some households. Debt problems accumulate particularly to households in the lowest income brackets, and rising interest rates have burdened particularly households with consumer credit, which is reflected in the increasing number of payment defaults. The rising cost of living, caused by inflation, together with the ongoing increases in market rates, further weaken the debt servicing capacity of households with a housing loan. Moreover, there may be growing pressure for banks to increase the interest rate margin on loans, due to the rise in banks' funding costs.

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Banks' funding challenges continue

The credit crisis that started in August 2007 from the US subprime loan market has led to a loss in confidence between banks and other market participants. There was an increase in banks' need to store liquidity and their willingness to extend credit to other market participants diminished. These factors have dried up market liquidity, thereby considerably constraining banks' market-based funding. Uncertainty has also continued in early 2008 and is feared to persist.

Funding poses challenges amid ongoing market volatility

The uncertainty caused Finnish deposit banks to strengthen their liquidity buffers during the autumn. Despite the challenging market situation, banks' liquidity has remained good. According to a survey in February, banks have benefited from the flight-to-quality phenomenon, ie thanks to their good reputation they have been able to take deposits and particularly acquire short-term funding. The short-term money market has encountered no major problems: deposit growth that picked up in the latter part of last year has improved banks' liquidity situation and there is also demand both at home and abroad for certificates of deposits issued by banks.

Owing to the high price of long-term funding, Finnish deposit banks acquire long-term funding with caution. But in order to maintain a diversified funding structure, banks have also obtained longer-term funding to a limited extent. In the long run, however, attention need to be devoted to sound funding structures, ie to the share of market-based funding in total funding and to the adequacy of long-term funding. Diversification of funding sources is important, for instance, for the maintenance of good credit ratings. Reliance on mere short-term market-based funding may lead to instability at banks.

Funding via deposits embarked on a strong increase in the autumn

Deposit growth picked up in the autumn and was manifold compared with previous years. Deposits stood at EUR 95 billion in December 2007 (up 13.4% year-on-year).[1] This increase was particularly pronounced in fixed-term deposits, which grew by 43% in 2007, mainly because of lower popularity of mutual funds. Competition over deposits has clearly tightened, and bank margins have narrowed in response to higher costs for deposit funding. Even so, funding via deposits continues to be discernibly cheaper than market-based funding.

Deposits covered 74% of banks' lending to the public and public sector entities. The ratio started to edge up slightly in 2007 following a declining trend in a number of years earlier. The turn of the year ratio was also boosted by the commencement of S-Bank's operations. At the turn of the year, deposits accounted for about 40% of deposit banks' lending.

1 Source: Bank of Finland, Financial Markets - Statistical Review 2/2008.

Long-term market funding has become more expensive

Long-term funding is available, albeit at a clearly higher price. There has been only little issuance of bonds by banks in the course of the autumn and winter. Banks do not however have any acute need for long-term funding and are prepared to face a protracted period of market volatility.

The price of mortgage-backed funding acquired via covered bonds has also risen, but considerably less compared with unsecured bonds. In contrast to asset-backed securities, covered bonds involve responsibility on the part of the issuer, too. The relevant directive contains precise provisions on collateral related to covered bonds. Asset-backed securities are not as transparent as covered bonds and their prices have been significantly affected by market uncertainty about collateral eligible for such securities.

However, growth in funding acquired by Finnish mortgage banks via covered bonds came to an almost complete standstill in the autumn. The share of mortgage-backed funding is however set to grow in the long term, as the stock of mortgages continues to expand. Mortgage banks already play an important role in the funding of housing loans, as at the end of the year more than 9% of the mortgage stock was on the balance sheets of mortgage banks.

Average funding maturity shortened in the autumn

The share of market-based funding levelled off in the autumn, as there was only little issuance of new long-term bonds because of the market turbulence. Following robust growth in the spring, the stock declined in the autumn to close to the level seen at the previous turn of the year. The stock of bonds issued by deposit banks amounted to EUR 17 billion in December (up 3% year-on-year).

Banks continued to acquire shorter-term funding via issuance of certificates of deposit, even in excess of their daily requirements, in preparing for ongoing disorderly market developments. The stock of certificates of deposit in December stood at EUR 36 billion (up 25% year-on-year).

The average maturity of market-based funding shortened slightly in the autumn, when no new bond issues were launched to replace matured ones. Of the stock of bonds issued by deposit banks to the public, almost 70% were bonds with a maturity of one year. A total of 44% matured within three months. The corresponding figures at the end of 2006 were 66% and 38%, respectively. Shorter maturities for market-based funding increase structural funding risk, as the risk of renewing funding grows.

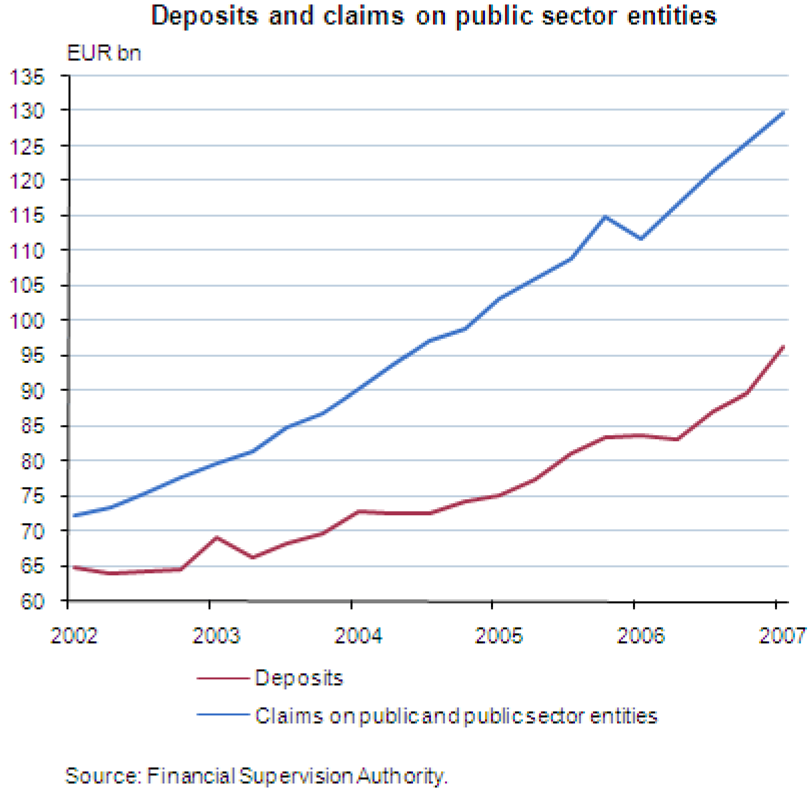
Short-term liquidity remained good

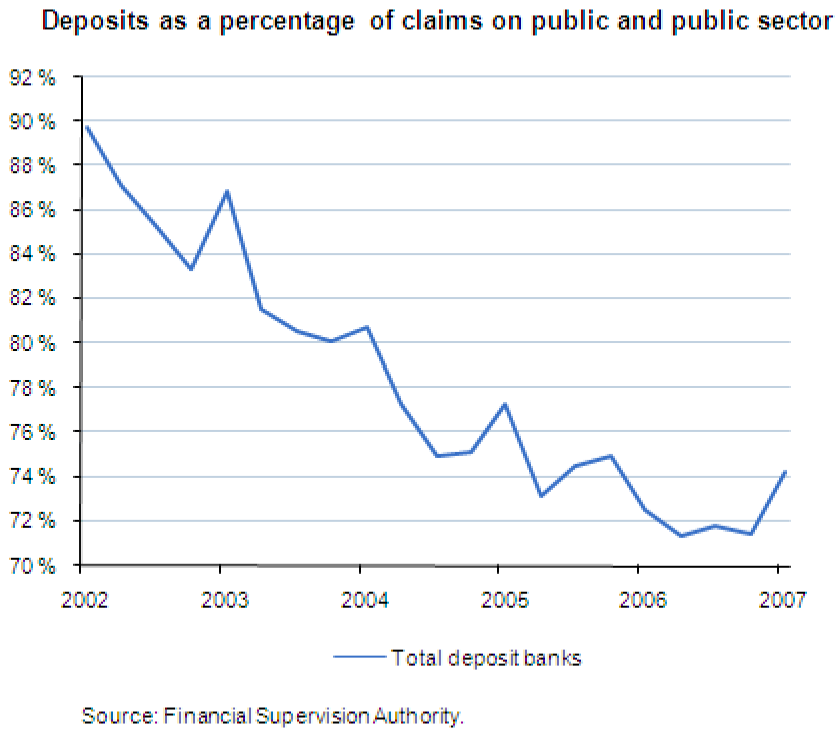
According to the FIN-FSA's survey, banks' short-term liquidity is good, as deposit growth has been vigorous and there has even been excess demand for short-term paper. Liquidity is further strengthened by growth in liquid assets. The volume of available debt securities eligible for use as collateral, ie debt securities eligible for refinancing with central banks within a maturity class of over one month, increased especially in the last quarter to reach almost EUR 9 billion. Other liquid assets such as other debt securities, listed shares and mutual fund units grew at a brisk pace in the autumn. Overall, the liquid assets buffer was discernibly larger than in the previous year. With market liquidity remaining tight, it is important for banks to hold buffers consisting of liquid, low-risk securities, which may quickly be turned into cash or used for acquisition of collateralised funding.

Market situation creates pressures on banks' funding costs

Finnish deposit banks have coped well with the autumn's market turmoil. Banks have also prepared for continued prolongation of the situation. Short-term liquidity has remained good. Structural funding risk has increased in respect of market-based funding, as average maturities have become shorter. However, the increased share of funding via deposits reduces dependence on market-based funding, with deposit growth contributing to lower structural funding risk.

The price of long-term market-based funding has however risen significantly, thereby causing pressure on profitability. The competition for deposits, in turn, creates upward pressure on interest rates paid on fixed-term deposits in particular, putting added pressure on profitability.





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Interest rate risks in the banking sector have remained moderate

The rise in the euro area interest rates, which has continued already for over two years as well as strong lending growth, now persisting for several years, have not increased banks’ interest rate risks to any significant degree.

Finnish banks’ absolute income risk as well as the relative income risk, income risk in proportion to net interest income, increased slightly in 2007. The income risk caused by a one percentage point increase in interest rates at the end of December 2007 was EUR 433 million (EUR 370 million at the end of 2006) or 13% (12%) relative to net interest income which had increased during the year . In other words, an increase of one percentage point in market rates would increase the net interest income of the banking sector by over EUR 400 million. When the interest rate risk is measured by combining the effects of income - and investment risk, caused by changes in the fair values of interest rate sensitive instruments, banks' total position is almost neutral against interest rate changes.

The markets are expecting a decrease of about 100 basis points in short euro-area money market rates during 2008. If such a change materialised, it would decrease the banking sector’s net interest income by about 10% but would not compromise its capital adequacy.

Increased lending is not shown in banks’ interest rate risks

Increased lending is reflected in the calculation of income risk as increased balance sheet items. The growth of balance sheet items did not have a large impact on income risk in euro terms. Relative to net interest income, the income risk has remained at a moderate level and has not shown any significant changes.

While the extent of (relative) income risk has been managed primarily by hedging through banks' counterbalancing balance sheet items and interest rate swaps, the increase in banks' net interest income has also had a mitigating effect on relative income risk.

The simplest method for controlling the income risk in the balance sheet is to ensure that any maturity imbalances between the asset and liability side of the balance sheet remain small. For the most part, income risk in the balance sheet is hedged through counterbalancing balance sheet items.

Structural income risk resulting from maturity differences between borrowing and lending is commonly managed through hedging with derivatives. By far the most frequently used derivatives instruments are interest rate swaps.

There have been no significant changes in the maturity structure of bank lending during the year and the majority, about 80%, of all banking sector’s claims on the public and credit institutions are linked to short market rates or banks' own prime rates.

Currencies’ proportion of income risk has decreased somewhat from the previous turn of the year. Whereas the proportion of currencies at the end of 2006 was 44%, it came down to 29% during 2007. In addition to the euro and Nordic currencies, the most significant currencies were the US dollar and the pound sterling.

Investment risks slightly increasing

The financial account includes bonds and derivatives associated with investment risk. The interest rate sensitivity of these items at the end of 2007 was EUR -8 million (EUR -110 million). Negative interest rate sensitivity means that the value of contracts in the banks' financial account decreases when the yield curve increases in all maturities by one percentage point. Unlike bonds, which practically always have negative interest rate sensitivity, the derivatives in the financial account have positive interest rate sensitivity. Thus, investment risk reflects the fact that banks have hedged their bonds against value changes with derivatives contracts.

Investment risk in the trading book increased during the previous year to EUR -419 million (EUR -275 million). The most significant reason for this was an increase in the investment risk of euro-denominated items.

Based on a combined interest rate risk indicator, in which the income risk in the financial account and the investment risks resulting from fair value changes in the financial account and trading book have been combined, banks are almost neutral to interest rate changes. Based on this measure, a one percentage point change in interest rates would only have a marginal impact on banks' aggregate net interest income.

Interest rate changes expected by the markets do not compromise the capital adequacy of the banking sector

Interest rate expectations calculated on the basis of the prices of actively traded interest rate options indicate that the three-month Euribor is expected to decrease by about one percentage point by the end of 2008. The interest rate change expected by the markets is comparable to the 100 basis points interest rate shock applied in the analysis above. If this interest rate scenario materialised, it would decrease banks' net interest income by about 10% but would not threaten their capital adequacy.

Combined interest-rate risk of the banking sector including derivatives: euro and foreign currencies combined

(Values in EUR million at a time of one percentage point increase in interest rates)

	31 Dec 2007	31 Dec 2006	Change
Banking book interest rate risk			
Income risk	433.1	369.9	17.1%
Net interest income	3,328.1	3,049.7	9.1%
Relative income risk, % of net interest income	13.0%	12.1%	7.3%
Stress test 1; sight deposits < 1mth	-114.3	-144.2	-20.7%
Stress test 2; foreign currency at absolute value	932.3	687.1	35.7%
Investment risk	-8.2	-109.5	-92.5%
Interest rate risk of the trading book			
Investment risk	-419.2	-275.6	52.1%
Stress test 3; foreign currency at absolute value	532.6	363.5	46.5%

Source: Financial Supervision Authority.

Definitions of interest rate risk and further information on the assessment methods

In FIN-FSA analyses, interest rate risk has been divided into income risk and investment risk.

Income risk measures the impact on net interest income of the maturity imbalances of receivables and debts when market rates increase, with the balance sheet structure expected to remain unchanged.

Investment risk measures the direct change in the market values of bonds and derivatives in the financial account or trading book when interest rates increase.

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More providers in investment services

Structural changes within investment services

Investment services may be provided by domestic credit institutions, investment firms and management companies engaging in asset management. Foreign credit institutions or investment firms have the opportunity to provide investment services either on a cross-border basis or through a branch located in Finland. The number of domestic investment firms authorised in Finland at the end of December 2007 was 37 (40 on 31 Dec 2006). In addition, investment services are being offered by three Finnish branches of foreign investment firms.

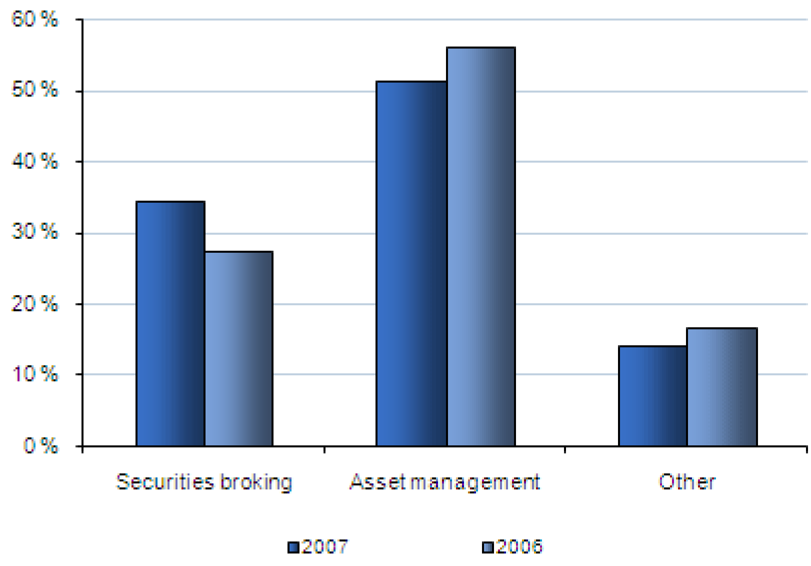
There has been corporate restructuring in the field in Finland, with investment firms have merging with banking groups. Applications for new authorisations have been filed actively. However, at the time of writing, it was anticipated that the real MiFID-related application rush was still ahead with the deadline for applications concerning investment advice and derivatives operations closing at the end of April.

Profitability of investment firms remained at a good level

Net income from investment services at the end of 2007 totalled EUR 297 million (EUR 367 million in 2006). The decrease of income is explained by corporate restructurings where investment firms have been merged with parent banks. The profitability of investment firms remained at a good level despite competition and uncertain market situation. Operating profit totalled about EUR 121 million and the operating margin (operating profit / net income from investment services x 100) was 41% (36% on 31 Dec 2006).

Over 80% of the net income from investment services was generated by asset management and securities broking. The distribution of net income from investment services shows that 51% of fees and commissions were derived from asset management, 35% from securities broking and the remaining 14% from other activities. Other activities include fees and commissions from eg investment advice and corporate finance.

Breakdown of income from investment services in 2007 and 2006



Source: Financial Supervision Authority.

Shifts in asset management due to corporate restructuring

The total amount of assets under management (by investment firms, banks and management companies) increased by almost 10% to EUR 143.3 billion. Due to corporate restructurings, the shift of assets under management from investment firms to credit institutions was shown as a decrease of net income from asset management. As the amount of assets managed by investment firms decreased by about 30%, net income from asset management decreased correspondingly by about 28%. The bulk of asset management still comprises discretionary asset management under a general power of attorney, and mutual funds still account for a high proportion of the assets.

Assets under management of investment firms

	12/2007 EUR bn	12/2006 EUR bn	change	change %
Discretionary asset management	68.1	90.2	-22.1	-24.5 %
whereof assets of domestic mutual funds	38.6	48.7	-10.2	-20.9%
Non-discretionary asset management	7	17.2	-10.1	-58.8 %
Total	75.2	107.4	-32.2	-30.0 %

Total assets in asset management

	12/2007 EUR bn	12/2006 EUR bn	change	change %
Discretionary asset management	103.6	97.4	6.2	6.3 %
whereof assets of domestic mutual funds	56.3	52.3	4.1	7.8 %
Non-discretionary asset management	39.7	36.2	3.5	9.7 %
Total	143.3	133.6	9.7	7.3 %

New capital adequacy requirements applied from beginning of 2008

2007 was a year of transition in capital adequacy calculation, when both Basel I and Basel II capital adequacy requirements were used. Investment firms must observe the capital adequacy requirements under Basel II from the beginning of 2008. Then companies must have a justified view of how their risk profile changes and how much planned risk taking will require capital when business operations are developed in accordance with the strategy. Risks relating to the nature of investment services, which must be taken into account by companies in mapping their capital need, comprise exposure risk and reputation risk.

More than half of investment firms reported their capital adequacy information for 2007 in accordance with the old set of regulations. The amount of such companies' own funds at the end of 2007 totalled almost EUR 77 million, and the minimum requirement of own funds EUR 19 million. The surplus of own funds at EUR 58 million was almost three times the minimum requirements.

Investment firms that have applied the Basel II capital adequacy framework already in 2007 will allocate the own funds requirements to the following three risk areas: credit risk, market risk and operational risk. The amount of such companies own funds totalled about EUR 50 million, while the minimum requirement for own funds was EUR 11 million. The surplus of own funds at EUR 39 million was about 3.5 times the minimum requirements. Proportionally the highest amount of own funds must be reserved for operational risks (about 60% of the minimum requirement for own funds).

All investment firms met the minimum requirements for own funds at the end of 2007, although there was large variation across companies. It is crucial for the continuity of operations that companies have a sufficient buffer of own funds.

Competition tightens in the investment services business

The profitability of investment firms depends on the development of fees and commissions. The operating environment has changed, and as a consequence, sustaining the present level of profit will become increasingly difficult. As deposits have become more attractive, people are no longer willing to pay for active asset management as much as previously. Similarly, decrease in the activity of equity markets reduces the fees and commissions from brokerage. Issues, IPOs and other major corporate arrangements will have to wait for a more favourable market situation. Income from corporate finance activities may be high, but their amount and timing is very difficult to predict.

The uncertain market situation and increase in the number of providers in the industry forebode intensifying competition.

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Change in direction for mutual fund assets development

A turnaround occurred in the mutual fund markets in August 2007 when the subprime crisis blew up. In July, mutual funds assets still stood at a record level of EUR 70 billion. Over the five last months of the year, about EUR 3.3 billion in net terms were redeemed from mutual funds. At the end of the year, mutual fund assets stood at about EUR 66 billion (EUR 60.9 billion in 2006).

In 2008, uncertainty in the markets has continued. In January-February, the amount of net redemptions exceeded EUR 2 billion, and mutual fund assets decreased to EUR 61.3 billion. In January, redemptions concentrated on equity funds, and in February, mainly on short-term fixed income funds. Impairments on corporate loans have had a negative impact on short-term funds considered risk-free. The increase in risk premia on corporate loans and on the other hand, positive development of deposit interest rates made investors favour risk-free deposit accounts.

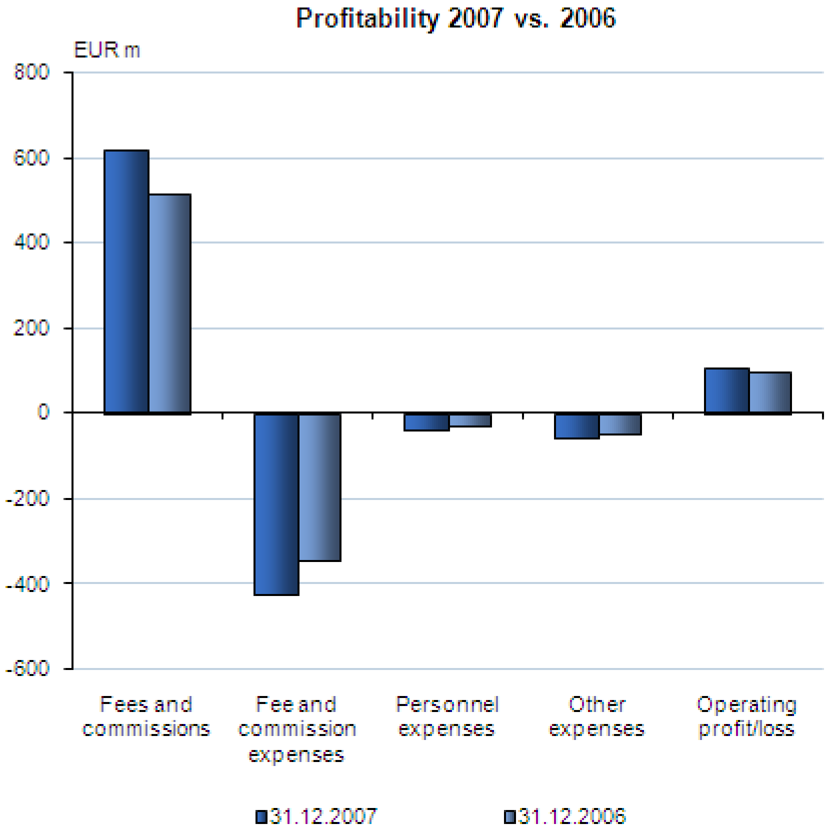
The proportion of fixed income funds on total mutual fund assets was 51.5% at the end of 2007 (48.3% in 2006). In euro terms, about EUR 4 billion of capital flowed into fixed income funds in 2007. The relative proportion of equity funds decreased from 35.4% at the end of 2006 to 33.1%. The decrease in the proportion is explained by the growth of total capital, since in euro terms mutual fund assets in equity funds stood at the previous year’s level.

Despite large redemptions in February 2008, the relative proportion of fixed income funds has remained over 50% of all mutual fund assets (54% as at 29 Feb 2008. The proportion of equity funds has decreased further and on 29 February 2008 stood at about 30.7%.

Turbulence in financial markets has not yet shown itself in the overall performance of the industry

A majority of management companies was able to improve their operating profit in 2007. Five management companies made a loss in 2007 despite good average profitability developments. Management companies’ fees and commissions increased by 20% to about EUR 620 million. Management fees still account for almost 90% of all fees and commissions.

The combined operating profit of management companies did not increase apace with income. Operating profit increased by about 9% while income grew by 20%. Personnel expenses in particular grew proportionally more than fees and commissions over the same period. Operating margin decreased from 18.7% in the previous year to 17.1%.



Source: Financial Supervision Authority.

Capital adequacy requirements were met

All management companies fulfilled the capital adequacy requirements under the Mutual Funds Act:

1. share capital must be at least EUR 125,000 (absolute minimum)
2. in addition to the minimum share capital, own funds must cover 0.02% of the proportion of combined assets managed by the mutual funds of the management company exceeding EUR 250 million. However, the amount of own funds does not have to exceed EUR 10 million.
3. Own funds may not ever decrease below a level corresponding to 25% of fixed expenses of the last period.

Management companies engaging in asset management belong to the scope of the Basel II capital adequacy requirements and they must, in addition to the requirements of the Mutual Funds Act, meet the Basel II capital adequacy requirements as of the beginning of 2008. Four management companies are reporting in accordance with the new capital adequacy framework already in 2007.

According to the capital adequacy reports, management companies' own funds were sufficient relative to the Pillar I requirements. Operational risk is the largest single risk area where companies must reserve own funds (87% of the total own funds requirement).

Market uncertainty revealed the risks of mutual fund investments

The recent market situation has shown how also fixed income funds perceived as risk-free are exposed to fluctuations in market prices. The risks of a mutual fund depend on its investment strategy and the risk profile of its investments. Depending on the type of mutual fund, risks relating to investments may be very different.

Market uncertainty highlights the importance of risk management. In particular, the watertight functionality of NAV calculation is highlighted in a market situation where the availability of prices is hindered and companies must resort to internal valuation methods.

The significance of counterparty risk is also highlighted in an uncertain market situation. Reduction in the value of an investment may have a material impact on the value of a mutual fund particularly in special investment funds which may, within the scope of their rules, deviate from the investment restrictions under the Mutual Funds Act.

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