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Finnish financial markets stable, but market uncertainty has increased

Finnish financial markets are stable at present. Supervised entities' economic situation is generally sound and risk-bearing capacity is also sufficient. The funding risk increases amid ongoing strong growth in mortgage lending. Banks have so far been able to keep their credit risk under control, but risks for mortgage holders are increasing further. Turbulence in global financial markets has not directly affected entities supervised by the FIN-FSA, but the possible indirect effects will also reach Finland. FIN-FSA continues to monitor investment and funding risks closely. The availability of sufficient economic information is becoming increasingly important.

Banks' capital and hedge fund investments, subprime risk exposures and funding situation

At the end of August 2007, the Financial Supervision Authority (FIN-FSA) conducted a survey among banks and bank groups to establish the extent to which Finnish banks have invested in or financed capital and hedge funds. In addition, the survey explored whether banks, either directly or through funds, had invested equity in instruments carrying US mortgage risk, with special focus on banks' exposure to the US subprime mortgage market.

Continued strong economic upswing

Economic growth both in Finland and elsewhere in the world is leading to upward revisions of forecasts for the current year. However, uncertainty surrounding economic developments has markedly increased.

Bank profits for the first part of 2007 hitting new record high

Banks operating in Finland again reached new records in profits for the first six months of the year. The main driver of growth was net interest income, up about one fifth from January–June last year.

Borrowing still on the rise

The demand for loans has continued its strong growth. The market situation still reflects banks' tight competition for customers. Increased house prices and interest rates have not particularly affected the propensity to borrow. However, uncertainty in the credit market has grown.

Lending quality good, debt risks concentrating

On the whole lending quality has remained good, but debt risks have clearly concentrated. Borrowing risks increase for some households, as the size of housing loans has increased due to high house prices. The accelerated growth in payment defaults in early 2007 mainly concerns consumer credits, but loan servicing problems of heavily indebted households may start showing also in housing loans, particularly if the rise in interest rates continues.

A growing proportion of banks’ funding is market funding

The volume of banks’ deposit funding has increased, but despite this the relative share of market funding of banks’ total liabilities has continued to grow due to the sustained strong increase in lending volumes. Banks have diversified their funding bases and drawn up contingency plans for dealing with liquidity crises and reducing their vulnerability to market disruptions.

Market changes do not affect banks' exposure to interest rate risk

Despite some heightening since the end of 2006, the income risk affecting banks' net interest income has remained very modest considering banks' risk bearing capacity. In contrast, the investment risk relating to the trading book has subsided as a result of the reduced size of the trading book and active measures taken by banks to hedge sensitive positions. Banks' positions and risk exposures as of June indicate that interest rates are expected to increase slightly. However, banks are also hedging against a fall in interest rates.

Basel II reform has not yet brought significant changes in banks' capital adequacy ratios

The capital adequacy reform (Basel II) that took effect at the beginning of 2007 has not significantly affected banks' capital adequacy ratios. The banking sector is financially sound.

Growth of investment services continued

Activity in the securities markets increased the demand for investment services, which was shown in improved profitability and solvency among investment firms. Income from investment operations increased by a total of 35% and operating profit by almost 69%.

Mutual fund saving boom improved profitability of management companies

The popularity of mutual fund saving continued in the first half of 2007. Assets in mutual funds increased to EUR 70.2 billion with annual growth at 34.2%. The supply of mutual funds also increased. The amount of assets under management also supported the profitability and capital adequacy of management companies.

Finnish financial markets stable, but market uncertainty has increased

Supervised entities' capital adequacy and profitability generally very strong

Supervised entities' profitability and capital adequacy are at solid levels. Banks' results have improved by as much as tens of per cent from a year earlier, and banking sector's loss buffer is close to EUR 10 billion. Banks' market and credit risks are also contained.

Investment firms' profitability improved considerably from a year earlier, and their capital adequacy is generally sound. Mutual funds also experienced stronger profitability and capital adequacy than last year. Both investment firms and mutual funds are mainly profitable with solid financial standing, but some individual firms in the sector have problems with profitability or capital adequacy.

Supervised entities' good economic situation is largely attributable to the favourable operating environment. The Finnish economy has grown strongly already for years. Employment and earning levels have risen, leading to ongoing high confidence among consumers in their own economic situation. This has translated into brisk household spending and lending. Despite increased interest rates, borrowers have also been able to service their debt relatively well.

In early 2007, positive developments in the securities markets fuelled demand for investment services. Managed assets are increasing at a rapid pace, and securities brokerage activity has been robust. The number of fund unitholders has risen, with fund assets already being close to the volume of bank deposits. The popularity of fund saving has grown markedly over the long term, although the recent financial market turmoil has led to a fall in fund saving volumes. Even deposit accounts have grown vigorously.

Financial markets stable, but threats also looming on the horizon

Supervised entities' risk-bearing capacity is strong in general, and the Finnish financial markets can be regarded as stable. Identified risks are under control at present, but funding and credit risks in particular need to be monitored closely. Financial market participants are actively introducing new instruments and operating practices, but are the markets prepared for the possible new risks imposed by them? Recent news from the global markets has reminded us of the possibility of risks being realised and how fast risks or market shocks can spread all over the world. Even though the domestic situation might be stable, problems could also hit Finland rapidly.

US subprime mortgage crisis created uncertainty in financial markets

The difficulties experienced in the United States regarding subprime mortgage lenders concentrating on customers with low credit ratings have stirred global financial markets. Subprime mortgage lenders securitised high-risk loans and continued their activities with the financing obtained as long as financial market confidence was maintained. Securitisation is a relatively new financing form in which illiquid claims (in this case high-risk housing loans) are packaged into instruments that can be sold to investors. At the same time, however, the transparency of financing decreases, ie the size and location of the risk remains unclear.

The fall in US housing prices led to the realisation of credit risks, which finally resulted in rating agencies downgrading their ratings on securities backed by subprime mortgages. Market confidence plummeted and funding was no longer available. The ECB and the Federal Reserve secured the availability of liquidity with additional operations in the interbank markets, thus saving the markets from an uncontrolled crash. This episode serves as a salient example of what can happen when market participants have no clear idea of how risks are distributed in the market.

Two German banks experienced liquidity problems in August on account of investment in the US markets. In September it was the turn of a British mortgage company. Some other foreign funds investing in subprime loans have also run into difficulties.

According to a survey conducted by the FIN-FSA, Finnish banks' direct investment in subprime financial instruments is minor, and hence the direct effects to banks will remain minimal. In addition, banks have not granted credit to hedge funds to any significant degree. Finnish funds have invested in these financing instruments, which are characterised by valuation and realisation difficulties, but there are no large risk exposures, since Finnish hedge funds are subject to tighter restrictions than some other foreign funds. Instead, Finnish financial market participants are affected by indirect effects arising for instance from financial market nervousness.

Structural funding risk on the increase

A few months ago the liquidity situation in the global financial markets was still ample, ie money was available at low prices, almost without limits. The present situation is different. The availability of financing has weakened, and risks have been priced accordingly. Finnish banks have however not been faced with funding constraints.

On the other hand, Finnish banks' structural funding risk has increased. Institutions have been forced to finance a growing proportion of claims through market-based funding. Banks have invested in deposit funding by introducing new investment accounts, but deposit growth has not reached lending growth. At times of rising interest rates, deposit funding is very profitable for banks, as the majority of savings are deposited into transaction accounts in which the rates are, regardless of rises in market interest rates, very close to zero. Competition on fixed-term deposits is still also low, because the spread between fixed-term deposit rates and market interest rates has narrowed only slightly.

Banks have diversified their funding base, with the emphasis on long-term market-based funding. Banks have increasingly issued bonds in which the yield is tied to some other factor than interest rates – often to the share price performance of equities or equity indices. Mortgage banks' issuances of mortgage-backed bonds have also grown. In contrast to the United States, mortgage banking is transparent in Finland, in that their risks can be estimated. Furthermore, in Finland the stock of collateral consists of good housing loans.

Now that it has become evident how fast the liquidity situation can change, the management of funding risk has gained more importance. Banks must be able to finance housing loans granted with narrow margins also in the far future and cheaply, or otherwise their profitability will weaken.

Credit risk contained for the present

Credit risk is the most pivotal risk related to banking activities. It realises if a bank contracting party cannot meet his obligations. So far bank contracting parties, ie customers, have been able to service their debts fairly well. A crisis comparable to the subprime mortgage crisis as experienced in the United States is not possible in Finland where bank lending is primarily based on borrowers' repayment capacity and not collateral value.

For the time being, nonperforming loans only present a small share of lending stock, and have increased only slightly. On the other hand, banks change loan repayment terms very eagerly at the moment if a customer's debt servicing ability is threatened for one reason or another. The amount of nonperforming loans does not therefore necessarily tell the whole truth about customers' real repayment ability. Signs of debt servicing difficulties have emerged in the markets, since an increasing share of consumer credit granted by finance companies remains unserviced.

Risks for mortgage holders are increasing

Banks' credit risks are still under control, but risks for mortgage holders have increased. Long loan maturities, variable rates and large loan amounts make a dangerous combination for households. The stability of the banking sector is not directly threatened by a large housing loan stock, but individual households may run into debt servicing problems, for example in the event of an interest rate rise, additional expenses (eg housing company renovation), unemployment or a fall in collateral value. Part of households have prepared themselves for problems by saving, fixing part of the loan to fixed interest rates or taking loan with an interest rate ceiling or a loan insurance policy. Recent statistical data shows that the proportion of

fixed-rate loans in new lending has declined this year. When taking up loans, customers need to remember that they bear the responsibility for being able to service the debt even in bad times. That a bank manager grants a loan is not necessarily a guarantee for customer that he can repay the loan.

Growing need and importance of market information

In addition to ensuring financial stability, the FIN-FSA's objective is to promote public confidence in financial markets, which is above all based on sufficient investor information. The turmoil in the global financial markets showed how greatly insufficient information affected the markets and led to wide lack of confidence. The markets did not know – and still do not know – the type and size of risks hedge funds have taken. The importance of openness cannot be emphasised enough. For this reason the FIN-FSA monitors intensively that supervised entities disclose to the markets adequate information on their capital adequacy and capital adequacy management as well as their risks, financial position and financial performance. International supervisory cooperation groups also promote increased information disclosure for hedge funds.

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Banks' capital and hedge fund investments, subprime risk exposures and funding situation

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The survey was addressed to Nordea Bank Finland, Sampo Bank, OP Bank Group, Aktia Savings Bank, Bank of Åland and Tapiola Bank.

Hedge fund investment and financing

A hedge fund refers to a special mutual fund or explicit hedge fund which is managed by a Finnish or foreign fund management company and whose activities are divergence from the investment spreading rules under the–characterised by UCITS Directive

- divergence from the investment spreading rules under the UCITS Directive
- application of a significant leverage effect in the operations, for example through obtaining credit
- short selling
- securities lending
- use of derivatives.

The survey indicates that Finnish banks' exposures to hedge funds were low and limited only to a few banks, with total exposures to hedge funds amounting to roughly EUR 350 million. To this comes the sum of about EUR 800 million in trading limits made available but left unused. Banks reported only minor own investments in hedge funds, undertaken as protection against other risks.

Fund prospectuses must set out investment policy and risks

In the marketing of mutual funds (including hedge funds), the fund management company must provide investors with a simplified fund prospectus which gives an outline of the fund's investment policy and related risks. Finnish hedge funds have not generally been as risk-weighted as foreign hedge funds. One contributory factor is the fact that borrowing for investment purposes has not, at least so far, been allowed in Finland. Admittedly, in Finland too it has been possible to lever up the portfolio risk weight through the use of derivatives.

Capital fund investment and financing

A capital fund refers to activities carried out under a limited partnership where the assets of the limited partnership are invested in target companies mainly in the form of equity instruments either at the start up of a new company (venture capital) or in connection with ownership and/or management reorganisation of an existing company (private equity).

Capital fund investments totalled just over EUR 1.5 billion, which represents about 1.5% of banks' total lending volume. The target companies are mainly Nordic companies well known to the banks. Developments in investments have been positive.

Banks have not provided financing to capital funds to any significant extent.

Investments in subprime risk instruments of the US mortgage market

Finnish banks' investments in subprime risk instruments of the US mortgage market have been very moderate, in the region of EUR 20 million, which represents about 0.1% of banks' original own funds. In addition, banks have invested very little, or just over EUR 20 million, in senior tranches of instruments carrying US mortgage risk. The risk positions assumed are either CDO (Collateralised Debt Obligation) or credit derivative positions.

Impact of financial market conditions on banks' and bank groups' operations

The banks were asked to report what consequences the unstable market conditions had had on their operations in money and capital markets, as well as on the availability and price of funding.

The banks' answers reveal that there has been and still is poor liquidity in international money and capital markets. Nevertheless, Finnish banks have been able to conduct fairly normal operations in international money markets. Banks report that the availability of short-term funding has remained more or less unchanged, but with some changes in investors. The price of short-term financing relative to the Euribor has remained intact. Finnish banks' liquidity position is good and there is, if necessary, ample central bank eligible collateral freely available.

In contrast, the price of long-term funding has increased and there are only few investors in the market. If market demand continues to remain very poor, banks believe that they can satisfy their long-term demand for finance through short-term funding or by borrowing against central bank eligible collateral.

Some banks report that market conditions have not had any special impact on their access to refinancing. They also maintain that the domestic bilateral repurchase market conducts nearly normal operations with banks enjoying a sound liquidity position.

Despite the stable financial position of Finnish banks, disruptions in international financial markets will, if they persist, have negative consequences for all banks in the form of higher prices for refinancing and downward adjustment of investment instruments mainly held as liquidity buffers.

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Continued strong economic upswing

The Finnish economy has grown in summer faster than forecast in the early part of the year (FSA Newsline, 2/2007 economic issue), with private consumption in particular showing renewed vigour. The growth forecast for the current year is likely to be revised upwards in the second half of the year. Growth in the next few years, however, is expected to assume a downward trend. The repercussions of the uncertainty that spread over the financial markets in July may contribute to a further deepening of the downward trend.

Economic growth stronger than forecast earlier in the year

The Bank of Finland's early-spring forecast for Finland's economic growth in the current year (3.0%) is proving lower than actual outcomes. Private consumption in particular has exceeded expectations. According to Statistics Finland's quarterly accounts, GDP in the second quarter was 4.4% higher than in the second quarter of 2006.

Households' confidence in their own finances at record high levels

Drivers of private consumption growth are both higher employment and better income developments. Improved employment figures have strengthened households' confidence in economic prospects. Especially households' confidence in their own greater saving potential reached an all-time high in August, according to Statistics Finland's consumer survey. Also, according to the survey, households' confidence in the near-term outlook for their own finances was almost at record high levels. This has been buttressed by higher residential property and share valuations and wage increases.

Industrial capacity utilisation rate and order books continued to rise in August month-on-month. The rise in the industrial confidence indicator since the latter part of 2001 has persisted, approaching the record observed in 2000. Statistics Finland's volume index of newbuilding also confirms the cyclical peak in industry, showing a clear increase in non-residential construction both year-on-year and in relation to residential construction. Especially construction and engineering have reported capacity and labour shortages.

Very robust growth sustained in China and India

World economic activity has also contributed to upward revisions of growth forecasts. World trade is still performing buoyantly, with Asian-led growth showing no signs of easing. Economic growth in China continued at a pace of 12% in the second quarter, and the rate of growth for India is also estimated to have sustained a level higher than 9%.

US housing market problems have not shaken household confidence in consumption opportunities

The most acute threat to the global economy has emerged from problems triggered by a cooling of the US housing market. The US housing market started to weaken as early as the end of 2005. There was first a decline in demand and then a reversal in prices. Meanwhile, the central bank continued to raise interest rates. In the course of last winter, fears started to mount, as there was concern of a realisation of risks included in housing loans granted to borrowers not qualifying for prime loans because of weaker repayment capacity.

Private consumption accounts for two thirds of US aggregate demand. Last winter it was anticipated that the weakening housing market could rapidly change households' saving ratio so that aggregate demand growth would essentially decelerate, leading at its worst even to a demand slump. This did not happen, however, and private consumption has remained surprisingly strong, although banks that had granted housing loans to customers with weaker repayment capacity started to encounter difficulties in the course of the spring.

Despite better-than-expected developments, threats to world economic activity have increased

As noted above, this year's economic growth will probably be clearly stronger than forecast in early spring, but risks have remained unchanged, warranting a closer look at the United States. Not only a collapse of confidence across US households but also reorganisation in financial markets following the subprime crisis may have important implications for the global economy.

Threat of an overly fast unwinding of US current account deficit has not disappeared

The threat of global imbalances, widely debated in recent years, remains unchanged. The still further widening US current account deficit, on one hand, and the accumulation of surpluses in Asia and oil-producing countries, on the other, continue to pose a risk to the world economy. A disorderly unwinding of global imbalances would lead to a further depreciation of the dollar and boost long-term rates. The Bank of Finland sees such imbalances as also adding to protectionist pressures in world trade.[1] If, as a consequence, world trade flows were to be exhausted, the threat of a global slump would be even more imminent.

1 Bank of Finland Bulletin 2/2007.

Heightened threat of higher inflation

While risks of a weakening in global economic growth have risen, the threat of higher inflation has also increased. The price of oil has started to rebound. Higher energy prices and the biofuel boom have elevated food prices worldwide. In Finland, particularly costs for housing and also for mobile phone calls have increased rapidly.

US mortgage loan market threatens growth through two channels?

If US housing market problems worsen so that household consumption is more strongly affected, it would have a dampening impact on global economic growth over time. The US outlook has been further undermined by losses suffered in connection with housing loans granted to subprime borrowers and by an unparalleled plunge in housing prices. A fall in residential property valuations may have an increasingly stronger downward impact on household consumption.

However, not only subprime loans and their securitisation are of concern but also, on a broader scale, new complex financial instruments that have emerged in the last few years. Dispersion of global interdependencies and risks is mainly a positive phenomenon that brings stability to financial markets, but this time too much trust has been placed in it. The crisis indicates that investors no longer had a clear perception of credit risk dispersion in the market. Unwinding of the tangle is a necessary correction that may reveal market overreaction and gaps in risk management. Risk packaging and diversification have also led to new type of non-transparency.

Even so, banks' risk bearing capacity is generally good because of a long period of favourable profitability performance. Increased uncertainty may, however, affect the economy through a large number of channels. Firstly, higher financing costs may cause firms to reduce their investments and demand for bank loans. On the other hand, a fall in asset prices threatens private consumption growth. Changes in exchange rates, caused primarily by the use of the Japanese yen in ‘carry trade’ investments, have a bearing on international trade flows. An overall weakening in confidence may have a broader impact on financial markets. The implications of the crisis for the financial system and global economic expansion are, however, difficult to assess for the time being. The Bank of Finland's new forecast will appear in October.

Asia continues as driver of growth

Even if problems in the United States and Europe worsened, Asia's economic tigers would still perform at full capacity for a long time and demand for Finnish metal industry products, for instance, could remain high. Another factor that brings equilibrium to the world economy is the increasing prosperity of the Chinese and Indian populations and higher local consumer demand. But the fuel needed for the world economic engine and a large and well-paying part of carriage passengers continue to come from outside the emerging economies.

The time for stronger optimism begins to be over, but the outlook is still reasonably good

Although the current year's economic growth in Finland appears to turn out stronger than forecast and both consumer and industrial confidence peak, the ramifications of the US housing market problems will overshadow global economic performance. With order books full and engines running at high speed in both Asia and Finland, strong growth can, with good reason, be expected to continue for a fairly long time and the slowdown to unwind in an orderly fashion. A clear dip in confidence among global industrial clients, ie US households, in their consumption opportunities would undoubtedly affect growth in the next few years. US housing market problems can also be reflected in the economy otherwise. However, if stocktaking in the financial markets continues for a long time and the problems prove larger and more wide-ranging than is currently known, the consequences through higher financing costs, for example, may be considerable for the world economy, including Finland.

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Bank profits for the first part of 2007 hitting new record high

The earning capacity of banks operating in Finland continued to improve in the first part of 2007 from a year ago. Banks typically generated even 40–60% higher growth in profits than in January–June last year. The main factor contributing to profit growth was an increase in net interest income by about one fifth. Expenses, however, have also started to expand. Looking ahead, it may prove increasingly challenging to maintain the strong performance level.

The good shape of the Finnish economy and the rise in interest rates spurred most banks' operating profits for January–June, bringing them to record high levels. The rate of growth also accelerated.

Due to the presence of large players, overall growth does not reflect performance typical of the banking sector. Especially in the case of Sampo, operating profits are not comparable owing to changes in group structure. Comparability of Nordea Bank Finland's figures for the current and last year is also distorted by partial divestment of earlier holdings, but most of all by lower profits of Nordea Markets, a unit serving the entire Swedish Nordea Group. Taken as a whole, a number of divergent factors have an impact on both banks' figures.[1]

The bottom line for the largest domestically owned banking group, OP Bank Group (now OP-Pohjola Group), was substantially higher (34%) than last year, although bonuses for shareholder-customers increased by 75%. OP-Pohjola's financial performance continued to be constrained by expenses and depreciation charges from the combination of Pohjola's operations, but their impact was more than compensated for by considerably improved profits from non-life insurance business. Profit growth is largely explained by an increase in net income from investment.

Other Finnish banks' aggregate profits rose by 57% from last year. Worth mentioning is the savings bank, Nooa Säästöpankki, for which the first two quarters of this year were also the first two quarters in its history for which it recorded profits. The aggregate profits of foreign bank branches operating in Finland also grew robustly, 41%, from January–June 2006.

Underlying this profit performance is mainly higher growth in net interest income. Lending stock continued to grow at a brisk pace, and although the average lending margin declined further still, the rise in interest rates boosted net interest income, bringing it to a level of about 20% higher than in the first half of last year. With sustained strong growth in fee income, the rate of increase in expenses (typically about +10%) – burdened by higher performance-linked bonuses and wage rises – lagged far behind the rate of increase in profits. Although there have been signs of an increase in impairment losses on loans, their impact on profits has so far remained insignificant. Banks' cost efficiency and profitability improved appreciably compared with the first part of last year.

1) Profit developments at Nordea Bank Finland (-2%) and Sampo Bank (+230%) compared with January–June 2006 are strongly affected by changes in group structures. In addition, net income from trading at the Finland-based Nordea Markets declined by about one third (by about EUR 90 million), from January–June last year, when Nordea Markets booked higher-than-normal profits for derivative products sold to customers. Nordea Bank Finland sold its shareholding in International Moscow Bank (IMB) in 2006. This deal resulted in about EUR 200 million worth of sales profits recorded in the third quarter. Mainly due to the divestment of the IMB shareholding, associates' financial results were more than EUR 25 million lower in January–June 2007 than in the corresponding period a year earlier. Sampo Bank's Baltic operations were sold to the parent company Danske Bank in January 2007, since when income and expenses generated in the Baltic have been booked in Denmark. Excluding the effect of changes in group structure, Sampo's expenses grew by 6%. According to Sampo Bank, a comparable figure for growth in operating expenses from the first part of last year is 4%, excluding expenses from its integration into Danske Bank. If the integration expenses are included, operating expenses increased by 36% from the first half of last year, according to Sampo Bank's announcement. Overall, the integration is expected to result in expenses amounting to EUR 200 million in the next three years. In the first quarter, Sampo Bank booked a one-off net gain of about EUR 450 million in available-for-sale financial assets for its Baltic subsidiaries.

Robust growth compared with the early part of last year, but easing already started

Growth figures for the first part of 2007 are strong, but in respect of net interest income also reflect a base effect from low readings in January–June 2006. Profit growth for the current financial year is expected to be robust, but a number of factors suggest a deceleration in growth in a slightly longer term.

Strong fee income growth continued in the first half of the year. Financial market problems may be reflected in growth towards year-end

Although demand for asset management services has continued to increase and growth in mutual funds' assets in January–June still maintained an extremely strong momentum, growth in fee income did not accelerate any longer. Looking ahead, financial market volatility originating from subprime loan problems is also likely to be reflected to some extent in fee income for the best-performing asset managers and mutual funds, when savers and investors start shifting the focus of their portfolios towards products with lower risks and fees. On the other hand, Statistics Finland's August consumer survey pointed to an all-time high in households' confidence in their increased saving potential.

Higher growth in expenses also worth noting

Even if growth in expenses has continued to be lower than income growth, wage increases in particular start to be a drag on bank profits. Part of higher staff expenses stems from performance-linked bonuses, but a potential negative turn in the bank product market would not be reflected in the level of expenses until after a time lag.

Net interest income growth already bottomed out after the first part of 2006

Growth in net interest income, while being very robust relative to the benchmark period, has already levelled off according to data releases from banks. The last three quarters have witnessed no quarter-on-quarter increases in net interest income.

A number of reasons explain stalling growth in net interest income.

The rise in interest rates has eased since last year. One reason for rapid net interest income growth compared with the first half of last year is that in January–June 2006 more than half of mortgage borrowers still amortised their loans at rates of interest determined by the market rate low prevailing from mid-2003 until autumn 2005 (12-month Euribor only slightly higher than 2%). The situation is set to stabilise towards the end of the year.

Competition for mortgage loan customers and revision of margins in old loans continue to have some influence. The average loan margin charged to customers continued to narrow in the first two quarters of the year, although the margin for new housing loans was not lowered any longer.

Another constraint on higher interest income is the ongoing gradual slowdown in loan stock growth since the beginning of 2006.

At the same time as interest income growth shows signs of easing, growth in interest expenses is picking up. Fixed-term deposits have increased their share of total deposits, and the rates of interest paid on fixed-term deposits have risen.

In addition, a loss in confidence triggered by subprime loan problems and the re-pricing of credit risk may, when protracted, have an impact on banks' net interest income through higher costs for market-based funding. If the impact on the real economy proves significant, it may be mirrored in banks' financial performance in the form of lower income generation, as loan stock growth slows more rapidly than anticipated and impairment losses on loans increase.

On the other hand, weaker financial market conditions have had an upward impact on short-term market rates, which again contributes to net interest income growth. The three- and six-month Euribor rates, typically serving as a benchmark for banks' consumer credit, have been staying at the level of the twelve-month Euribor in the last few weeks, amid an increased loss in confidence among banks with respect to each other' subprime exposures. The spread vis-à-vis the twelve-month rate is set to widen again as soon as a more accurate picture of the total amount of subprime-based losses is obtained; meanwhile, income from lending tied to the shortest market rates will increase.

Earning capacity remains high, at least this year, but risks have increased

It is highly probable that this year banks will post excellent and clearly better results than last year. In the coming years, however, maintenance of earning capacity, including management of both expenses and impairment losses, may prove essentially more challenging than at present. The latter part of this year is already likely to see a slight slowdown in banks' main income source – net interest income – which in January–June recorded its highest annual growth since 2000.

The financial market turbulence that started in July has also affected prices for interbank funding. On average, investment is no important source of revenue for Finnish banks. According to bank announcements, they only have marginal investments in securities linked to subprime mortgage loans that have been losing value. If uncertainty continues for a long time, it will start to be reflected in Finnish banks' funding costs and in demand for loan and savings products.

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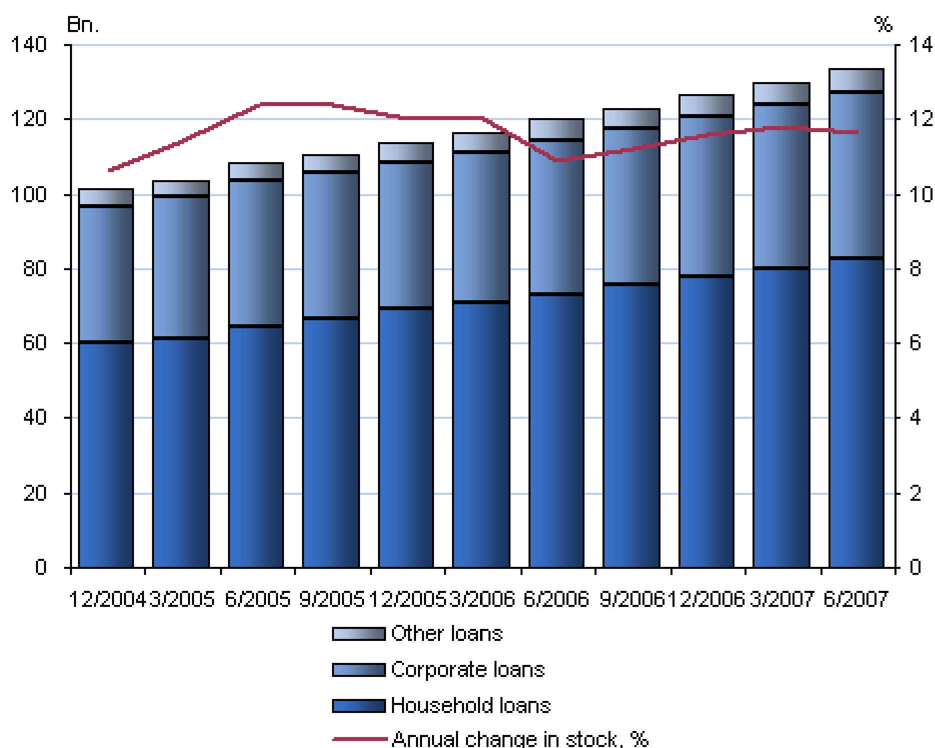
Borrowing still on the rise

Demand for loans still rising

The strong demand for loans in the financial market continued in the second quarter of 2007. The growth rate of loans exceeded that at the end of the corresponding quarter in 2006 by nearly one percentage point. In June the annual growth was 11.6% and the stock of loans amounted to EUR 134.0 billion. The share of household lending represented about 62% of the outstanding stock of loans. Most of the household lending was housing loans, which accounted for about 44% of the stock. Corporate lending represented about 33% of the stock.



Competition for customers has brought new types of credit

Banks still actively market housing loans and consumer credits. Competition in the market continues in various forms. There is a wide supply of credits, and parallel to traditional housing loans, product development has introduced credit types suitable to different life situations. The competition against instant loan companies has also forced banks to start marketing instant unsecured consumer lending. The amount of banks' secured consumer lending has increased as well.

Favourable economic performance expected to continue, while rising interest rates still have only marginal effect on borrowing

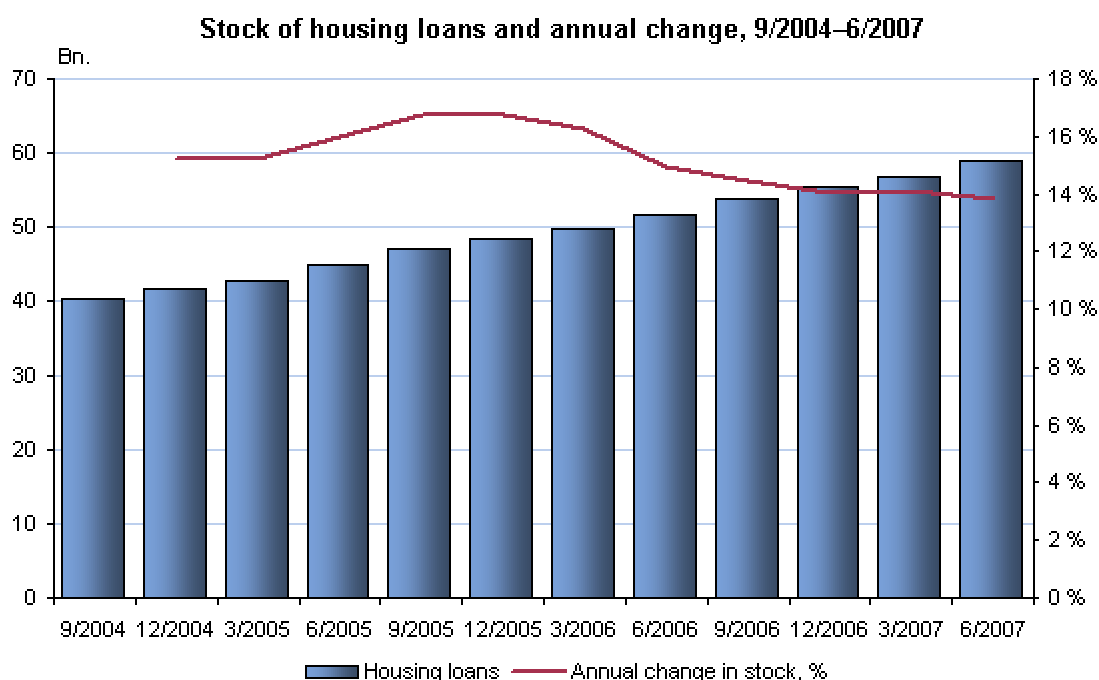
The macroeconomic fundamentals are sound and according to business outlook indicators the favourable cyclical conditions have been predicted to last throughout the rest of the year.[1] In the third quarter of 2005 there was an upward turn in interest rates of all new loans. In two years the average rate of new housing loans has increased by 1.9 percentage points, and in June it was 4.75%. In the same time the average interest rate of new consumer credits increased by 1.7 percentage points to 5.68%. In July the average rate of new housing loan agreements was 4.86%.[2]

The growth rate of loans is significant in spite of the rise in interest rates and house prices. Household borrowing is still undaunted and the annual growth rate of corporate lending has been significant.

Housing market has levelled off slightly, but growth in housing loans still continues
In the second quarter of 2007 prices of old Finnish flats rose by 1.3% on average on the previous quarter according to Statistics Finland. In the Greater Helsinki Area the prices rose by 1.1%. The annual country-wide price hike averaged at 6.3%. In the Helsinki region the rise was 7.5% and elsewhere in Finland 5.0%.

However, the growth rate of house prices is slowing. Property agents' information of longer selling periods and fewer housing transactions also points to a slowdown in the housing market.

The interest rate rise that started towards the end of 2005 has slowed the demand for housing loans only marginally. The annual growth in housing loans slowed by only about one percentage point and in June it was still 13.8%. At the end of June a new record level in housing loans was again reached at EUR 58.9 billion of a total household lending of EUR 82.5 billion.



Source: Bank of Finland.

A predicted upward trend in purchasing power and a sustained robust economic outlook has maintained the growth. According to Statistics Finland's consumer confidence indicator, households' confidence in their own finances and in improved employment remained strong in August. Saving was considered more profitable than ever, but borrowing was not considered as favourable as a year earlier. However, those intending to buy a home were still many, as 9% of the households planned to purchase a home of their own within a year. According to the banks' economic outlook indicator,[3] bank managers expected that households' propensity to borrow would slightly increase in the fourth quarter of 2007, but the propensity is expected to level off within one year.

1) Confederation of Finnish Industries, Business outlook indicator, August 2007.
2) Bank of Finland, Statistical publications, July 2007.
3) Federation of Finnish Financial Services, Banks' economic outlook indicator 2/2007, 6 June 2007.

Significant growth in corporate lending

At the end of June the annual growth rate of corporate lending was no less than 9.1% compared to 4.9% in June the previous year. According to a business financing survey[4] banks' position as the primary source of

business financing has strengthened and the share of companies using bank financing has already increased for several years. Companies describe the cyclical conditions as definitely better than normal in several sectors. Continued growth in industry and construction is predicted for the next few months, albeit at a somewhat slower pace. In the service sector the estimates are more modest.[5]

4) Confederation of Finnish Industries, Ministry of Trade and Industry and Bank of Finland, Business financing survey 2006 concerning companies in the industrial and service sectors, 23 January 2007.
5) Confederation of Finnish Industries, Business outlook indicator, August 2007.

Long maturities and large loans commonplace

The supply of loans has been active and the availability good for several years. In spite of the rise in interest rates the rate is still very low, which has encouraged ever-increasing borrowing, as house prices have continued to rise.

In nine years the average maturities of housing loans have extended significantly from 11 to 18 years. Loan sizes have also increased throughout this decade. Households' outstanding housing loans average at EUR 65,300. Over the last year average loan sizes have increased particularly in the Helsinki region, where residents now has an average housing loan of EUR 85,600 compared to EUR 72,000 one year ago. About 5% of the households with housing loans outstanding have large loans exceeding EUR 150,000.[6] Also the amounts of secured consumer credits granted by banks have increased.

6) Federation of Finnish Financial Services, Saving and the use of credit, May 2007.

Indebtedness rising continuously, debt to income ratio higher than ever

So far the rise in interest rates has not decreased indebtedness much. The annual debt to income ratio has risen significantly in the last three years. Last year household indebtedness increased by more than 8 percentage points and reached 97.7%. This was a new all-time high in the debt to income ratio.[7] In 1989, one year prior to the recession, indebtedness was about 87%.

7 Statistics Finland's review, 12 July 2007.

Higher interest rates cut the biggest notch in the demand for consumer credits

In June 2007 the annual growth in consumer credits was still 9.6%, but the growth rate had slowed compared to the previous year by almost three percentage points. The rise in short-term market rates reduces the demand for consumer credits most of all. At the end of June households' consumer credits amounted to EUR 11 billion. According to the consumer confidence indicator consumers still consider purchase of durable goods worthwhile and many households intend to use money to redecorate their homes and purchase home appliances.

Slight uncertainty in the credit market

The growth in the credit market has been long-lasting, but the higher interest rates have already levelled off the demand. Volatility and unrest due to problems in the US housing loan market have lately occurred in the international financial markets. Time will tell whether a possible prolonged and extended disruption will have second-round effects on Finnish credit markets as well.

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Lending quality good, debt risks concentrating

Lending quality has remained good

On the whole the lending quality is still good. At the end of June 2007 banks' nonperforming assets[1] (loans overdue for more than 90 days) represented 0.29% of the lending stock (0.31% in 6/2006). The amount of past due items (loans overdue for 30–90 days) has also remained quite small; their share of the stock of loans and guarantees was 0.44% (0.47% in 6/2006). Based on these figures there are no indications of major problems in the loan repayment capacity.

Banks' net impairment losses amounted to EUR 12.6 million. In 2006 net impairment losses were still negative in every quarter, as loss recoveries and reversals exceeded recognised gross impairment losses. Also the relation between gross impairment losses (EUR 98.0 million) and stock of loans and guarantees was small in June, at 0.07% (0.05% in 6/2006).

1) Nonperforming assets = nonperforming assets + guarantee claims + zero-interest assets outside the group.

Not problems in servicing of corporate and household loans

In spite of the steep rise in lending, loan servicing problems have not caused a strong growth in banks' nonperforming assets and past due items.

The corporate sector's nonperforming assets in euro and relative terms have shrunk compared to 2006. Their share of the sector's stock of loans and guarantees was 0.29% (0.33% in 6/2006). Gross impairment losses represented only 0.07% (0.09% in 6/2006) of the corporate sector's stock of loans and guarantees. Recoveries of the corporate sector's impairment losses still exceeded new impairments and thus net impairments were negative.

One way of measuring loan repayment capacity is to look at households' nonperforming assets, which have increased by about EUR 39 million per annum. However, in June 2007 their share of the stock of household lending stayed at the 2006 level, at about 0.35%. The annual growth in household lending was no less than EUR 9 billion.

The annual growth in households' past due items amounted to EUR 46 million. Still their share of the stock of household lending had decreased over the year and was 0.58% in June. Banks' nonperforming assets and past due items in relation to total exposures were still low compared to the level of nonperforming assets during the recession, when household nonperforming assets' relation to household lending were several percentage points. Loan servicing problems of households with outstanding housing loans do not quickly appear as growth in nonperforming assets, as banks can rearrange the loan, if necessary.

In general, households' loan repayment capacity has remained good. Unemployment has not been a problem during the cyclical upswing and low interest rates and long maturities have kept loan servicing costs within the limits of households' repayment capacity.

Already every third Finn has a housing loan

Households' indebtedness has still strongly increased. The number of households with outstanding housing loans has increased by seven percentage points in the last eight years. 31% of the Finns have a housing loan outstanding, which means that there are about 1.2 million of them altogether.

Housing loans and other borrowing have concentrated in families with children, 73% of which are borrowers in some way. The average housing loan of families with children below school age is EUR 89,000, as compared to EUR 82,000 one year earlier. Among the age groups, 29–34 year olds are the borrowers with the largest housing loans and 57% of them have a housing loan outstanding.[2]

2 Federation of Finnish Financial Services, Saving and the use of credit, May 2007.

Payment defaults on the rise

Registered new payment defaults increased in January–June 2007 by about 21%. There was 23% growth in defaults by private individuals and about 5% in the case of companies. The growth in private individuals' payment defaults mainly consisted of increased registered cases of lack of means. The increased number of demand-for-payment rulings was largely due to running accounts, one-off credits and financial company claims (consumer credits), which caused an increase in payment defaults of 5.3% in six months. In spite of the increase in new payment defaults, there was only about 1% more of the defaulting individuals compared to a year earlier. The growth in new payment defaults is predicted to continue as in early 2007, which also may include an increase in the number of defaulting individuals.[3]

3 Suomen Asiakastieto Oy, 5 July 2007.

Interest rate rise threatens households with housing loans

The very low interest rates and long maturities have so far kept households' debt servicing costs tolerable although house prices have risen sharply and loan sizes expanded strongly. Gradually the rising interest rates have burdened particularly households with consumer credits and this has shown in growing payment defaults. The expected rise in interest rates will also inevitably cause severe loan servicing problems at least to part of the households with housing loans. In addition to the effect of rising interest rates, the greatest debt risks of individual households stem from lower earnings due to for example unemployment, extraordinary expenses or sickness.

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A growing proportion of banks' funding is market funding

In recent years, the proportion of deposit funding of banks' total funding has fallen notably. In June, banks were able to finance 72% of their lending through deposits, whereas back in 2004 this ratio was over 80%.

Proportion of deposit funding has diminished further

In the first half of 2007, lending by monetary financial institutions (MFIs) grew by EUR 7.3 billion, which translates into an annual increase of 11.6%.1 The long-lasting lending boom is exerting pressure on bank funding. Since the rate of growth of deposits from the public has not kept up with lending growth, banks have had to acquire an increasing part of their funding from the market.

Deposit funding is cheaper than market funding. Deposits held by the public are protected through the statutory Deposit Guarantee Fund, and hence they are affected by market conditions to a lesser degree. Banks continue to diversify their market funding bases so as to be less dependent on a single funding source and hence less vulnerable to market disruptions. However, increased market funding is likely to heighten banks' structural funding risks.

Banks are investing in deposit funding

In the first half of 2007, deposit growth started to recover, and the rate of increase in fixed-term deposits, in particular, accelerated in the spring. In June, banks' total stock of deposit amounted to EUR 87 billion. In particular, banks have been marketing different types of investment accounts. The rate of interest paid on fixed-term deposits1 has risen along with rising market rates, but the difference vis-à-vis markets rates has narrowed only slightly. The tightening competition over deposits has not yet has any marked impact on

funding costs, since the spread of interest rates on transaction accounts has widened as a result of the rise in the level of interest rates. A rise in funding costs will immediately be reflected in weaker net interest income and profitability of banks.

Changes in the eligibility of CDs as collateral

After the European Central Bank (ECB) introduced a single list in the collateral framework of the Eurosystem, certificates of deposit (CDs) are eligible only if they are quoted in a regulated market. Banks have started to quote part of their CDs on the stock exchange, whereby they have remained eligible as collateral. There has been continued demand for bank CDs, and in fact the stock of outstanding CDs grew by nearly 20% in the first half of 2007, amounting to more than EUR 34 billion in June. CDs and interbank claims and liabilities are money market funding that normally matures in less than 12 months. Banks' strong dependency of short-term financing tends to make them vulnerable to market disruptions and higher risk premia, as they have to renegotiate short-term funding on an on-going basis.

Long-term market funding is on the increase

The stock of bonds issued by the banking sector has grown with the emphasis on mortgage bonds issued by mortgage banks and structured bonds issued by banks. In June the stock of bonds issued by deposit banks totalled EUR 18 billion. The stock of MFI bonds issued for the public (mainly bonds, CDs and commercial paper) has primarily grown where maturities of more than two years are concerned, while the stocks of CDs and other debt instruments of shorter maturities have grown only slightly.[1] Of the stock of debt instruments issued by deposit banks, more than a third had a maturity of more than one year.

Structured funding, where yield is tied to other factors than interest rates, grew in the first half of 2007 by more than a quarter and amounted to EUR 6.3 billion in June. The demand for structured products has continued to grow. The products used in funding are mainly bonds, the yield of which is typically tied to the share price performance of equities or equity indices. By the end of June, structured bonds already accounted for more than a third of deposit banks' stock of bonds.

The stock of mortgage bonds issued by mortgage banks continued to grow and totalled EUR 4.5 billion at the end of June. Mortgage banks have already become significant financiers of housing mortgages. The stock of mortgage bonds grew by nearly 40% in the first half of 2007. Finnish mortgage banks score high credit ratings and, according to their own internal ratings, the stock of collateral consists of first-rate housing loans. The mortgage banking business is fairly transparent, ie risks can be calculated clearly. Therefore, the current market disruptions, especially in the United States, will not necessarily affect the demand for non-structured covered bonds.

Banks have drawn up contingency plans to deal with disruptions

The stress testing guidelines issued by the Committee of European Banking Supervisors (CEBS) recommend that banks also draw up contingency plans to deal with liquidity crises. Nearly all banks have contingency plans, although they could be developed further. The majority of commercial banks have also drawn up scenarios of disruptions in market funding and have made stress calculations on the impact of disruptions on funding costs. Banks that mainly use deposit funding have made limit arrangements with their central monetary financial institution for unexpected situations.

Commercial banks that use market funding have diversified their funding bases as regards counterparties, maturities and instruments, and hence reduced their vulnerability to market disruptions.

Short-term liquidity improved in spring 2007

In the first half of 2007, the aggregate one-month funding deficit that reflects deposit banks' short-term liquidity declined to a marked degree. Deposit banks' funding deficits contracted and surpluses expanded as maturities became longer. The ratio of funding maturing in less than a month to total funding declined in the spring, but it had an immediate impact on the funding deficit.

The volume of available debt securities eligible for use as collateral for central bank financing decreased slightly as a result of the new eligibility criteria, but other liquid funds, such as debt securities, listed shares and mutual fund units, were available to a larger extent than at the end of 2006. On average, banks were able to cover 11% of deposits payable on demand by means of eligible securities. When liquidity is short in the market, it is important that banks have buffers of liquid, low-risk securities, which may quickly be turned into cash or be used for acquiring collateralised funding.

Contingency plans, stress tests and strict funding plans will reduce banks' vulnerability to market disruptions

By drawing up various kinds of contingency plans and 'what if' scenarios, banks are able to prepare for sudden liquidity disruptions, enabling them to run their normal business without disruption. Stress tests should be performed not only in respect of risks attendant on price and availability of funding but also in respect of the impact of deterioration of market liquidity on balance sheet assets and liquid investments. Banks can prepare for sudden increases in their financing needs by holding liquid, low-risk assets on their balance sheets.

Diversification of market funding as regards maturities, counterparties, markets and instruments will also reduce banks' dependency on one single market source. Funding plans should take account of bank-specific strategies and possible deviations from projected growth paths and their impact on financing needs so that the smoothest possible running of operations can be ensured for banks in different market situations.

As lending continues to grow at a rapid rate, there will be an increasing need for market funding in the future. Structural funding risk can be managed by preparing for disruptions and price and availability risks and drawing up long-term funding plans.

1) Source: Bank of Finland, Financial Markets–Statistical Review 8/2007.

Funding risk

Funding risks are divided into long-term structural funding risks and liquidity risks related to short-term cash flow imbalances.

Structural funding risks are monitored by assessing what proportion of balance sheet assets in general, and lending in particular, is financed through deposits and market funding sources.

Short-term liquidity risk is measured on the basis of the difference in cash flows originating from income and expenditure, separately for each maturity category. Cash flow calculations also include off-balance sheet items. The difference that arises from the maturity mismatch indicates the amount that the bank needs to either invest or finance as assets and liabilities fall due, for each maturity category.

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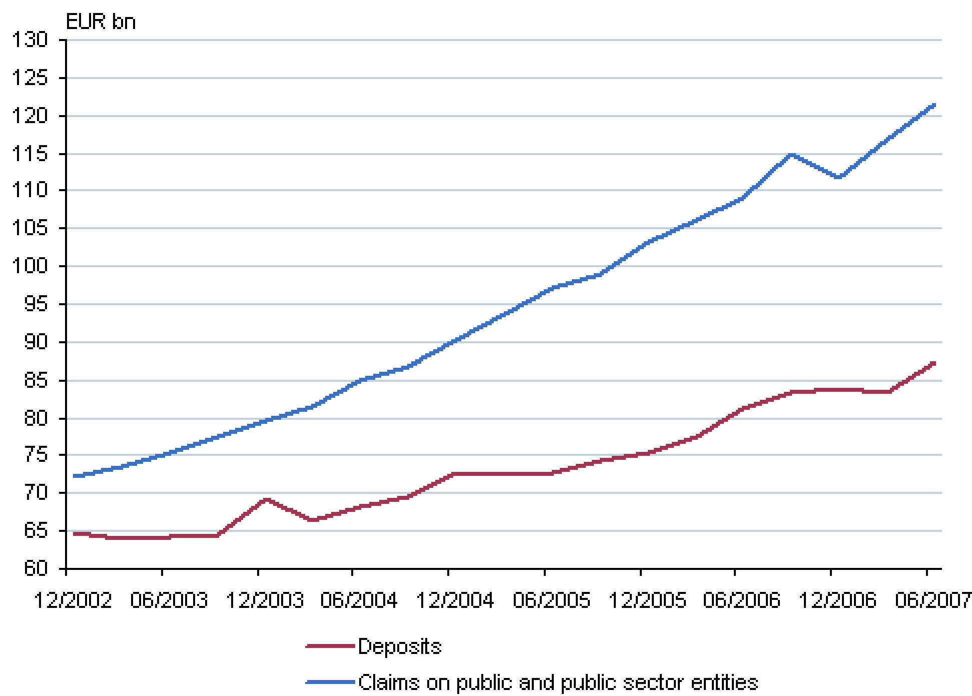

Source: Financial Supervision Authority.

Source: Financial Supervision Authority.

Market changes do not affect banks' exposure to interest rate risk

Changes in interest rates are among key risks affecting banks' earnings

A key objective for banks is to generate as lucrative profits as possible. However, sustained profit improvement is not possible without heightened risk exposure, because improved profits are associated with greater risks. In the banking business, exposure to both credit risk and interest rate risk is a key factor influencing banks' profit-making ability. Both of these risks are integral to the banking business; in fact, traditional banking business is not even possible without exposure to these risks.

Consequently, profit objectives and risk exposures must be appropriately balanced. Focus on profit making may drive the bank to take excessive risks with a view to its volume of business and risk-bearing capacity, while narrowing the focus on containing risk exposures is likely to thwart the bank's profit-making capacity. Thus, driven to take extreme actions at either end may jeopardise the opportunity for sustained business.

The purpose of official supervision is to monitor banks' risk exposures and thus to protect the assets of banks' customers and to safeguard the capital entrusted by investors to banks. Ultimately, safeguarding banks' operating conditions through supervision by authorities benefits the society as a whole. The purpose of monitoring exposure to the interest rate risk is to ensure that banks do not take higher risks than they can bear without jeopardising sustained business.

Lower interest rate level would reduce banks' net interest income

Interest rate risks for banks operating in Finland are mainly in the domestic currency. At the end of June, the risk in euro out of total income risk amounted to more than 70%. Significant outstanding positions with exposure to the interest rate risk were also in Nordic currencies, US dollar and the pound sterling.

The majority of the receivables in the balance sheet are in short maturities either because of the short duration of the contracts or because the contracts have been tied to short market rates. The most important items are receivables from credit institutions and the general public. Inter-bank receivables are generally very short-term by nature and are therefore also reflected in the shorter maturities. The imbalance in maturity allocation has an influence on inter-bank receivables out of all receivables. Looking at loans to the general public, the maturities allocation is dependent on the interest rate linkage of the loans. The majority of the loans taken out by the general public in recent years have been tied to the 12-month Euribor. Increased interest in banks' own prime rates at the expense of the Euribor has brought receivables from the general public to the shorter maturities and thus contributed to the imbalance in maturities.

Banks' liabilities are also dominated by the short maturities. This reduces maturity imbalances and alleviates the above described impact on the income risk arising from the shorter maturities. A significant exception to the accumulation of debts in the shorter maturities is attributed to the maturity assumption of 10.5 months applicable to deposits payable on demand. The large proportion of deposits payable on demand out of banks' liabilities shifts the emphasis towards longer maturities.

The situation as at the end of June shows that banks' net interest income decreases when interest rates fall ie banks are said to be sensitive to reductions in interest rates. The reason for this is the situation, described above, where the volume of receivables in the shorter maturities exceeds that of the liabilities. All in all, the figures for the income risk can be considered to reflect banks' expectations of increases in interest rates in the short term. However, a closer examination of derivatives positions reveals that banks are also hedging against a fall in interest rates.

In the first half of 2007, growth in lending to the general public is reflected in both shorter and longer maturities. This means that the rates applicable to new loans are more evenly divided into banks' own prime rates and the 12-month Euribor. The alleviating impact on the income risk, associated with the reduction in receivables by credit institutions due in less than one month, is offset with lending to the general public which has nearly doubled. Furthermore, the heightened income risk on receivables is increased by the fall in liabilities at credit institutions, which has outpaced the reduction in receivables at credit institutions. The

resulting net impact on the income risk is on the upside. The sensitivity of net interest income to changes in interest rates arising from balance-sheet items has thus heightened in the first half of 2007.

Income risk well under banks' control

Both general and bank-specific examination supports the finding that exposure to the interest rate risk is well under banks' control. The figure for the income risk alone does not directly reveal if the situation regarding the interest rate risk is known to banks or if the risk has been taken intentionally or unintentionally. In order to identify these factors, the FIN-FSA monitors banks' internal risk reporting and supervises the adequacy of banks' own instructions.

Banks' positions and the ensuing risks are also compared to changes in markets and market expectations. On the basis of these analyses and the available information it can be concluded that no such risk factors can be expected to emerge through the interest rate market that would seriously affect banks' business.

Banks use derivatives to hedge their interest rate positions

Good interest rate risk management is reflected in banks' business in that hedging with balance-sheet items is supplemented with derivatives agreements.

At the end of June, the most common hedging made with derivatives involved interest rate swaps and interest rate options. Interest rate swaps had been commonly used in altering the maturities of items on both sides of the balance sheet. The net impact of swap contracts in the shorter maturities was the replacement of shorter maturities with longer ones, which resulted in reduced exposure to income risk for banks. Interest rate options had been used to hedge against both rising and falling interest rates. When the impact of linearised options was taken into account, the impact of options hedging against a fall in interest rates was dominant. Accordingly, options can also be considered to alleviate exposure to the interest rate risk.

In 2007, the imbalance of the shortest maturities has been reduced and hedging has been improved by extending the maturities of receivables. Although the volume of options hedging against a fall in interest rates has increased, the alleviating impact on risks associated with the contracts is offset, because the volume of interest rate swaps hedging against slightly longer maturities has contracted significantly.

The trading book continues to reduce its exposure to investment risk

Exposure to the investment risk of the trading book fell to approximately a third from the level as at turn of the year. This also serves to restrict any losses to banks arising from unexpected changes in the market. At the end of June, an increase of 1% in interest rates would have contracted the value of the trading book by EUR 94 million.

Although the volume of the trading book has decreased, reduced sensitivity to the interest rate risk is mainly due from the hedging of positions. The increase in hedging is reflected in the relationship of sensitivity to interest rate risk and the value of the trading book. At the end of June, the sensitivity of the trading book to a change of 1% in interest rates was only slightly more than 1% of the value of the trading book, compared to 2.6% at the turn of the year.

Banks active in monitoring their interest rate risk

Because developments in net interest income are key to banks' performance, they actively measure and monitor any related risks. Banks are therefore well aware of risks associated with changes in interest rates, so monitoring the interest rate risk is very common.

The transition to the of Basel II capital adequacy calculations throughout Europe as of 2008 entails a number of changes in risk assessment and monitoring. While the calculation of own funds changes, banks also need to provide a risk-based assessment of their capital adequacy and allocate capital to the identified risk areas.

Following the transition to the new capital adequacy calculation principles, a risk-based capital requirement will have to be calculated for the interest rate risk. Allocation of own capital and the associated requirements by authorities will mean that banks' own monitoring of the interest rate risk will be enhanced further. Banks' own monitoring will be controlled through expanded risk reporting by authorities.

The FIN-FSA will enhance supervision with effect from the beginning of 2008 by introducing risk calculations based on the present value of items sensitive to changes in interest rates. The new method aims to take better account of the special characteristics of derivatives agreements, such as non-linearity. Introduction of the method of calculation based on the present value is part of international cooperation in supervision and standard development work in improving methods of risk monitoring.

Despite positive developments banks' exposure to income risk has increased

Finnish banks' combined exposure to the income risk has increased from EUR 370 at the end of 2006 to EUR 432 at the end of June. Banks' combined relative income risk as at the end of the June thus accounted for 14% of net interest income.

In terms of percentages, euro-denominated income risk showed an increase of just less than 17%. Relative income risk had also increased in equal proportion. This is due to the adjustment of the euro-denominated income risk to net interest income at the turn of the previous year, which was the same in both cases. The observed increase in exposure to the income risk is due to the greater imbalance in balance-sheet items as discussed in the above and the weakening impact of hedging against derivatives.

Heightened exposure to income risk is partly illusory

However, the result produced by the measure for the relative income risk involves a systematic fallacy due to the previous year's net interest income, which is used as the divisor, remaining unchanged. In other words, the measure does not account for developments in net interest income in the current year.

In 2007, net interest income was more than 21% higher than at the same time in 2006. If this were taken into account in calculating the relative income risk exposure, the measure would indicate a decline in income risk as opposed to growth, as at present. However, use of the previous year's net interest income is justified because changes in the measure can be explained more easily when the denominator remains unchanged.

The weakening impact of hedging against derivatives is justified by the distinctive change in markets' and banks' expectations. A decrease in hedging reflects well the situation at the end of June, when a fall in interest rates was considered unlikely. In such a situation it is natural that banks run down derivatives positions hedged against falling interest rates.

Irrespective of whether developments in net interest income in 2007 are accounted for or not, the level of banks' combined exposure to the income risk is still very low. Banks' performance and capital adequacy withstand well changes in the interest rate level that exceed the assumed level of interest rates.

Loan margins and subprime loans have no impact on banks' exposure to interest rate risk

The low level of interest rate margins on lending by banks has been under some debate. Although the size of the margin affects banks' net income from financial operations, it has nothing to do with bank's exposure to the interest rate risk.

Interest rate risk refers to the negative impact that a change in the level of interest rates may cause to banks. Because the size of the margin is not dependent on the prevailing interest rate level, it has nothing to do with banks' exposure to the interest rate risk. The margin is concerned with the bank's assessment of the customer's solvency and is thus part of banks' credit risk management.

Risks arising from banks' subprime exposures also fall under exposure to the credit risk, not exposure to the interest rate risk. Although the rise in interest rates would weaken customers' solvency and thus increase

losses arising from subprime contracts, this does not constitute exposure to the interest rate risk. Any losses arise from customers' insolvency or bankruptcy and thus they fall under exposure to the credit risk.

Exposure to the credit risk associated with lending and investment should not be confused with banks' exposure to the interest rate risk, although some converging channels of impact do exist.

What is an interest rate risk?

An income risk measures the impact on net income from financial operations for the year of maturity imbalances relating to receivables and debts when market rates increase.

An 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. In other words, an investment risk measures the sensitivity of the current values of securities portfolios to changes in interest rates.

See also

Assessment of exposure to the interest rate risk of deposit banks

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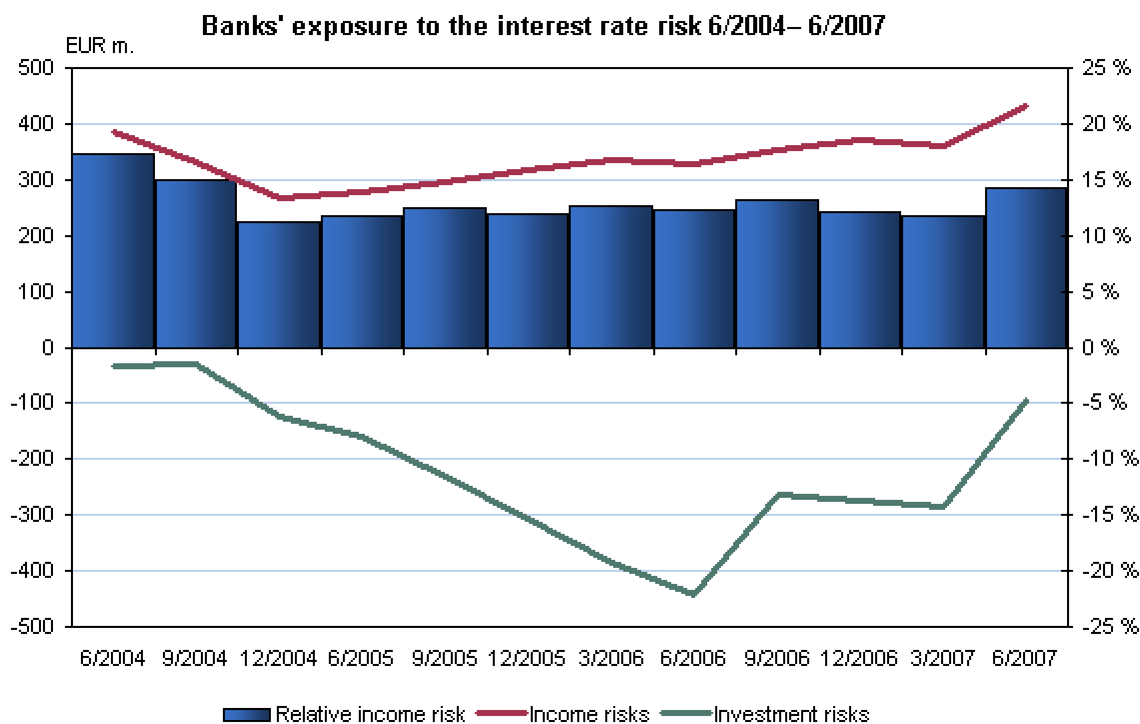
Combined interest rate risk for the banking sector in euro and other currencies with derivatives included

(Value in EUR m at a time of one percentage point rise in interest rates)

	30 Jun 2007	31 Dec 2006	Change
Exposure to banks interest rate risk of the banking book			
Exposure to the income risk	432,3	369,9	16,9 %
Net interest income (31.12.2006)	3 049,7	3 049,7	
Relative income risk, % from net interest income	14,2%	12,1%	
Stress test 1; sign deposit < 1 month	-98,1	-144,2	-31,9%
Stress test 2; currencies to absolute value	877,7	687,1	27,7%
Exposure to the investment risk	-81,3	-109,5	-25,8%
Exposure to the interest rate risk of the trading book			
Exposure to the investment risk	-94,3	-275,6	-65,8%
Trading book market value	8 136,3	10 524,7	-22,7%
Trading book value relative to risk	-1,2%	-2,6%	
Stress test 3; currencies to absolute value	279,6	363,5	-23,1%



Source: Financial Supervision Authority.

Basel II reform has not yet brought significant changes in banks' capital adequacy ratios

New capital adequacy provisions (Basel II) entered into force at the beginning of 2007. The Basel II regulation is expected to decrease banks' capital requirements. However, the reform of the capital adequacy calculation has not yet brought significant changes in banks' capital adequacy ratios. The banking sector's capital adequacy remained at the same level as at the turn of the year, at 15.1%.

Banks are only just turning to advanced methods of credit risk management, which are expected to decrease capital requirements

The standardised approach in calculating capital requirement for credit risk and the foundation internal risk-based approach (FIRB)[1] were adopted in 2007. Capital requirements are expected to decrease most for banks applying advanced methods, particularly for banks that adopt the most advanced models (AIRB).[2] However, AIRB models can be used from the start of 2008 at the earliest.

1 Foundation Internal Risk-Based Approach, FIRB.
2 Advanced Internal Risk-Based Approach, AIRB.

Transitional provisions for advanced Basel II methods stagger introduction of new capital requirement calculation

In the switch to the advanced Basel II methods transitional provisions are followed for prudential reasons. The provisions are used for staggering the switch to the new capital requirement calculation. According to these so-called floor provisions the capital requirement of banks using the advanced methods may at the

most fall by 5% during the first year after introduction, by 10% after the second year and 20% after the third year compared to the previous capital adequacy calculation (Basel I).

OP-Pohjola Group and Sampo Bank still apply Basel I calculation

The reform is not carried out in all banks at the same time. General transitional provisions were implemented through changes in the Credit Institutions Act. They give credit institutions the option to start applying the new capital adequacy legislation from the start of 2008. Two central factors of the Finnish banking sector, OP-Pohjola Group and Sampo Bank, still apply Basel I calculation. Thus the reform's effect on the whole sector cannot be assessed until 2008.

Capital requirement for operational risk eliminate decrease of capital requirement for credit risk

The growth in the stock of lending still burdens the capital adequacy. However, the strongest growth has occurred in housing loans, whose capital requirement has decreased in the new capital adequacy calculation. On the other hand the new capital requirement for operational risk has partly eliminated the lowered capital requirement for credit risk.

Banking sector's capital adequacy all right

Presently the Finnish banking sector is financially sound. The sector's aggregate loss buffer amounts to EUR 9.2 billion and the sector's predicted financial performance is good, which provides the preconditions for increasing the buffers. All banks have a solid capital adequacy. The banks' capital adequacy range was 10.2–22.1% at conglomeration and group level.

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Growth of investment services continued

Number of investment services providers increased

Investment services may be provided by domestic credit institutions, investment firms or management companies engaging in asset management as well as foreign credit institutions or investment firms either across borders or through a branch based in Finland.

Investment firm refers to a company operating in a professional capacity and providing investment services subject to authorisation and laid down specifically in the law. Typical forms of investment services include securities broking, asset management, market making, underwriting of issues, provision of advice and consulting. The bulk of domestic investment firms are small in terms of the number of personnel. In addition, a significant proportion of services providers operate as part of a banking group.

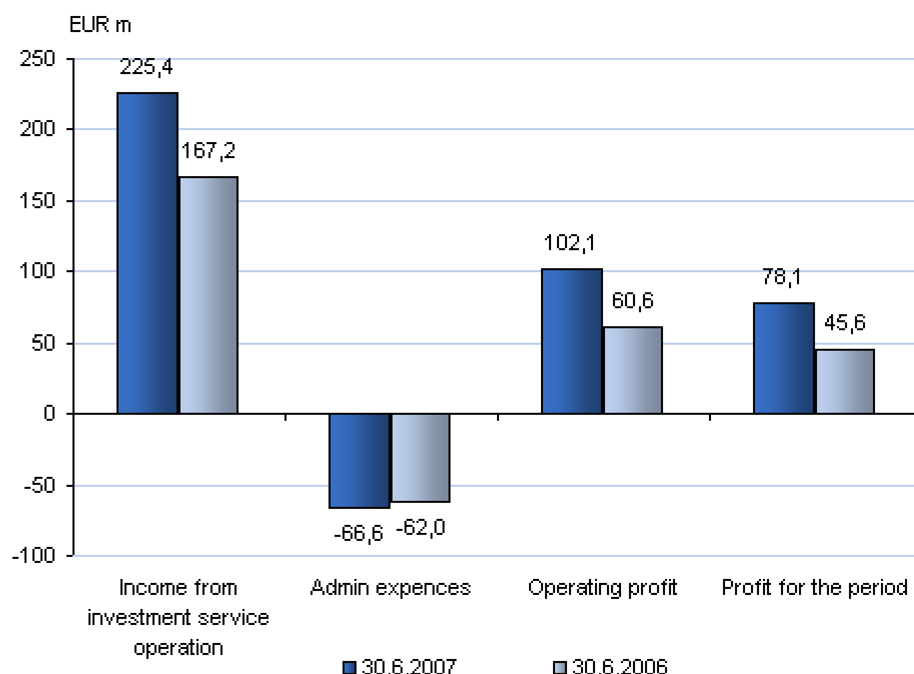
At the end of June 2007, there were a total of 44 domestic investment firms (40 on 31 Dec 2006). The number of investment firms is expected to increase as a result of the Directive on Markets in Financial Instruments (MiFID, 2004/39/EC). The Directive, drafted in 2004 enters into force on 1 November 2007. As a result of the Directive, the Investment Firms Act will also be reformed. A government bill (HE 43/3007) has been made on the new Act, and the Act is intended to enter into force on 1 November 2007. As a consequence of the Directive, for example investment advice operations will be subject to authorisation. Hence, companies engaging in investment operations will have to apply for authorisation for their operations.

Securities markets activity increased demand for investment services

The demand for investment services is affected partly by the general economic and securities markets situation. For example, the demand for securities broking and underwriting of issues is directly linked to the level of activity in the securities markets. The General Index in the Helsinki Stock Exchange rose to 11,347 points at the end of June, showing an increase of almost 17.9% from the beginning of the year. At the same time, the Portfolio Index (Cap) rose by 13.4%. Increased activity is also reflected in the fact that the share trading volume in terms of euro increased by 27.8% and in terms of the number of transactions by 50.6%. Mutual fund assets grew by 34.6%. The persistent favourable developments in the securities markets laid a solid foundation for the operations of investment firms and for the demand for their services.

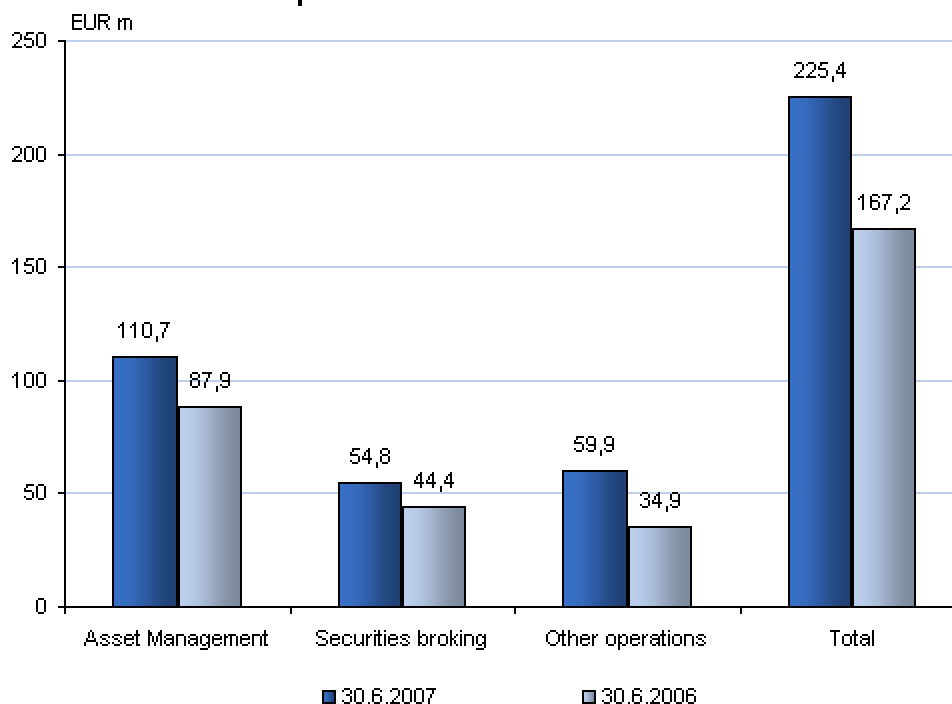
Profitability of investment firms improved

The profitability of investment firms stood at an excellent level in June 2007. Income from investment service operations rose to EUR 225.4 million (1/2007–6/2007), showing a year-on-year growth of almost 34.7%. Similarly, operating profit increased to EUR 102.1 million, growing year-on-year a whopping 68.5%. Operating margin (operating profit / income from investment service operations * 100) stood at 45.3% (36.2% on 30 June 2006). The profitability of investment firms improved markedly, although variation across companies was very large.



Source: Financial Supervision Authority.

The distribution of income from investment operations shows that 49% of fee income was generated in asset management, 24% in securities broking and 27% from other operations. Fees from other operations surpassed securities broking during the early part of the year. Other operations include fee income from market making, underwriting of issues and investment and financial advice, among which advice has shown very rapid growth. Asset management fees have a logical correlation with the growth of assets under management. In contrast, fees from securities broking grew more slowly in comparison to, for example, the number of or euro value of share trading transactions.



Transition year in calculation of capital adequacy

The uniform calculation of the capital adequacy of investment firms is challenging. Beginning of 2007 saw the entry into force of new capital adequacy regulations (Basel II), which introduce a comprehensive reform of capital adequacy calculation. However, investment firms are allowed to use an option granted by the transitional provisions to adopt the new regulations only from 1 January 2008 onwards. This option has been embraced by a majority of investment firms. In other words, 2007 may be considered a transition year, when both the old and new capital adequacy regulations are being used. As a result of the new calculation methods, at least the requirement of own funds for operative risk will increase.

Among the domestic investment firms, 28 follow the old capital adequacy regulations (so-called Basel I). The own funds of these companies in June 2007 totalled almost EUR 63.6 million (EUR 60.7 million in 30 June 2006). The largest amount of own funds is required for operative risks, often related to the company's operating procedures, information systems, personnel, processes and external factors. The relative surplus of own funds describes the percentage amount of own funds the company has in excess of the minimum requirements. Measured with this indicator, investment firms had own funds about 1.5 times the minimum requirement. The relative surplus of own funds has decreased somewhat, as a year ago the corresponding figure was 2.1.

The remaining domestic investment firms have adopted the new capital adequacy regulations (Basel II). The minimum requirement for own funds is based on the so-called Pillar I of the capital adequacy framework, stating that the company has to have own funds for three separate risk areas: operative, credit and market risk. When the requirements for all risk areas are combined, the result is the minimum requirement for the own funds of an investment firm. The own funds of investment firms belonging to this group amounted to EUR 53.3 million and the minimum requirement for own funds EUR 14.0 million. The remaining surplus of own funds is EUR 39.5 million, ie 2.8 times the minimum requirement. Most of the minimum requirement for own funds was related to operative risks.

The capital adequacy of investment firms was on a good level, which is a consequence of excellent profitability. On the other hand, variation in capital adequacy is large across the companies. In particular, the

surpluses of own funds are markedly smaller among new agents in comparison with other companies in the industry. From the beginning of 2008, all investment firms will apply the new capital adequacy regulations, making comparison easier.

Importance of asset management increased

Asset management services constitute a significant proportion of the operations on an investment firm. The amount of assets under management increased by 22% to EUR 117.8 billion. This was also shown in increased fee income. A major share of asset management was discretionary asset management, where the asset manager has the control over the investments. The trend would seem to be that the proportion of mutual funds in funds under asset management increases year by year. In June 2007, mutual fund assets in asset management amounted already to EUR 55.9 billion, ie 33% more than a year ago. The total amount of funds in asset management (investment firms, banks and management companies) grew to EUR 147.5 billion. A majority of the funds are at the responsibility of investment firms.

Assets under management of investment firms in 6/2006–6/2007 (EUR bn)

	6/2007	6/2006	Change	
	EUR bn	EUR bn	EUR bn	%
Discretionary asset management	98,8	80,1	18,7	23%
whereof assets of mutual funds	55,9	41,9	14,0	33%
Non-discretionary asset management	19,0	16,3	2,7	17%
Total	117,8	96,4	21,4	22%

Total assets in asset management 6/2006–6/2007 (EUR bn)

	6/2007	6/2006	Change	
	EUR bn	EUR bn	EUR bn	%
Discretionary asset management	107,2	86,4	20,7	24%
whereof assets of domestic mutual funds	60,2	44,9	15,2	34%
Non-discretionary asset management	40,3	33,4	6,9	21%
Total	147,5	119,9	27,6	23%

Investment service business is doing well

The profitability of investment firms saw outstanding development in the first half of 2007. Capital adequacy in the industry is also solid. On the other hand, variation in both profitability and capital adequacy across companies is high. Favourable developments in the securities markets have continued for a relatively long period, which has made a positive contribution to the profitability of investment firms. This has attracted new agents into the industry.

Uncertainty in the securities markets has increased particularly due to the subprime problems, but this has not had an impact on the demand for investment services. If the problems remain for an extended period, this will very likely also have a negative impact on the demand for investment services. This would in turn be reflected in the profitability and capital adequacy of investment firms. The number of investment firms has increased year by year. Furthermore, due to the MiFID, the concept of investment services will be extended,

which will increase the number of companies. It is probable that as a result of the changes, competition in the investment services industry will increase.

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Mutual fund saving boom improved profitability of management companies

Supply of mutual funds increased

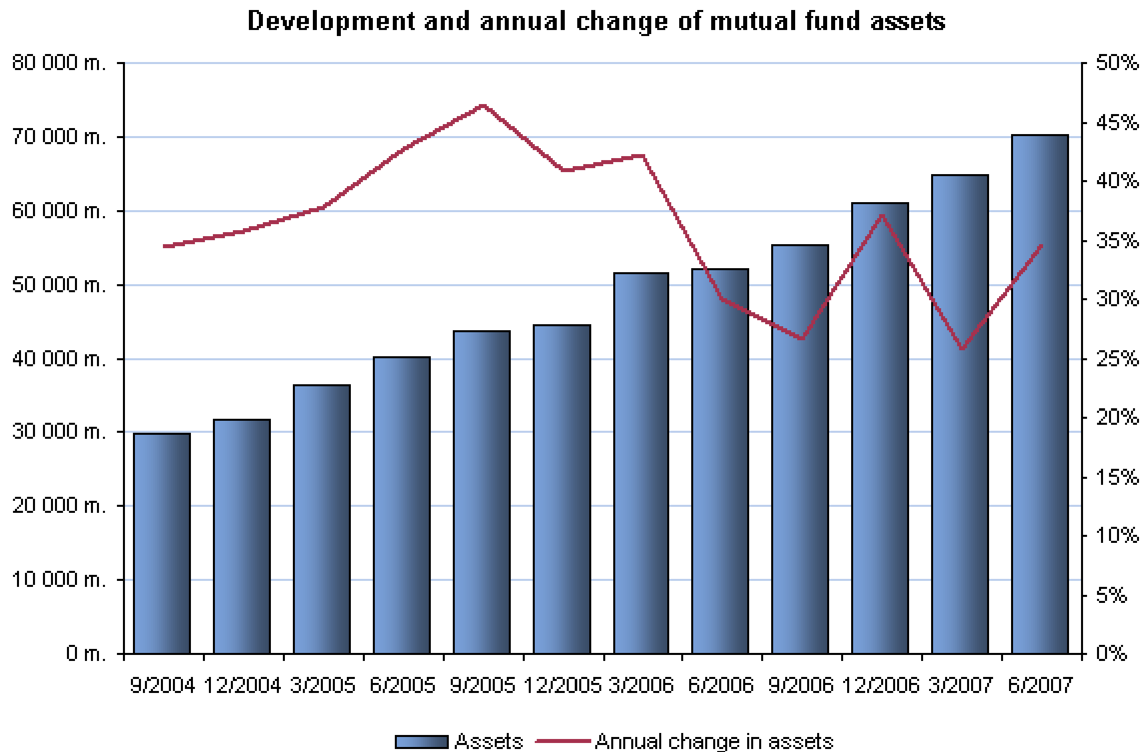
A management company refers to an authorised entity engaging in mutual fund operations. In addition, management companies may engage in asset management, provision of investment and financial advice and custodial and management services for mutual fund units.

At the end of June 2007, there were a total of 28 Finnish management companies. In the first half of 2007, the authorisation of a management company was granted to one new agent. Among the domestic management companies, four engage in asset management in addition to mutual fund operations.

The range of domestic mutual funds offered expanded further. At the end of June, there were 523 mutual funds, whereas the figure stood at 508 at the end of 2006. The number of mutual funds has been growing steadily for an extended period at a rate of about 50 new mutual funds a year. This year, growth seems to have slowed somewhat.

Mutual fund assets continued to grow briskly

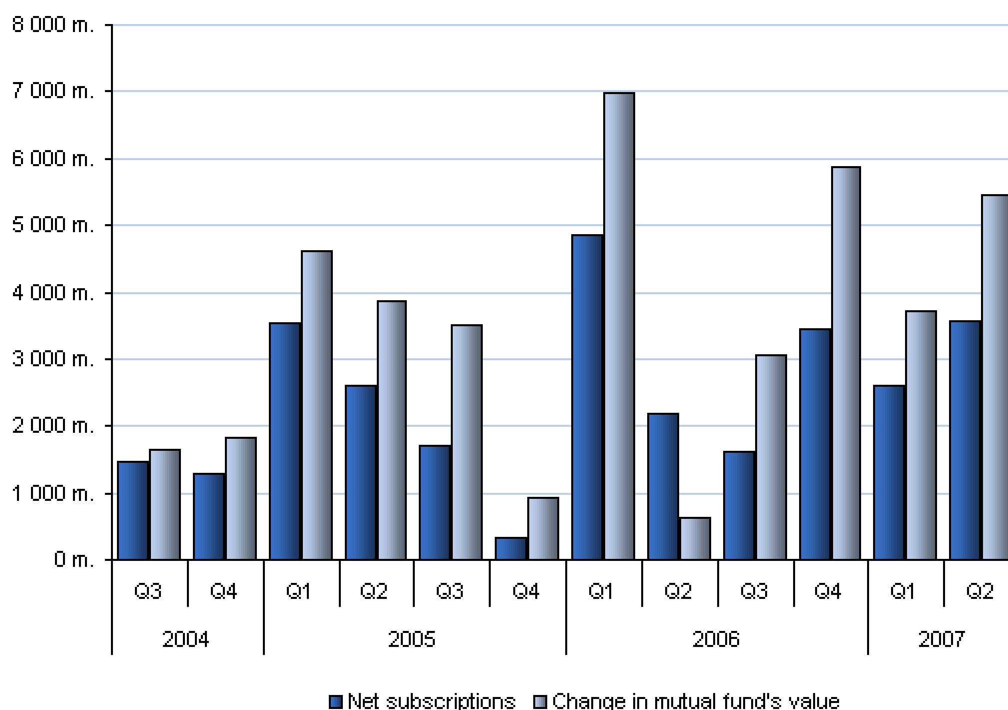
The amount of assets invested in mutual funds has grown steadily for many consecutive years. At the end of June, the amount of assets increased to EUR 70.2 billion, growing 34.2% year-on-year. At the end of 2006, the assets amounted to EUR 61.3 billion. On average, one mutual fund contained about EUR 134 million in assets. The amount of assets in mutual funds is already closing in on the deposit stock of EUR 86 million at domestic monetary financial institutions.



Source: Financial Supervision Authority.

There are many reasons behind the growth of mutual fund assets. First, positive developments in the securities markets have increased the value of mutual fund units. For example, at the Helsinki Stock Exchange, the annual change of the general index was 32% and the annual change of the portfolio index was 33%. Positive development of the securities markets is directly reflected in the growth of the value of mutual fund units, particularly in equity funds. This has in turn attracted new mutual fund savers, which is reflected in net subscriptions. On the other hand, efforts by management companies in the sales and marketing of mutual funds have also brought results.

Net subscriptions in domestic mutual funds during the first half of 2007 amounted to almost EUR 6.2 billion. A year ago, the corresponding figure stood at EUR 7.1 billion. Therefore, in light of net subscriptions, the popularity of mutual fund saving seems to have decreased somewhat. On the other hand, in June 2007, net subscriptions amounted to almost 54% more than in the previous year. The chart below shows that more than half of the growth of mutual funds is the direct result of increased net subscriptions, while the rest came from value appreciation.



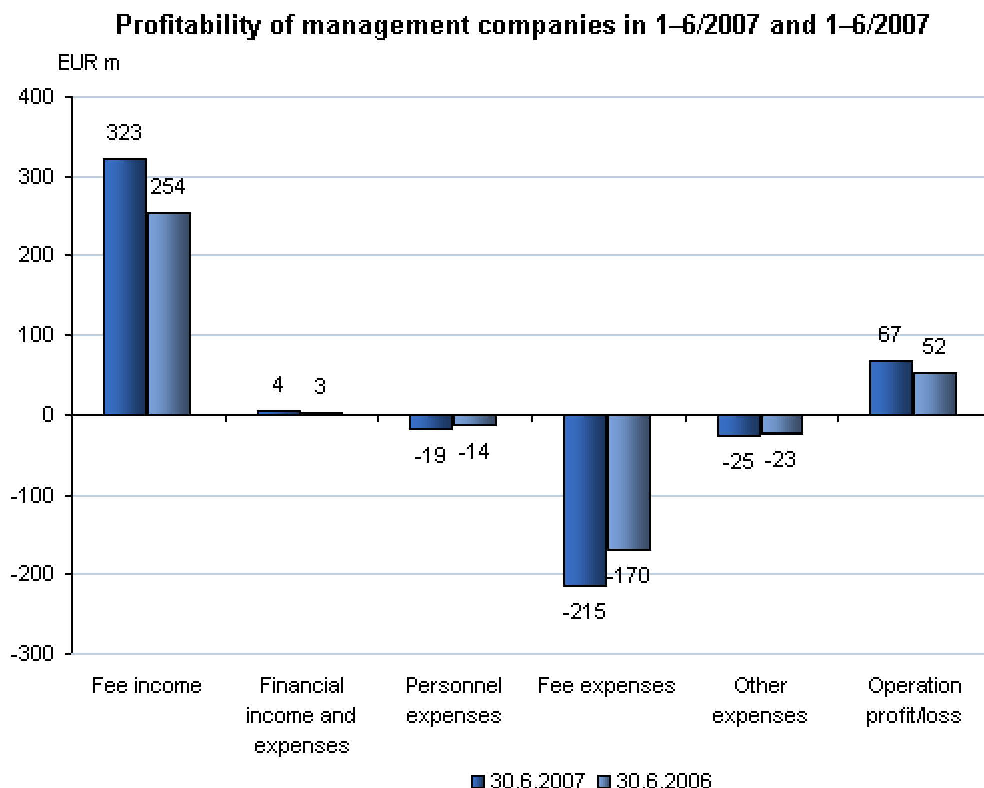
Source: Financial Supervision Authority.

Number of unitholders increased

The popularity of mutual fund saving is also reflected in the growth of the number of unitholders. In June 2007, domestic mutual funds had over 2.5 million unitholders. From the end of 2006, the number of unitholders increased by 198,000. The proportion of individuals in all unitholders has increased somewhat, with the share standing at the end of June 2007 at almost 93%. It must be kept in mind that one individual may have units in many mutual funds. In contrast, the share of individuals in fund assets is considerably lower. At the end of June, individuals' share of fund assets only amounted to 28%, ie EUR 19.7 billion. A year ago, the proportion was almost the same. Other significant mutual fund investors are insurance institutions, financial institutions and foreign investors.

Mutual fund saving boom improved profitability of management companies

Management companies amassed almost EUR 323.1 million in fee income between January and June 2007. The corresponding figure stood at EUR 254.3 million in the corresponding period a year ago, so annual growth amounted to 27.1%. A majority of the fee income consisted of the management fees of mutual funds, which accounted for over 90% of total fee income. Other fees consisted of subscription and redemption fees and other fees. In addition, fee income includes management companies' income from asset management, investment and financial advice and securities custodial services. These amounted to about EUR 17.4 million by the end of June.



Source: Financial Supervision Authority.

The ratio of fee income to assets under management has decreased somewhat. Fee income over half a year has been scaled to correspond to annual income. The ratio of fee income to assets under management at the end of June 2007 stood at about 0.92% (0.98% on 30 June 2006). The decrease may indicate that the management fees of management companies have decreased somewhat. However, in practice eg the range of mutual funds has an impact on the size of the management fee, since for example special and equity funds typically entail higher management fees in comparison to fixed-income funds.

As a result of increased fee income, the profitability of management companies also improved. Operating profit increased 29% to EUR 66.7 million in 1–6/2007. Operating margin stood at 20.6%, while a year ago the corresponding figure was 20.3%. Although total fee income increased in line with fund assets, profitability did not show as strong an improvement.

The popularity of mutual funds is shown in the growth of fund assets and unitholders. The popularity is also directly reflected in better profitability of management companies. At the same time, the capital adequacy of management companies improved. The profitability of management companies on average is at an excellent level.

In spite of solid profitability among management companies, three companies made a loss in the first half of 2007. One of these companies has been launched within a year, explaining the loss. The losses were small in euro terms, so the observation does not give grounds for major concern.

Capital adequacy requirements were met

Management companies do not apply the Basel II capital adequacy regulations. Only management companies engaging in asset management are subject to the same capital adequacy regulations as banks and investment firms. The Mutual Funds Act requires that a management company has the following own funds:

1. Share capital at least EUR 125,000 (absolute minimum)
2. In addition to the minimum share capital, the management company must have 0.02% of own funds of the amount whereby the total value of the assets managed by it exceeds EUR 250 million. However, the maximum own funds requirement is EUR 10 million.
3. The amount of own funds may not fall below 25% of the fixed costs in the previous financial period.

In June 2007, the surplus of own funds of management companies was almost EUR 73.8 million. A year ago, the surplus of own funds was EUR 68.7 million, which means that risk buffers in the industry have improved. Own funds are required for expected and unexpected losses. A few management companies had a very small surplus of own funds so they had low loss buffers. Such management companies were primarily new management companies with only a few years of operations in the industry. Development of capital adequacy among these management companies is followed more closely by the Financial Supervision Authority.

Despite solid performance of mutual funds, mutual fund saving involves risks

Despite the extended positive performance of mutual funds, it is appropriate to recall that there are risks related to mutual funds. Similarly to equity investments, mutual fund saving involves a risk of decrease in value. In July 2007, the value of mutual funds decreased by almost a billion euro despite the fact that the amount of net subscriptions remained unchanged.

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