Contents

Customer guidance and risk identification are gaining importance in an economic boom

The financial sector is currently doing well. Despite of this, or probably because of it, a supervisor must be vigilant. Old known risks can still realise and new risks still unidentified may emerge. The change in households' attitude towards careless lending also emphasises the importance of customer guidance. Interest rates have risen by almost 2 percentage points in the past one and a half years, and the rise has already caused problems for some households.

Economic growth peaked in 2006

The upswing of the global economy which started in 2002 is estimated to have peaked in 2006. Finnish GDP growth is also expected to start slowing in 2007–2009, following extremely rapid growth in 2006.

Continued rapid growth in the securities markets

Year 2006 was particularly favourable for the securities markets. The all-share index (OMXH) of price movements rose to 9,625 points, with the annual rise totalling 17.9%. Moreover, equity trading was considerably more active than in 2005.

Growth in banks' profits reaches cyclical peak

Year 2006 as a whole was extremely successful for Finnish banks and banking groups. Growth in net interest income increased to 15%, from 10% in 2005. The positive economic cycle was reflected also in banks' net fee income.

Finnish banks are efficient and profitable by European standards

In terms of cost efficiency, Finnish banks rank among the best in the EU. Finnish banks also do well in terms of profitability, measured by return on assets (ROA). As regards return on equity (ROE), Finland however, ranks low among the EU countries.

Capital adequacy of the Finnish banking sector remains high

Capital adequacy of the Finnish banking sector is among the highest in Europe. The structure of the banking sector is nevertheless such that banks' capital position may weaken as a result of restructuring.

Credit demand has eased only slightly

Demand for credit has continued to grow strongly. The competitive situation in the market is changing and competition is focusing on other financial services besides lending. So far households' propensity to borrow has not been much affected by rising lending rates and house prices.

Mortgage holders exposed to mounting risks

Households with outstanding housing loans are exposed to mounting risks since loans raised by households tend to be very large relative to their income. Hence, those households that have made poor or no preparation for unforeseen expenses are likely to run into debt-servicing problems whenever interest rates rise or their financial circumstances change. On the whole, however, households continue to be well able to serve their debts. Although non-performing household assets are gradually increasing, they still represent only a modest part of the household stock of lending. However, the rapid growth of matured assets may be signalling a deterioration.

Funding risks on the increase: Banks are investing in funding via deposits and diversifying market-based funding

Dependency on market-based funding continues to increase, which is why credit ratings are increasingly important for banks. Short-term liquidity risk heightened towards the end of the year. Banks' competition over customers seems to be slowly shifting from loans to deposits.

Only minor changes in banks' interest rate risks

Finnish deposit banks' combined absolute exposure to income risk has increased from the end of December 2005, totalling EUR 357 million at the end of 2006. In relation to net interest income, however, which increased during the same period, exposure to income risk has decreased. Exposure to investment risk of the trading book, which has the opposite sign to amounts reported as income risk of financial operations, dropped from the previous turn of the year.

Positive stock market momentum reflected in profitability and growth figures of investment firms

2006 was a particularly favourable year in the securities markets, which reflected in the profitability and growth figures of investment firms. The profitability of investment firms was on average at a very good level. There were many significant structural changes in the industry during the year, which complicates monitoring and comparison in the field. Asset management continued to make a key contribution to commissions and assets under management last year, too.

Capital inflows to mutual funds at record levels - rapid growth poses a challenge to both management companies and supervision

At the end of 2006, the amount of assets under management was EUR 61.3bn, having grown as much as 37.1%. The most popular mutual funds were still fixed income funds. The increase in capital also boosted the financial position of management companies, since the combined profit for the period of the companies increased by a gigantic 58%. Rapid growth of the mutual fund market is a challenge to both management companies and supervision. From the investor’s point of view, it is important to understand the risks related to mutual funds investing in emerging market that are still attracting attention. It remains yet to be seen whether price competition will also extend to mutual funds in the coming year.

Customer guidance and risk identification are gaining importance in an economic boom

Financial sector is making record results

The domestic banking sector is making record results in the current economic boom. Housing loans are selling well and net interest income continues to increase banks' results further, despite the narrowing of credit margins. Finnish banks are effective and profitable compared with banks of other EU countries. The quality of credit portfolio does not show clear signs of weakening yet. Instead of deposits, deposit banks have increasingly funded their growing lending with market-based financing, but their funding risk can still be regarded as moderate. Even great interest rate changes alone would not jeopardise banks' results or capital adequacy.

Favourable share price developments and households' willingness to save and invest are reflected in higher profits for banks as well as investment firms. Funds under asset management are growing rapidly and investment service business is booming on the whole.

Supervisor must remain vigilant even in good times

Supervision must not relax in the current very good economic conditions. It must proactively seek to assess what risks already identified can realise in future. Above all, supervision must devote efforts to identifying possible new risks threatening the financial sector. In addition, customer guidence has gained more importance in the work of a supervisor as a result of change in household behaviour.

Funding risks may be realised

One of the risks requiring especially vigilant monitoring is the funding risk. The clear change observed in the housing loan market in the lengthening of loan repayment periods increases the funding risk directly in the longer period. This results from the fact that banks must be able to fund the loans granted also in the far future. The bulk of lending is still funded with deposits, but banks' dependence on market-based financing is increasing all the time.

At the current juncture, there is ample liquidity available at a reasonable price, but what will the future situation be like? Long-term loans granted with very narrow credit margins also pose a risk to banks' profitability. If banks' funding costs rise in future their profitability would weaken, since the margins of loans granted with narrow margins cannot be changed.

Structural changes in economic sectors a source of risk?

Another possible source of risk is the structural change that is occurring in the Finnish financial sector. Two major banks have transferred to foreign ownership. The supervision of a financial institution operating in several countries need be organised in practice so that all supervisors have the necessary information and powers. However, getting an overall picture of an international financial institution is a very challenging task. In addition, risks realising from international banking activities can be such that they are difficult to assess.

The Finnish financial market has also seen the rise of new financial conglomerates. Supervisors must be able to make a picture of all possible risks arising when banking, investment service and insurance activities are conducted in one and the same financial conglomerate. The supervision of risks to financial conglomerates together with insurance supervisory authorities is becoming increasingly important.

Risks to households are increasing – borrowers must be careful in assessing their risk-bearing capacity

The risk that is the largest and also already visible is related to households' sizable housing loans. Households' vigorous borrowing does not cause a problem for financial stability yet, but borrowers' behaviour in itself increases risks. There is a clear change in attitudes towards indebtedness in Finland. Young families easily take large loans with long maturities and very small buffers. On top of large housing loans customers can also take consumer credit without hesitation. Customer guidence is therefore clearly needed.

Supervisory findings show that lending is often based on collateral and not on customers' ability to service their loans. Even a small addition to normal expenditure could mean that a customer might not necessarily be able to service the loan. Household credit that has not been serviced for over 90 days, ie nonperforming loans, have resumed an upward trend but are still at a very low level. The proportion of nonperforming assets in the stock of lending does not give as adequate a picture of the quality of credit portfolio as before. Currently banks address customers' payment problems immediately and rearrange the credit. Loan repayment problems are seen as growth in nonperforming loans only at the stage when problems have already been there for a long time.

Banks may come through with the next downturn with moderate damage from households' nonperforming housing loans because they have backed their claims with collateral. House prices must plunge considerably before the stability of the banking system is threatened. However, part of households can run into difficulties in servicing their loans when interest rates rise or households' own financial situation changes. Part of the customers have prepared themselves for bad times with insurance policies and against interest rate rises with fixed-rate loans, but the majority of customers have tied their loans to floating rates, and have no insurance coverage. Although the responsibility for borrowing lies naturally with the customer, banks should also consider the customer's realistic loan servicing ability when granting loans.

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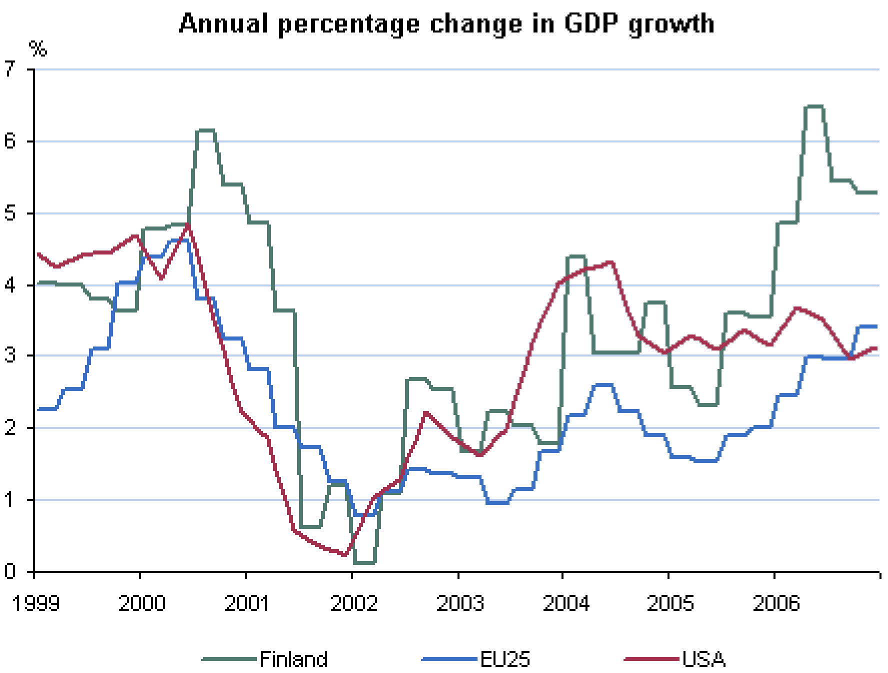
Economic growth peaked in 2006

2002 marked the start of a global economic upswing, which was characterised by, for example, geographically more broadly-based growth. Growth is however considered to have peaked in 2006, the year when also the Finnish GDP grew by as much as 5.5%. The Bank of Finland expects Finland's economic growth to gradually slow in the next few years.

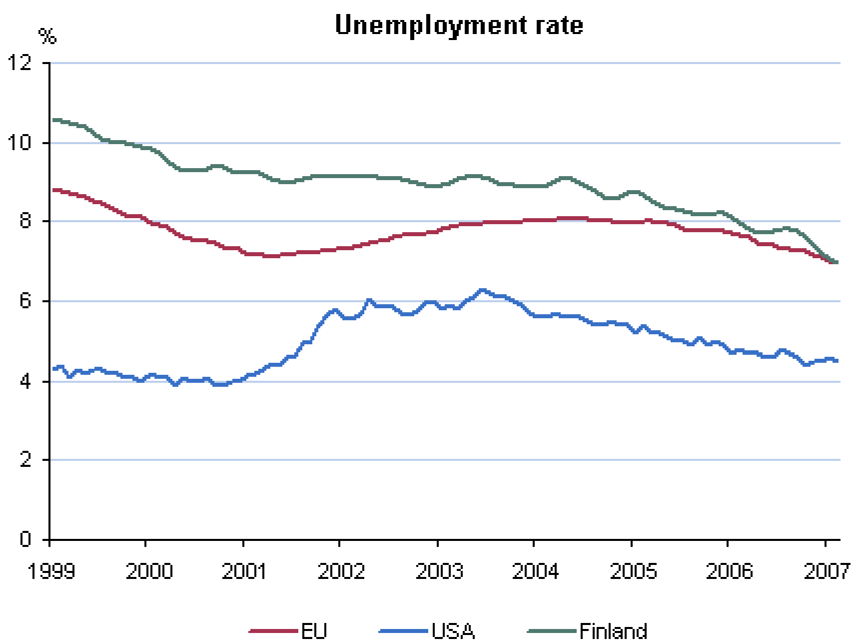
Upswing in the global economy in 2002–2006

2002 marked the start of a global economic upswing, which peaked in 2006. Economic growth picked up almost continuously in the major economic regions, with the exception of the small peak at the turn of the 2004, followed by a momentary slowdown.



Sources: Statistics Finland, Eurostat and BEA.

GDP growth gained momentum and unemployment declined both in the United States and particularly in the European Union, where GDP growth has been rapid especially after 2004. The Finnish employment situation continues to improve faster than the EU average. The employment rate in Finland is nevertheless still fairly high.



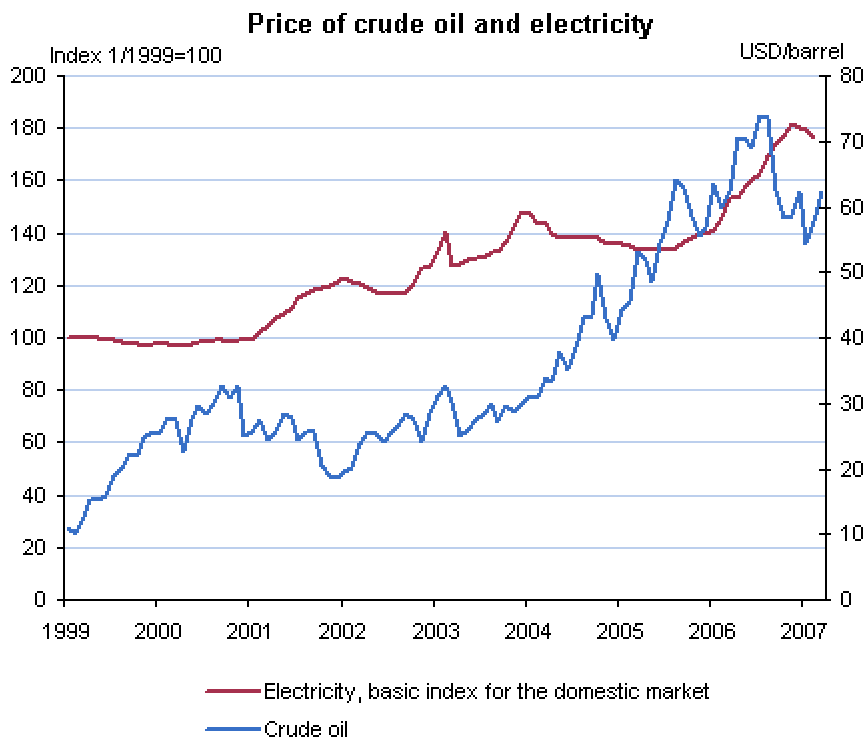
Sources: Statistics Finland and Eurostat.

China – the engine of world economic growth

This upturn has been marked by economic growth that has been geographically more broadly-based. Particularly in China, but also in the other emerging economies, growth was significantly above average. Robust growth in industrial output in these countries contributed to the strong rise in oil prices, which in turn boosted export receipts and economic growth in oil producing countries.

As a result, the current account deficit, and indicator of external balance, deepened in the United States. Of the current account surplus equivalent to the US deficit, two-thirds are accounted for by China and the oil exporting countries.

In 2006 economic growth gained further momentum in non-Japan Asia and Europe. In the EU countries, annual GDP growth reached 2.8%, compared to 1.6% in 2005. In the United States, GDP growth peaked in the first months of the year, but started to slow significantly towards the end of the year due to rising interest rates and the cooling housing market.



Sources: Statistics Finland and Bloomberg.

Finland's economic growth in 2006 surprising

The Finnish GDP grew in 2006 by as much as 5.5%. The growth rate was surprising, even though almost one percentage point can be explained by the low reference figure, which was the result of the lockout in the paper industry in spring 2005. Economic growth was broadly based, as economic growth was boosted particularly by exports. In addition, investments reached a level previously witnessed in 2001.

Export growth was supported particularly by a pick-up in the German economy and, as earlier, growth in Russia's oil revenues. Growth in fixed investments started to accelerate in mid-2005, continuing throughout 2006. Stronger export demand and inexpensive financing encouraged also Finnish companies to invest in production capacity. Housing construction also remained buoyant, but started to slow towards the end of the year.

Private consumption no longer the engine of growth

Of the components of aggregate demand, private consumption slowed compared to 2005. Growth in consumption weakened despite a rapid improvement in employment close to the EU average and an increase in household wealth. The slow-down in growth was due, for instance, to the easing growth in real incomes, which was the result of a slight rise in inflation. Households' debt servicing expenses also increased with the continued rapid growth in the stock of loans and rising interest rates. The rise in interest rates, which started in autumn 2005, began to affect loan instalments by 2006, when interest rates on loans were checked. Overall, households' incomes were not enough to cover expenses, which turned the saving ratio negative.

Economic cycle has peaked; the downswing is nevertheless expected to be gradual

2006 was the year world growth peaked. The decline in private consumption-based growth in the United States is likely to start affecting also other economic regions in 2007. The steepness of the turnaround nevertheless depends mainly on how controlled the cooling of the US housing market will be and on the extent of its impact on the economy.

According to the Bank of Finland forecast, the Finnish economy will gradually slow in the next few years. GDP is forecast to grow by some 3% in 2007 and to slow further to 2.7% in 2008 and 2009.[1] The employment situation is projected to improve further and the unemployment rate to fall to 6.6% at the end of 2009.

1 Bank of Finland Bulletin 1 • 2007.

The US economy may slow faster than hoped for

The tightening of monetary policy began to significantly slow the US economy in 2006. As expected, this was reflected first on the housing market, which had already showed signs of overheating. As the impact of rate increases started to be felt, the rise in housing and housing construction prices stopped.

For many years, US households had become accustomed to inexpensive loans and continuously rising housing prices. Household indebtedness increased and the saving ratio turned negative. Since spring 2005, households' expenses have exceeded their income. Growth in households' housing assets has boosted households' sense of improved outlook for consumption and improved their possibilities of obtaining new credit, by using the increase in the value of their asset as collateral.

One of the risks for the economic outlook is the possible emergence in the US housing market of a bubble, the bursting of which would have a disastrous impact. Instead of a controlled cooling, in the worst case we would experience an 'emergency landing,' in which a rapid fall in housing prices would cause a steep rise in households' saving ratio and a decrease in consumption. As a result, the United States could drift into deep recession, which would have a significant impact on the world economy.

Information available up to March 2007 shows that the US housing market is cooling slightly faster than expected, but so far developments have remained controlled.

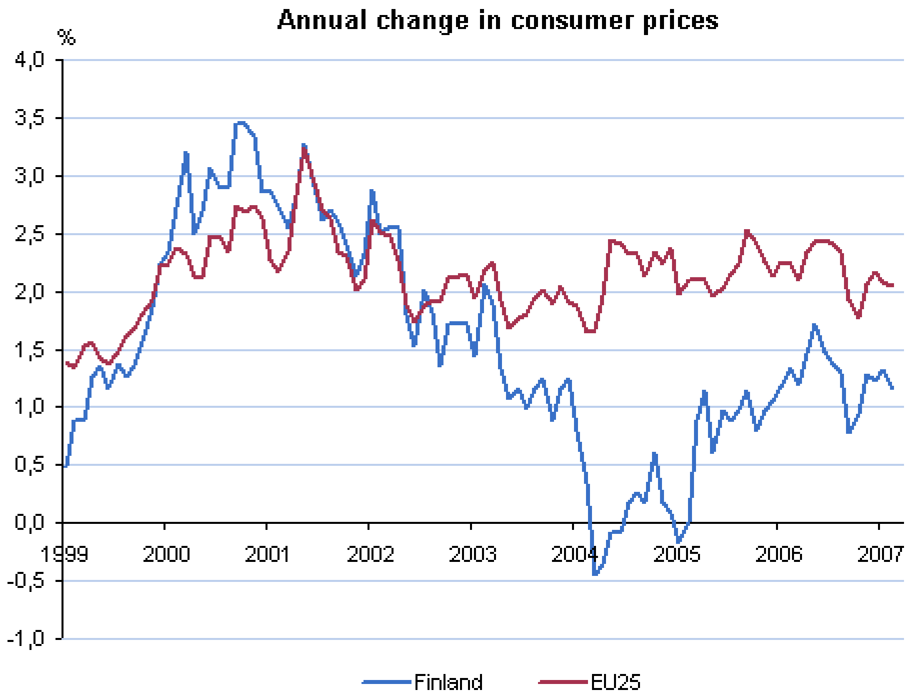
Continued rapid growth of emerging economies will dampen slowdown

Declining US consumer demand will weaken demand for Chinese export goods and export goods of other emerging economies in Asia. The impact will however be eased by increased consumer demand in emerging economies and favourable developments in exports to Europe.

China and the other emerging economies will thus continue to experience rapid growth, which will be reflected in increased growth potential in eg Europe. In the long run, import growth is however expected to slow in the United States, followed by Europe, which will also start to affect growth rates in the emerging economies.

Rising interest rates, slight increase in inflation and slowing developments in employment start to moderate growth in consumption

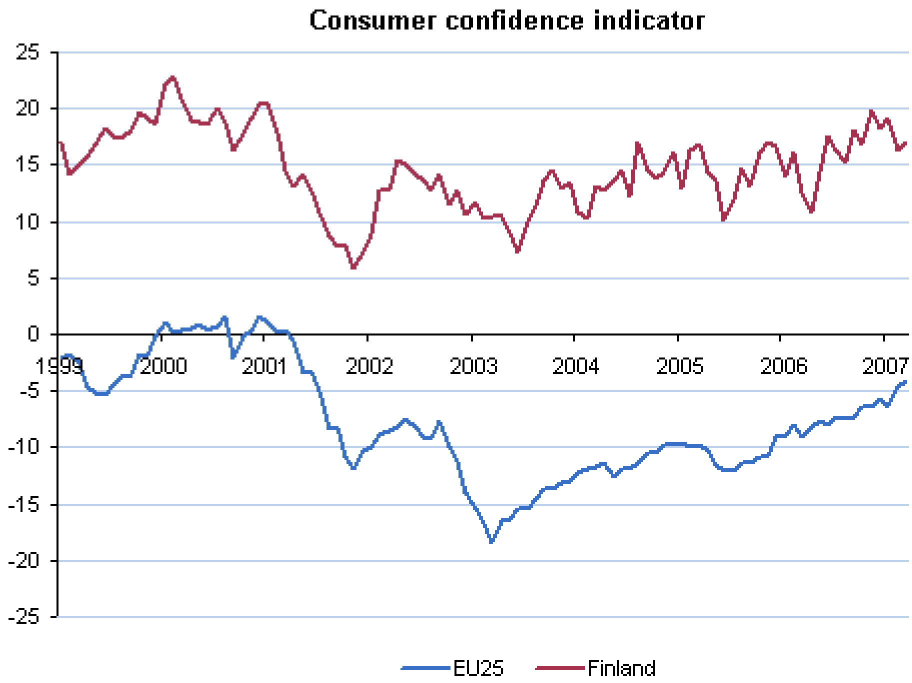
Finnish households' outlook for consumption is not expected to improve as rapidly as in previous years. Growth in income and employment is projected to ease, and the period of exceptionally subdued inflation will end. In addition, interest rates are estimated to be slightly higher than the exceptionally low level witnessed in recent years. A permanent global fall in asset values would further weaken the outlook for consumption.



Sources: Statistics Finland and Eurostat.

Household behaviour does not yet imply a slowdown

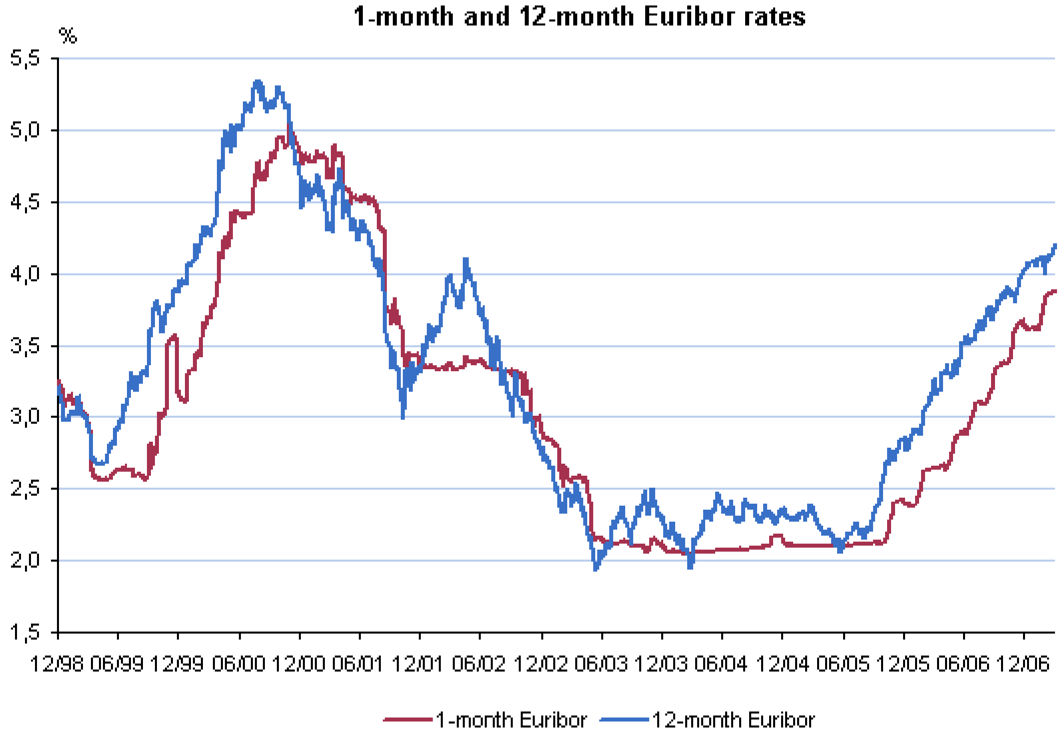
In early 2007, the unemployment rate in Finland fell to the EU average and consumers' confidence in their economic outlook continued to improve. Housing prices continued to rise at a brisk pace in the first months of 2007, accompanied by a sustained rapid growth in the stock of housing loans.



Source: European Commission.

Despite growth in 2007 still remaining relatively rapid, rising interest rates and inflation will inevitably begin to contract growth in consumer spending. The consumer confidence indicator for February 2007 also shows that a growing proportion of households estimate that this is a good time to save, and a growing proportion estimate that this is a bad time to take up a loan.

A factor with a larger impact than private consumption is however, the weakening cycle of the world economy, which is expected to slow down the exceptionally rapid growth in exports witnessed in 2006. This is expected to be accompanied by a slight easing of growth in fixed investments.



Source: Bank of Finland.

Summary: Economic slowdown is likely to be reflected also in supervised entities' financial performance in 2007–2008

The world economy has experienced robust growth since 2002. According to the Bank of Finland's forecast, Finland's economic growth peaked in 2006, and in 2007–2009 GDP growth will be on a slowing trend. This slowing is expected to affect all components of aggregate demand.

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Continued rapid growth in the securities markets

Good year for the Helsinki Stock Exchange

Year 2006 was particularly favourable for the securities markets. The all-share index (OMXH) of price movements rose to 9,625 points, with the annual rise totalling 17.9%. Measured by the portfolio index (OMXH Cap), share prices rose by nearly 25.2%. Following a dip in spring 2006, share prices have risen steadily and rapidly. This is also indicated by the moderate daily changes in the all-share index: in 2006, the biggest daily rise was only 4.05% and the biggest daily fall -4.31%.

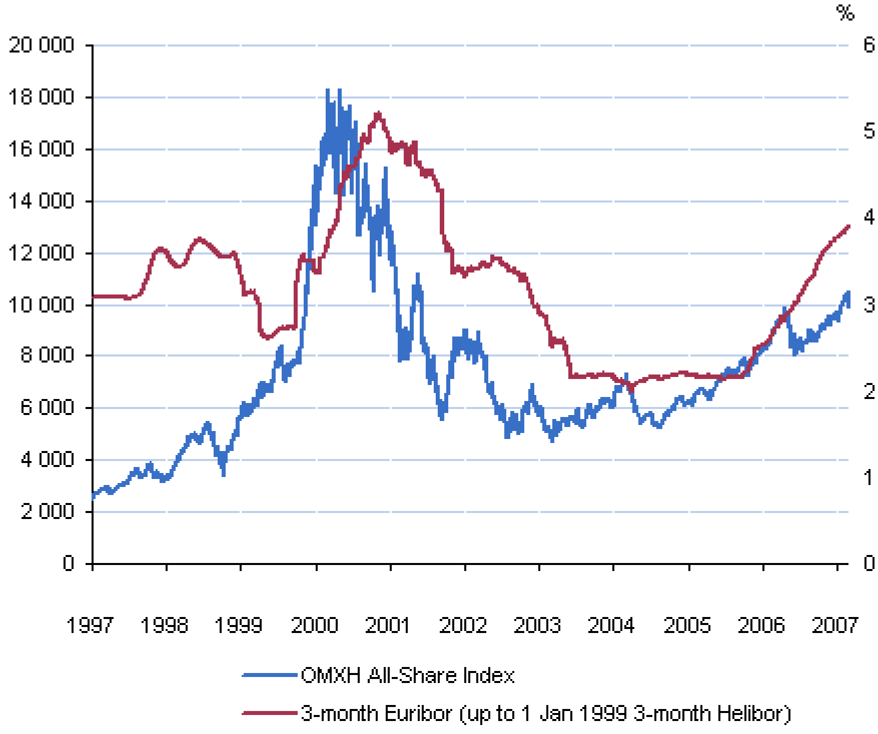
Equity trading was significantly more active than in 2005: euro-denominated trading totalled EUR 287.9 billion (EUR 223.4 billion in 2005), number of trades was 8.1 million (5.4 million), and the number of new listed companies was 6. Euro-denominated trading in options, warrants, bonds, and index shares also increased sharply in 2006, with the total trading volume increasing to EUR 3.7 billion (EUR 1.6 billion).

Key OMXH figures 2005-2006

	31.12.2006	31.12.2005	Change (%)
Equity trading volume (EUR bn)	287,9	223,4	28,9 %
Number of trades (million)	8,1	5,4	50,0 %
Total trading volume (EUR bn)	291,6	225,0	29,6 %
OMXH all-share index	9 625	8 167	17,9 %
OMXH CAP all-share index	5 397	4 312	25,2 %
Number of listed companies	136	137	-0,7 %
Market value of listed companies (EUR bn)	234,7	203,1	15,6 %

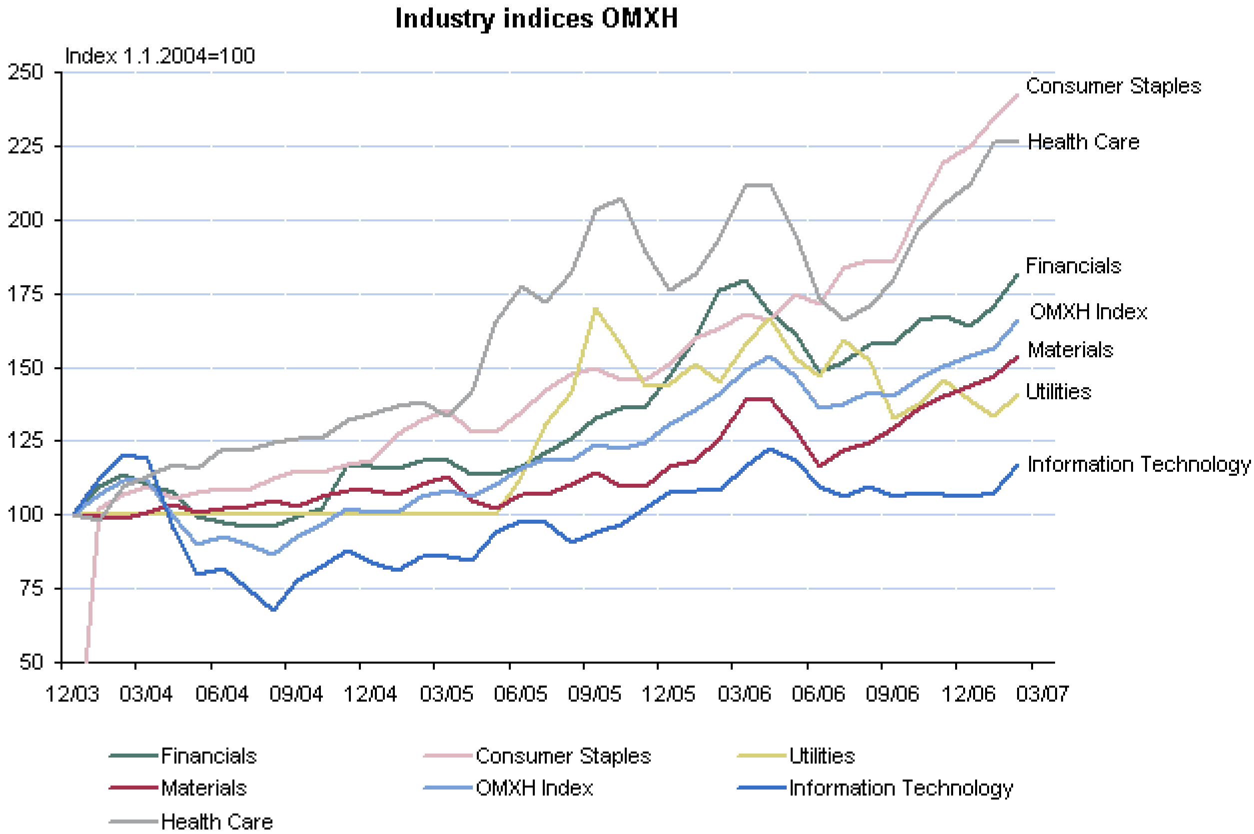
The recent increase in interest rates has not dampened the rise in share prices – on the contrary. It is interesting to note the link between interest rates and share prices: the correlation between the OMXH all-share index and the 3-month Euribor has since 2002 remained approximately 0.49, based on daily observations. Interest rates lag slightly behind share prices which seems logical if interest rate rises are used to slow down economic growth.

OMXH all-share index and 3-month Euribor 1997–2007



Sources: OMXH, Reuters and Bank of Finland.

On the industry-level, differences in share price developments are considerable. The best performer was the consumer staples sector and the weakest was the information technology sector. The index of the financials sector risen more rapidly than the all-share index.

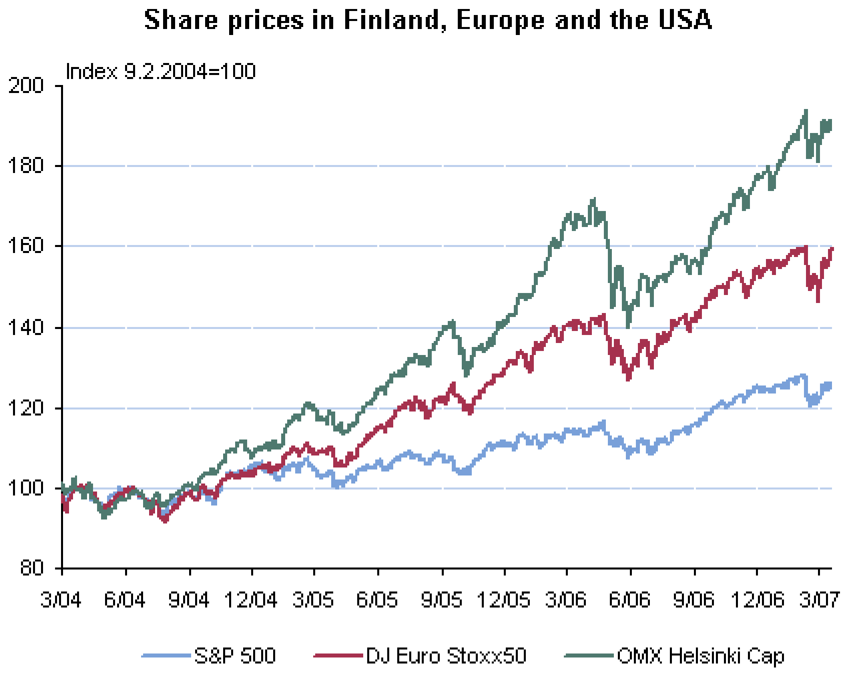


Source: OMXH.

Favourable developments in share prices and active equities trading were mainly due to positive developments in the economy. Macroeconomic fundamentals formed a particularly favourable basis for economic growth, which was also reflected on listed companies' results. Improved results, in turn, had a positive impact on share prices.

Finnish equities already valued fairly high

In international comparison, the OMXH Cap index has developed more favourably than the S&P 500 and DJ Euro Stoxx50 indices. The difference between the indices is surprisingly large: in the past three years, the OMXH Cap has almost doubled, whereas the S&P 500 index has gained only around 23%.[1]



Sources: OMXH and Bloomberg.

The overvaluation and pricing of shares can be assessed based on the price-to-earnings ratio (P/E ratio). In February 2007, the median P/E ratio of Finnish shares (in the OMXH) was nearly 20. The figure for companies in the S&P 500 was 17 and that for Euro Stoxx50-companies was13. The long-term average P/E ratio for companies listed in Finland is about 15.[2]

1 S&P 500 index consists of 500 large US companies with a good financial standing, and the DJ Stoxx50 index consists of (50) market leaders of blue chip companies in various sectors in the euro area.
2 Taloussanomat Survey 2/2007.

Nordic lists combined into a joint list

Nordic securities trading was reformed on 2 October 2006 with the launch of a new list. The new list combines the lists of the OMX Copenhagen, Stockholm, Helsinki, and Iceland exchanges under a joint list, the Nordic List. The Nordic List is not a merger of exchanges; it is more a term used for marketing purposes. The aim of the reform was to improve the liquidity and comparability of securities. The List includes ca 600 listed companies, divided into three segments by market capitalisation: Large Cap, Mid Cap and Small Cap.

The Nordic List has not significantly increased foreign ownership of Finnish companies. Foreign ownership of Finnish listed companies was about 50.1% at year-end 2006, compared to 50.9% at year-end 2005. The Nordic List has been operating for about six months and therefore actual changes are still difficult to detect.

Global fall in share prices in February 2007 weakened outlook for growth

Share prices have been on a continuous upward trend already since 2002, with the exception of a slight downturn on a couple of occasions. Growth was particularly strong in the second half of 2006.

Macroeconomic fundamentals do not suggest a strong decline in share prices. Currently, nearly every indicator shows positive developments. However, according to the Bank of Finland forecasts, economic growth has already peaked in Finland, and growth is expected to slow at a moderate pace. At least in the Finnish economy, there is no evidence that would suggest a significant decline in share prices.

Share prices in Finland react strongly to global developments in share prices. The link between share prices is obvious: for example, the correlation between the OMXH and S&P 500 indices, calculated based on daily observations, has since 2002 been 0.86, and the correlation between the OMXH and DJ Stoxx50 has been as high as 0.95.

Dependencies between stock exchanges around the world became evident in 2007, when share prices in China started to decline relatively strongly, affecting all stock exchanges. In Finland, the OMXH all-share index fell by -3.4% in one day. Stock exchanges recovered from this brief dip; the mood has nevertheless remained expectant. The fall in share prices could not be explained by a single factor, instead it was mainly considered a correction to balance to overly positive developments. On the other hand, markets are currently keeping a close eye on developments in the United States.

Finnish companies' financial ratios continue to be good. Results for the first quarter of 2007 will show how companies' financial position will develop. Securities markets will probably continue to grow, nevertheless at a slower pace than in 2006. Interesting issues in 2007 will be the opportunities provided by the Nordic List, the First North marketplace, and Sampo Group's possible investments. In addition, according to some forecasts, the number of listings in European stock exchanges is expected to increase on 2006. The pessimistic view is nevertheless that listing activity is an indicator of a future decline.

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Growth in banks' profits reaches cyclical peak

Banks' profits increased in 2006 by as much as 30%. Growth in profits was boosted particularly by improved net interest income, as a result of rising interest rates. Although banks' performance capacity can be expected to remain good also in the coming years, annual growth in banks' profits can be expected to be more moderate than in 2006, due to slowing economic growth.

Continued growth in lending stock and rising interest rates boosted growth in net interest income in 2006

Growth in domestic banks' net interest income accelerated in 2006 to approximately 15%, from 10% in the previous year. The increase in net interest income was driven particularly by rising interest rates and continued rapid growth in the stock of lending to households. The increase in net interest income was curbed by the further narrowing of margins on lending as a result of competition and the increased proportion of market-based funding.

Both the rate of growth and the absolute level of net interest income almost reached the cyclical peak observed in 2000. The difference is that in 2000, the same amount of net interest income was gained from a lending stock almost half the size of the current. This shows that banks' aggregate margin has shrunk considerably in the past six years.

Net interest income is still the major source of revenue for banks and banking groups. In 2006, net interest income accounted for 57% of banks' total income, on average, despite the growing importance of insurance and investment services.

Stronger economic growth reflected in net fee income

Continuation of the positive economic cycle was reflected in banks' net fee income. Demand for various types of capital market-based services remained strong. The correction in share prices in May contributed to some extent to an increase in net subscriptions for bond funds, at the expense of equity funds.

Banks and banking groups' other income remained at the level of 2005 for the majority of banks. Pohjola's operations were combined with OP Bank Group's in 2006. As a result, 35% of the group's income was from other sources than net interest income or net fee income. Moreover, Nordea Bank Finland received a large one-off capital gain.

Accelerated rise in expenses

Expenses rose by approximately 10% year-on-year for the majority of banks. Differences between banks were however major, due to eg structural arrangements. OP Bank Group's expenses grew by a third as a result of the Pohjola deal. Sampo Bank group's expenses increased by approximately 17% as Sampo plc sold its investment services companies to Sampo Bank. Nordea Bank Finland's expenses remained unchanged.

Higher staff expenses were due to recruiting, changes in staff structure, and higher wages. The expansion of operations has increased the total number of staff, particularly in foreign operations. The proportion of senior banking officers and directors is growing, and the proportion of banking officers and employees is decreasing. The growth in expenses was also partly due to wage increases and growth in performance-linked bonuses.

In 2000–2006 the proportion of staff expenses of total expenses increased. Progress in the automation of basic banking services has led to a situation in which staff expenses account for an increasing proportion of total expenses. In 2000, staff expenses accounted for 40–45% of banks' total expenses, whereas in 2006, they accounted for almost half of total expenses.

Cost efficiency improves

Despite rising expenses, cost efficiency of the banking sector improved close to its peak in 2000. In 2006, the cost-to-income ratio for the whole banking sector was only 49%. In 2002–2004 when interest rates were at a historically low level for a long time, banks' cost efficiency was lower. The entering of Nordea Markets' income under the Finnish subsidiary and the subsidiary's one-off capital gain nevertheless improve the ratio for the whole sector by several percentage points. If Nordea Bank Finland is excluded from the calculations, cost efficiency for 2006 will decrease to 59% (58% in 2000).

Impairment losses on loans continue to decline

Impairment losses continued to be extremely low in 2006, as has been since 1999. The amount of reversals and recoveries of impairment losses recorded by Nordea Bank Finland alone exceeded the amount of new impairment losses recorded so considerably that it improved the banking sector's profits by approximately EUR 55 million.

Operating profits increase by over 30%

Banks' operating profits increased overall, by over 30%. The increase in profits was even higher than that for Nordea Bank Finland Group, as a result of the above-mentioned capital gain and the increase in Nordea Markets' income entered under Nordea Bank Finland's income. For the sector as a whole, nearly 52% of income was entered as operating profit, which is 7 percentage points more than in 2000. Nordea included, 42% of income was entered as operating profit in 2000 and 2006, whereas in 2002–2005, the ratio varied between 35 and 38%.

Despite the exceptionally high results, profitability, measured by return on equity (ROE) remained nevertheless at slightly over 10% for the majority of banks. In 2002–2006, the increase in return on equity was extremely slow for the majority of banks. Finnish banks have over the years retained a large part of profits to bolster equity capital. Of the large banks, only Sampo Bank has succeeded in significantly improving its return on equity in the current decade. Finnish banks' ROE is fairly modest also by international standards. On the other hand, measured by return on assets (ROA), profitability of the Finnish banking sector is among the highest in Europe. In 2006, Finnish banks' average ROA was 1.0%.

At the peak of the previous cycle in 2000, banks' profitability was significantly higher than currently, measured by both ROE and ROA. The average ROE was as high as 20% and ROA approximately 1.2%. Before banks' lending stock doubled, the denominators of both the profitability indicators were considerably lower than currently.

Growth in profits likely to slow in 2007

Banks' good financial performance is likely to continue in 2007, due to eg the continued good quality of banks' credit portfolios. Considering the growth figures in the Bank of Finland's latest macroeconomic forecast (Bank of Finland Bulletin 1/ 2007) and expectations for a slowing rise in interest rates in 2007, banks' financial performance can be expected to start weakening, compared to 2006. Growth in profits is slowed particularly by the increase in net interest income which in 2007–2008 is likely to be slower than in 2006. Growth in fee income may also start to decline if there is a slowing trend in households' savings possibilities and if the capital markets' pull starts to weaken. Impairment losses are also expected to increase in 2007–2008. Their profit impact will nevertheless remain low.

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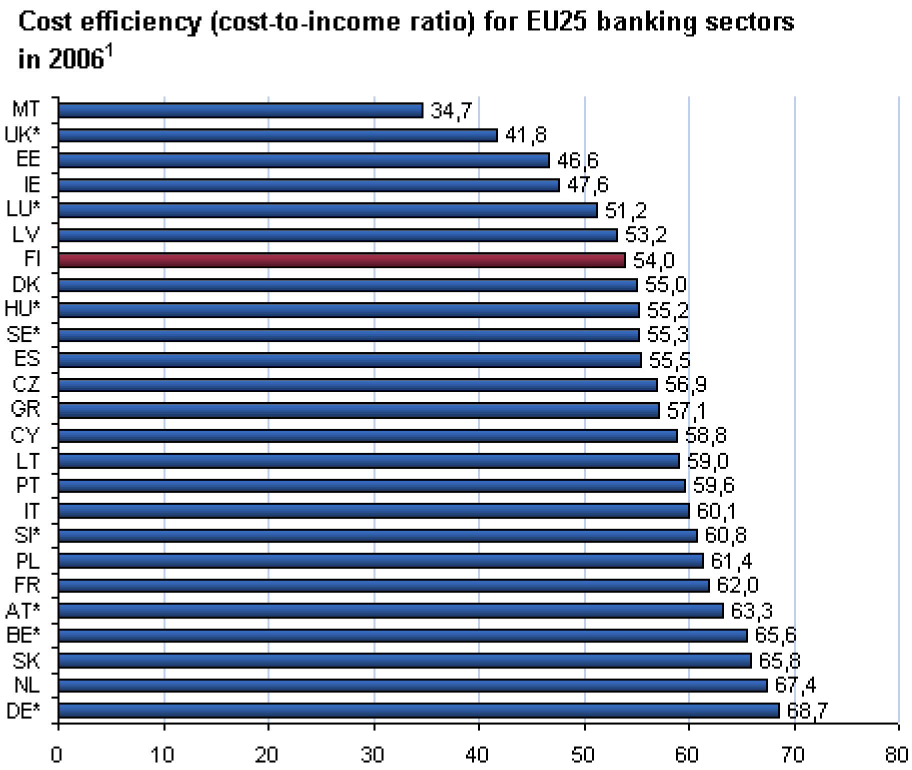
Finnish banks are efficient and profitable by European standards

Finnish banks' cost efficiency is among the highest in the EU, as shown by the Banking Sector Stability report published by the ECB in November 2006.The publication, which is based on data reported for 2005, shows that Finnish banks' profitability is high by European comparison, measured by return on assets (ROA). Return on equity (ROE) for Finnish banks is however, significantly below the EU average. This is due to the structure of the banking sector and banks' conservative strategies.

Finnish banks' cost efficiency among the highest

Finnish banks' cost efficiency is among the highest in the EU. Of EU25 banking sectors, only seven banking sectors were more cost efficient than Finnish banks in 2005.

Among the countries whose banking sector is more efficient than the Finnish are Estonia and Latvia, where GDP growth has been rapid in recent years – due to the lower starting level. Rapid economic growth has also boosted banks' net income. At the same time, banks have succeeded in cost containment, due to the fact that the majority of banks operating in the countries are branches of large Nordic banks. As fairly large operators in the market, Nordic banking groups achieve economies of scale, and they also utilise information technology efficiently. The data published show that the Finnish banking sector is the most efficient in the Nordic countries, followed nevertheless closely, by a margin of less than a percentage point, by Denmark and Sweden. In 2006, Finnish banks' cost efficiency continued to improve slightly. Aggregate comparative data for the EU for 2006 is not yet available.



Source: EU Banking Sector Stability, European Central Bank, November 2006.

1) The majority of countries reported the figures for 2005 in accordance with the principles of the new IFRSs. Countries marked with an asterisk refer to countries whose banking sectors in 2005 still, as a rule, applied national accounting principles. The countries thus reported the figures for their banking sector in accordance with the previous framework. The figures can nevertheless be considered comparable.

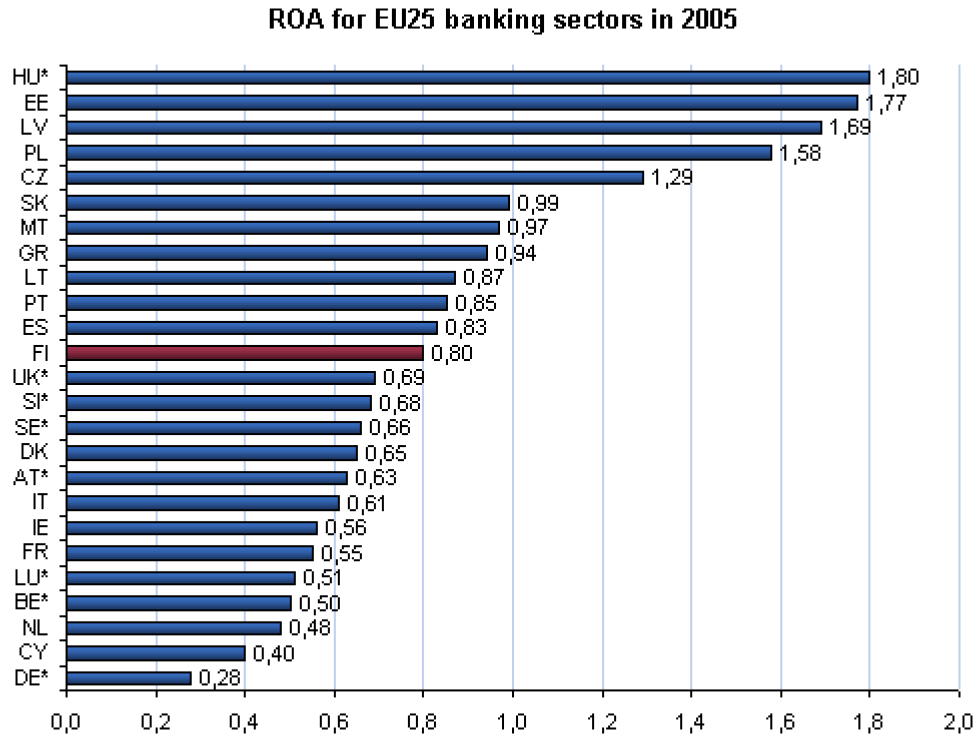
Competition in the Finnish banking sector is tight, at least based on the fact that margins on housing loans are among the lowest in Europe. In addition, Finnish consumers have only recently started to use investment services, and banks' own investment activities are minor. High efficiency must thus be explained by cost and not by income. Efficiency is thus likely due to the low number of branches per capita and widespread Internet banking, for instance.

The picture of the efficiency of the Finnish banking sector fades however, slightly if foreign banks' subsidiaries (Nordea) are excluded from the examination. In that case, banks' efficiency, measured by the cost-to-income ratio, is 58%, which is average by EU standards.

The most realistic picture is perhaps created by taking into consideration in the calculation the economies of scale gained by Nordea Bank Finland in its retail banking operations. By including in the calculation not only the other Finnish banks but also Nordea Bank Finland's retail banking operations in Finland, the figure falls between the above-mentioned ones, ie around 55 to 56%. Then, the efficiency of the Finnish banking sector will be close to that of the Swedish and Danish.

Profitability good by European comparison

If profitability is measured by return on assets (ROA), the Finnish banking sector ranks among the average in the group of EU countries. If the eastern member states with the highest growth rates are excluded from the calculation, Finland's placing moves close to the top. Even if Nordea is excluded, the ROA remains virtually unchanged (0.78%).



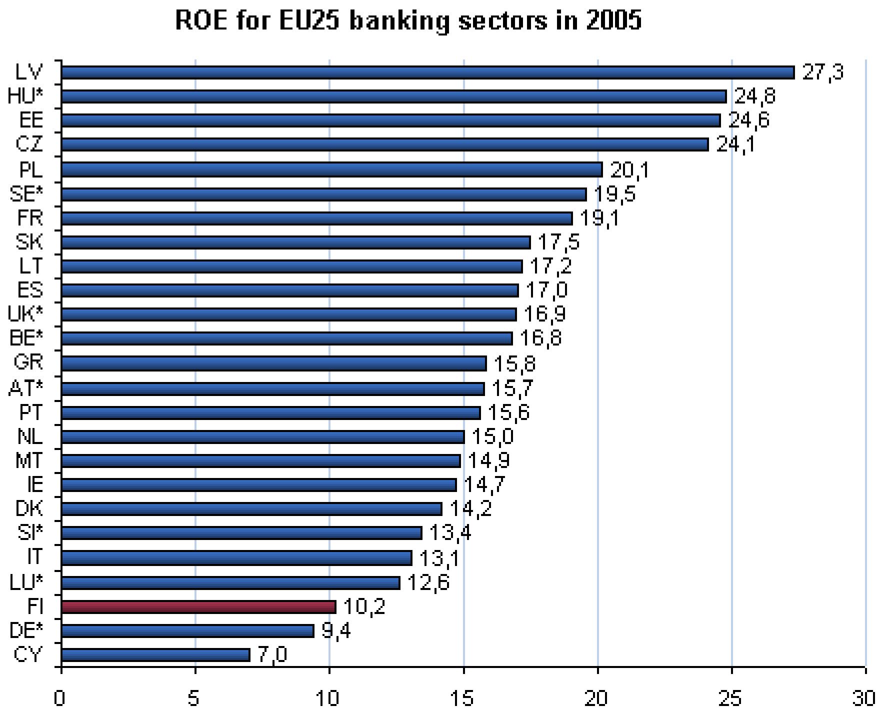
Source: EU Banking Sector Stability, European Central Bank, November 2006.

ROE appreciated by investors does not flatter Finnish banks

If profitability is measured by return on equity (ROE), the Finnish banking sector will place, despite its cost efficiency, among the least profitable EU banking sectors.

The return on equity ratio reflects the ability of a company to manage the equity invested and the profits retained. The ratio is boosted by improved results and a decline in equity.

Equity growth can be dampened by, for example, distributing the profit for the period to shareholders. Dividends are direct earnings for shareholders. In addition, expectations for future payment of dividends and an improved ratio as a result of lighter equity may support the company's share price.



Source: EU Banking Sector Stability, European Central Bank, November 2006.

These types of growth targets related to shareholder value are natural for commercial banks. ROE is however not a good indicator of profitability of the EU banking sectors, due to differences in the proportion of commercial banks.

A significant proportion of Finnish banks are cooperative and savings banks whose shareholders do not strive for a high ROE ratio. Their low ratio does not reflect weak results but rather a strong balance sheet. Finnish banks have, in the current decade, kept their capital buffers strong, mainly by retaining the majority of net profit for the financial years to bolster equity.

Until the beginning of 2007, Sampo Bank was the largest independent commercial bank in Finland. In recent years, the development of Sampo Bank Group's return on equity has differed significantly from that of other Finnish banks. Only a few years ago, Sampo's, ROE was around 10 to12%, like that of the majority of Finnish banks. In 2004–2005 Sampo Bank's ROE rose close to 20%, almost reaching 25% in 2006.

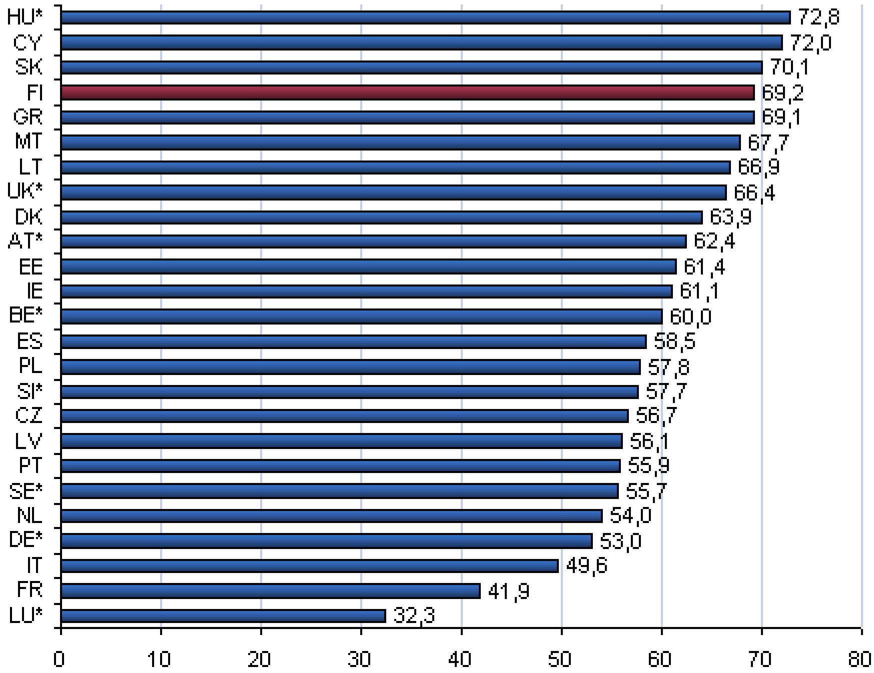
Nordea has maintained the amount of Nordea Bank Finland's own funds high, which weakens the average ROE ratio for the banking sector. Finland's ranking among the EU countries does however, not change by excluding Nordea from the calculations. Excluding Nordea, the ROE for the Finnish banking sector is 11.6%.

Proportion of net interest income of total income above average

The proportion of net interest income of Finnish banks' total income is above average.

Net interest income accounts for over two-thirds of Finnish banks' (incl. Nordea) total income. Excluding Nordea and its net interest income from derivatives trading, the proportion of net interest income is however only approximately 62%. This figure places Finland slightly above average among EU countries.

Net interest income of EU25 banking sectors in 2005 (% of total income)



Source: EU Banking Sector Stability, European Central Bank, November 2006.

Banks in the other EU countries thus seem, on average, to have more sources of income than Finnish banks. This is reflected also in the combined balance sheet of the EU banking sector in which other claims and liabilities (after deposits and loans), as a rule, exceed those of Finnish banks (excl. Nordea). Only when Nordea Bank Finland Group (incl. Nordea's derivatives trading) is included in the calculations, Finnish banks rank among the EU average, based on this indicator.

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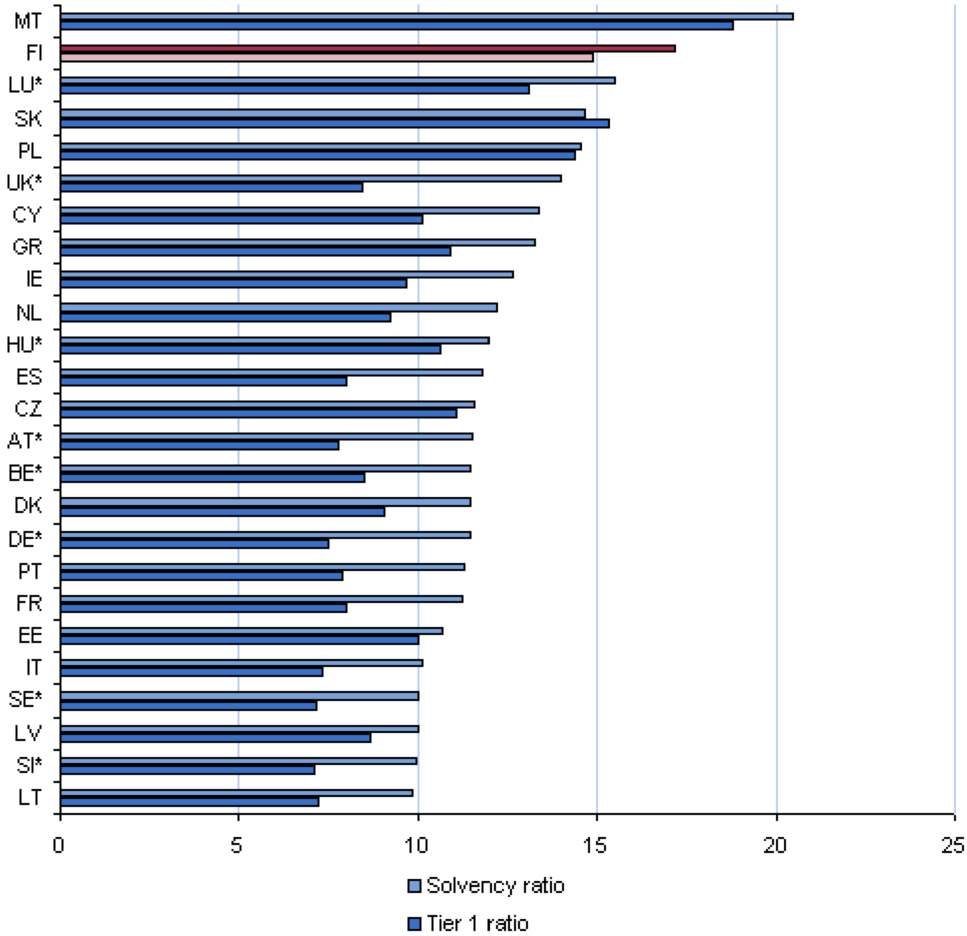
Capital adequacy of the Finnish banking sector remains high

Capital adequacy of the Finnish banking sector is among the highest in Europe. At the end of 2005, the average capital adequacy ratio in the banking sector was 17.2%, which is second highest in the EU25. Capital adequacy of Nordea Bank Finland Group remains clearly higher than that of the whole Nordea Group.

Solvency (total and Tier 1 ratio) of EU25 banking sectors in 2005



Source: EU Banking Sector Stability, European Central Bank, November 2006.

Restructuring in Nordea Bank Finland Group causes fluctuations in aggregate figures

The capital adequacy ratio of the Finnish banking sector has been declining since 2005, mainly due to restructuring in Nordea Bank Finland Group. Internal dividends paid by Nordea caused capital adequacy of the banking sector to fall to 15.1%, from 17.2%. In 2006, Nordea Bank Finland Group paid its parent company EUR 4 billion in dividends. These record dividends resulted in a decline in capital adequacy of the Group, from 20% to slightly over 16%.

Fluctuations in banks' capital adequacy – capital adequacy ratios are nevertheless not low

Banks' capital adequacy ratio on the conglomerate and group level fluctuated between 11.4 and 22.6%. At the turn of the year, the lowest tier 1 capital adequacy ratio was 7.1%, and the lowest total capital adequacy ratio 11.4%. Capital adequacy of Finnish banking groups is adequate.

Amount of capital loans remains unchanged

The quality of capital remained good, as original own funds accounted for the majority of total own funds. No new capital loans were raised in 2006, nor were capital loans paid off. As a result, their amount remained unchanged, at approximately EUR 570 million.

Basel II will affect monitoring of capital adequacy

In 2007, the majority of supervised entities will switch to Basel II-compliant accounting. Data collection by the FIN-FSA will also undergo changes as capital adequacy information will be collected in the COREP data collection framework designed based on the new regulations on capital adequacy calculation.

Comparisons of banks' capital adequacy shall in future take into account differences in banks' methods of calculating capital requirements. Some of the banks will use more advanced internal models, whereas some of the banks will calculate their capital requirement, eg credit risk-weighted assets and exposures using the so-called standardised approach.

Floors included in the new framework

Introduction of the Basel II capital adequacy framework will lead to more efficient use of capital, and the need for capital will decrease as capital adequacy calculations will be increasingly based on risk. This assessment is based on a study (QIS 5) published by the Committee of European Banking Supervisors (CEBS) in June 2006. In transferring to Basel II, so-called floors will however be applied. This means the gradual introduction of a new capital adequacy calculation method. The floors limit the decrease in capital requirement in the first three years as follows: 95% in 2007, 90% in 2008 and 80% in 2009. The figure refers to the maximum amount own funds may decrease relative to the Basel I calculation regime.

Currently, the Finnish banking sector is financially sound and will transfer to the Basel II calculation regime with adequate capital buffers.

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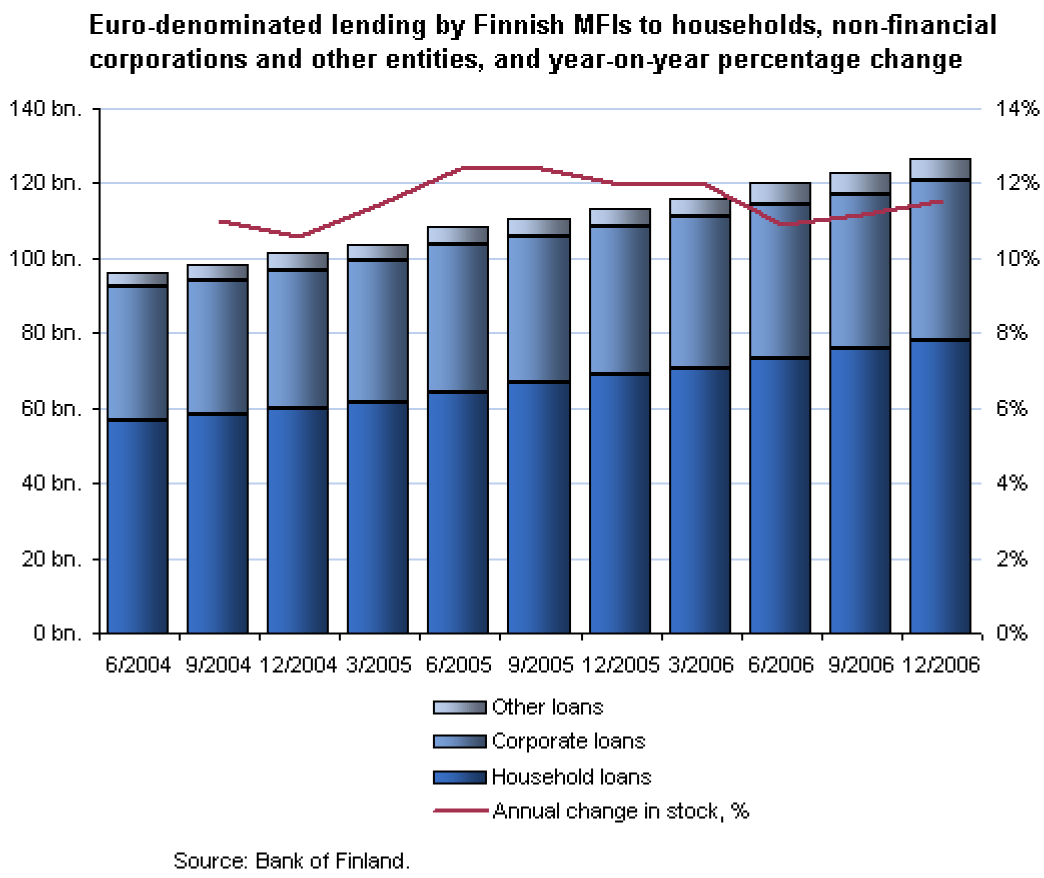
Credit demand has eased only slightly

Credit demand continued to grow strongly

Credit demand in the financial markets continued to grow at a pace that was only about one percentage point lower than in 2005. The stock of lending grew by 11.5% in 2006 and amounted to EUR 127 bn at the end of the year. In early 2007, there were already signs of increasing caution in the market for housing loans.

Credits extended to households accounted for about 62% of MFI lending. A large proportion of outstanding loans to households, about 44%, consisted of housing loans. Corporate credit represented 34% of MFI lending.



Average lending rates are rising

The average lending rate is rising in line with turnover of outstanding loans and repricing variable rate loans. According to the Bank of Finland, the average lending rate applied to new loans and average rate of interest paid on the total funds on deposit are expected to continue to rise.[1] In December 2005, the average lending rate on new household loan contracts was 3.27% compared with 4.17% in December 2006. By February 2007, the average lending rate had reached 4.41%.[2] By February 2007, the lending rate applied in to new consumer credit contracts had risen to 5.30%, exceeding the corresponding rate in December 2005 by more than one percentage point.

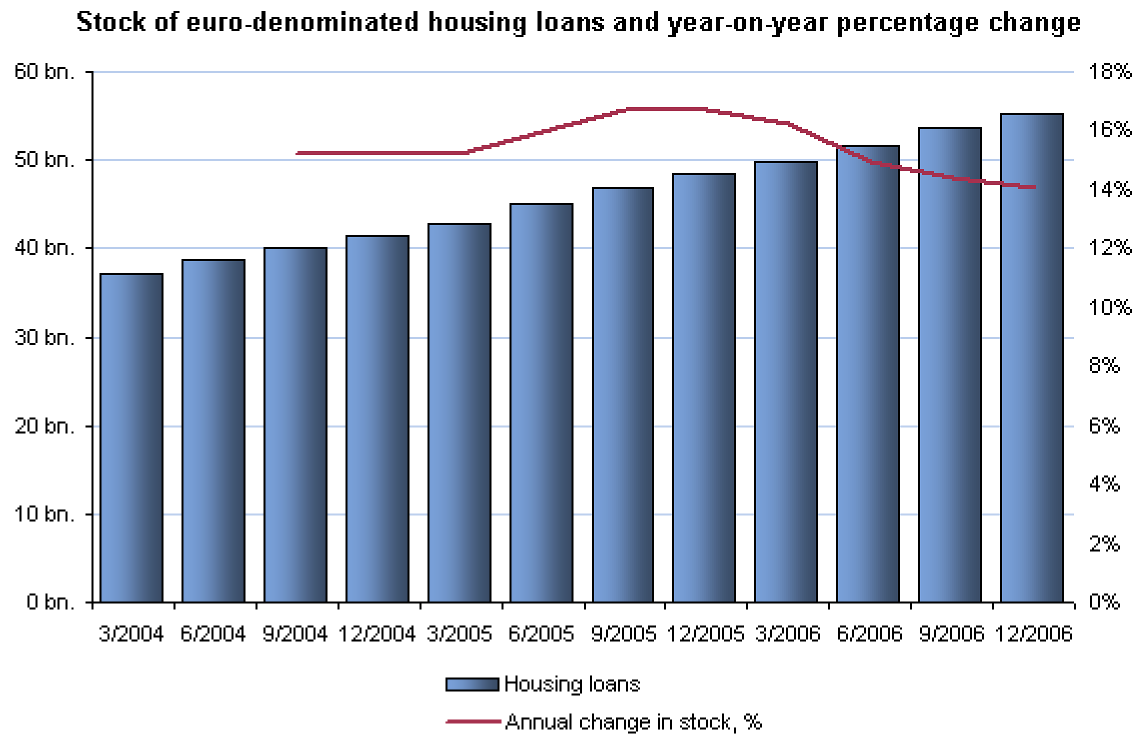
1 Bank of Finland, 6 October 2006.
2 Bank of Finland, preliminary figures, 30 March 2007.

Financial market competition is moving into new areas

The competition in the financial markets is becoming fiercer in many ways. Existing agents in the market are increasing their efforts to expand their market shares as new agents are entering the market. In a retail banking orientated market like the Finnish one where the major customers are households and small enterprises, competition has focused on house lending and, more recently, on the consumer credit segment. There are also some signs that the competition for deposit-taking and other financial services is stepping up. Foreign banks' rising interest in the Finnish retail banking market is adding extra pressure to the situation.

The rate of growth of housing loans remains vigorous

Over the last four years, the stock of outstanding housing loans has grown at an average rate of more than 15% per annum. In 2006, the rate of increase remained as strong as 14%. But in February 2007, the stock of outstanding housing loans grew even faster than in December 2006. At the end of 2006, the household lending stock amounted to EUR 78 billion, of which housing loans accounted for an unprecedented EUR 55.3 billion.



Source: Bank of Finland.

Since the start of the rise in interest rates in the second half of 2005, the rate of increase in housing loans has only decerelated marginally. In part these developments can be explained by the fact that new loans have increasingly been raised at prime rates which since they have risen more slowly than market rates have appeared more advantageous at the time of borrowing than Euribor rate loans. The more significant effects of the rise in the level of interest rates are expected to pass through to the housing loan market later this year.

Household lending is expected to continue to grow briskly for the time being, albeit at a slightly lower rate. A large part of households still plan to buy housing: in January, 10% of households were planning to make a house purchase within a year, although they considered it clearly less worthwhile than twelve months earlier. Nevertheless, consumers' confidence in the economy and employment has remained solid: in February it was stronger than the long term average.[3]

Housing loans are often granted with very long repayment periods, amortisation-free years and at 100% financing, meaning no down-payment. Various kinds of product packages are also being offered. The lending margins of old housing loans may be lowered and other products thrown in at the same time. Nowadays, housing loans often serve as products to attract new custom.

3 Statistics Finland's consumer survey, February 2007.

Demand for consumer credit remained strong

In 2006, the rate of increase in consumer credit remained high, amounting to about 11%. Nevertheless, it was slower than the peak recorded in latter part of 2005. In February 2007, the rate of growth of consumer credit accelerated again and reached 12%. About 33% of the Finnish population, or some 1.3 million people, have outstanding consumer credit.[4] According to the Statistics Finland's consumer survey, many consumers considered that the time was favourable to buy durable goods and to spend money on entertainment electronics, household repairs and furnishing and travel.

The increase in consumer credit is expected to accelerate even more, since household income is rising and the competitive situation is likely to have a lowering effect on interest rates and fees of consumer credit. Over the past twelve months, housing and consumer lending rate spreads have narrowed as a result of the increase in secured consumer credit granted by banks. The banks compete aggressively with one another as well as with the fast loan providers. Inspired by the instant loan business, also banks have begun to launch unsecured consumer credits that are readily available.

4 The Finnish Bankers' Association, Saving and the use of credit, November 2006.

Demand for corporate credit is picking up

Following the brief dip in 2005, corporate lending started to pick up again and grew at a nearly one percentage point higher rate in 2006 than in the previous year. According to the Survey of Business Finance, [5] a larger number of non-financial corporations raised external funds in 2006 than in the previous year. Moreover, more non-financial corporations than in 2005 were planning to raise external funds in the near future. Banks have strengthened their position even further as major providers of corporate finance. According to the Bank Barometer of the Finnish Bankers' Association, the majority of bank managers believe that non-financial corporations' propensity to borrow has increased.

5 Confederation of Finnish Industries, Ministry of Trade and Industry and Bank of Finland, 23 January 2007.

The housing market has stabilised to some degree

Due to the continued house price inflation, loan amounts have grown and hence the entire stock of outstanding loans has expanded. According to house estate agents, there is no foreseeable prospect of a fall in house prices, but the level of caution in the housing market appears to be increasing.

According to Statistics Finland, the average price of a dwelling in an old block of flats in Finland rose by 1.3% in the last quarter of 2006 compared to the previous quarter. In the Greater Helsinki Area, the corresponding increase was 1.9%. The year-on-year price increase for the country as a whole amounted to 6.6.% on average. In the Greater Helsinki Area, the corresponding increase was 8.0% and in the rest of Finland 5.1%. Real prices of old stock housing has already exceeded the peak levels of 1989.

Nevertheless, house price inflation has slowed compared with the previous year. According to the Bank of Finland estimates, house prices will continue to increase but a rate that will taper off to about 3% in 2008. Longer selling periods and fewer housing transactions also point to a slowdown in the housing market compared to the peak activity of 2005. According to Statistics Finland, the number of housing transactions in 2006 declined by about 5% compared to the previous year.

Household debt levels continue to rise

Due to the favourable economic outlook and decline in unemployment, Finnish households' confidence in their own economic situation has become stronger and their level of debt has risen further. So far the rising level of lending rates has not to any marked degree attenuated neither households' nor non-financial corporations' propensity to borrow. According to the Bank Barometer, bank managers believe that households' propensity to raise loans will make a brief dip in the first quarter this year and then flatten out over a twelve month horizon.

By the end of September 2006, the average household debt ratio had already reached an all time high of 94.4%.[6] In the pre-recession year, 1989, the debt ratio had amounted to 86.6%. Indebtedness is to an increasing degree concentrated in young families with children. However, the debt levels in Finland are markedly lower than in Sweden and the United States, where debt ratios are in excess of 130%.

6 Statistics Finland, press release of 1 March 2007

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Mortgage holders exposed to mounting risks

Lending stock quality still remains high

The quality of the Finnish banking groups' credit portfolios still remains high in terms of non-performing assets and impairment losses, which still represent only a marginal share of their entire lending stock.

The ratio of non-performing assets[1] (loans not serviced for more than 90 days) to the entire lending stock declined somewhat, and amounted to 0.25% at the end of 2006 (0.27% at end-December 2005). On the other hand, banks' stock of matured assets (loans not serviced for 30 to 90 days) increased and accounted for 0.47% of the lending stock at the end of 2006 (0.45% at end-2005). This may be a signal that bank customers' repayment difficulties are increasing. For the time being, however, the relative share of matured assets is very small.

Banks' net impairment losses totalled some EUR -52 million owing to recoveries and reversals. In 2005 impairment losses weakened the financial results of the entire banking sector by about EUR 61 million. Banks' gross impairment losses represented 0.13% of the lending stock at the end of 2006 (0.22% at end-December 2005).

1 Non-performing assets = non-performing assets + guarantee claims + non-group zero-interest claims.

Quality of outstanding corporate loans remains high

Non-performing corporate-sector assets have declined both in absolute and relative terms. At the end of 2006, their relative share of the corporate-sector lending stock was 0.26% (0.30% at end-December 2005). In terms of non-performing assets, the stock of outstanding loans granted to the corporate sector continues to be of high quality. Impairment losses represented only 0.26% of the entire stock of corporate credits and guarantees (0.41% at end-December 2005). The corporate lending stock grew by somewhat more than EUR 3 billion in 2006.

Increase in the stock of matured household credits

The stock of matured household credits grew by about 13% in 2006. However, their relative share remained the same as at the end of 2005, ie about 0.30%. Household-sector lending grew by 13% (EUR 9 billion) in 2006.

The stock of matured household credits grew by about 20% in 2006, but their share in household lending rose only slightly: from 0.60% to 0.64%. This trend may point to an increase in debt-servicing problems in the future, although in terms of non-performing assets there are as yet no signs of a weakening in households' debt-servicing ability.

For the time being, banks' non-performing and even matured assets represent only a marginal share of their total exposures compared to the corresponding figures recorded in the recession years. At the end of 1992, non-performing loans accounted for 6.1% of all outstanding household-sector lending. On the other hand, the systems used to detect customer payment difficulty have improved so much that banks can get down to problems as soon as they occur and restructure repayment schedules. Under these circumstances, debt servicing difficulties do not show up in non-performing assets very quickly.

Large loans and long repayment periods pose problems as lending rates rise

Low lending rates and long maturities have enabled debt servicing costs to remain within the scope of mortgage holders' repayment ability despite the sharp increase in house prices and loan amounts. The average length of mortgage periods on new loans has more than doubled since the late 1980s. In the past two years, the average repayment period has increased from 11 to 17 years.[2] Long maturities also expose mortgage holders to risk, since customers' loan repayment schedules cannot be eased by extending the repayment period. Thus, no means of facilitating repayment remains. Of a 30 year annuity loan, for example, 80% of debt still remains after 10 years of repayment. Large loans amounts, long repayment periods and linkage to market rates make housing loans more vulnerable to rises in the general level of interest rates.

Another major risk for households with outstanding debts, besides rate rises, is the possibility of a drop in regular income, for example, due to unemployment or illness.

2 The Finnish Bankers' Association, Saving and use of credit, April 2006.

Indebted households increasingly vulnerable to risks

More than 30% of Finnish households, and 60% of families with children, have housing loans. Banks are granting large long-term loans (20–30 years) to personal customers with poor repayment capacity. In addition, banks may extend unsecured card credits to households that have already run into debt.

During inspections, the FIN-FSA has noted that collateral, and not customers' repayment capacity, too often seems to have played the major role for banks' decisions to grant loans. Credit decisions show that the situation for a debtor with poor solvency can become intolerable for a minor reason only, since in fact the borrower's debt servicing ability had been negligible from the start. In evaluating requests for loans, banks calculate customers' cash flow coverage ratio but the programs available often set living expenses too low. The loan amounts granted are frequently so large that customers are left with no buffers for unforeseen expense.

Could the symptoms in the US housing market spread to Finland?

According to the latest available information, the situation in the US housing market is coming to a head since credit institutions that have granted subprime housing loans to low-income borrowers have run into serious payment difficulties due to non-performing assets. At least two large banks, but also a number of smaller banks, that have been engaged in granting housing loans to households with very poor credit histories have announced that they have run out of assets. As a result of rising interest rates and slumping housing markets, the number of defaults by mortgage holders and loans taken in execution started to increase sharply towards the end of last year. Problems were aggravated by the fact that a large part of these junk loans were linked to variable reference rates.

Markets are expecting that the problems will be reflected in tighter finance in the entire the housing loan sector and that this will also affect consumer demand. A slowdown of economic activity in the United States would have an impact on the entire world economy and ultimately on the Finnish housing loan market.

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Funding risks on the increase: Banks are investing in funding via deposits and diversifying market-based funding

Continued strong growth in lending increases dependency on market-based funding. Last year, growth in the stock of loans amounted to more than EUR 13 billion as opposed to deposit growth, which accounted for less than a third of this, translating into EUR 4 billion. Market-based funding is expected to increase in the future as growth in lending will outpace deposit growth. Lending growth will heighten funding risk, especially as regards the cost and availability of funding. To avoid risk exposure, banks have started to diversify their funding programmes.

Dependency on market-based funding continues to increase

In 2006, growth in the stock of lending amounted to more than EUR 13 billion as opposed to a mere EUR 4 billion growth in deposits. Financial institutions' lending stock[1] grew by nearly 12% in 2006, corresponding to EUR 126.7 billion. Growth decelerated somewhat from the previous year at pace with the slower growth in mortgages and other consumer credits. Finnish deposit banks' deposit intake from the public grew by 5% over the course of 2006, ie to nearly EUR 84 billion. Against the background of subdued deposit growth and expansion of lending, banks' dependency on market-based funding became more pronounced.

At the end of 2006, 7% of banks' lending was financed through deposits. This ratio has decreased steadily at least since 2002, but in 2006 the decline seems to have slowed down. Transfer of mortgages to mortgage banks is thus starting to be reflected in the parent banks' ratio.
Market-based funding has been raised through the issuance of bonds, the stock of which exceeds that of certificates of deposit in most banks. The average maturity of bonds issued by deposit banks lengthened in 2006. At the end of 2006, bonds with maturities in excess of 12 months accounted for more than a third of all bonds, compared to less than 30% at the end of 2005.

1 Source: Bank of Finland.

The importance of credit ratings is increasing

As the need for market-based funding continues to grow, credit ratings are becoming increasingly important determinants of funding expenses. Many commercial banks are diversifying their funding programmes, with the securities they issue increasingly targeted at international investors, which heightens the importance of credit ratings. From the European perspective, Finnish banks' credit ratings are good. Finnish mortgage banks' mortgage bonds have somewhat higher ratings than their parent banks.

Market-based funding is expected to increase in the future as growth in lending outpaces deposit growth. This will heighten price and availability risks relating to funding. Banks have therefore diversified their funding programmes as regards instruments, maturities and counterparties. Longer maturities of market-based funding along with diversified sources of funding serve to reduce structural funding risk. In fact, the structural funding risk of the banking sector can still be considered moderate. The FIN-FSA will pay special attention to the contingency plans that supervised entities have made in respect of liquidity crises and on stress tests concerning the price and availability of funding.

Competition over bank customers shifting to deposits

In the contest over loans, there does not appear to be any flexibility over margins left, but competition over good loan customers continues. Banking groups have publicly announced that competition over deposits is intensifying. In summer 2006, the FIN-FSA conducted a survey on funding risks and most respondents anticipated competition over deposits will grow tighter. In particular, the issue has been raised whether structured products could also be offered to retail customers in the form of deposits. However, the stock of structured deposits is still very small. In fact, in recent years the stock has even diminished.

On the basis of the responses it became evident that banks' views about the current price of deposit funding varied. The most typical estimate was that deposits' interest expenses could continue to rise somewhat before market-based funding would be favoured over deposit funding. This notwithstanding, some banks already consider deposit interest rates to be too high. Opinions varied over whether competition would be dominated by transaction accounts or investment accounts.

According to the Bank of Finland's Financial Market Report (4/2006), competition is not yet reflected in the statistics on deposit interest rates. Households' transaction accounts' share of the total stock of deposits is almost one half, and their interest has for the past four years hovered around 0.5%. No major variations can be found in the interest rates on fixed-term deposits between different banks.
New sources of funding to finance lending

Structured acquisition of funds, where the yield is tied to other factors than interest rates, doubled over the course of 2006 to EUR 5 billion. The products in question are primarily bonds, the yield of which is typically tied to the share price performance of equities or equity indices.

Securitisation is used in credit risk control. By securitising their receivables banks can reduce the size of their own credit portfolio and thus lower their credit risk. However, banks can also purchase securitised claims and thus heighten their credit risk in some areas. Securitisation thus serves as a means of diversifying the credit portfolio. The initiator of traditional securitisation may also use transactions in liquidity management when selling credits from the balance sheet. By operating as investor, banks can take credit risk positions without having to tie capital to loans. In capital adequacy calculations, however, capital must be allocated for the covering of credit risk. Finnish banks act primarily as investors and providers of liquidity. Securitisation involves substantial management costs, which is why smaller banks are unlikely to initiate such procedures, at least in the short term.

Mortgage banks a major channel of funding for mortgages

Expansion of the mortgage banking business is slowly beginning to be reflected in the entire banking sector in terms of growth in lending by parent banks and when reviewing lending and funding (deposit) ratios. The heightened importance of mortgage banks is also seen as increased bond issuance in the entire sector. The mortgage banking business itself does not contribute to the expansion of lending in the entire banking sector, because banks continue to market and grant/supply loans. Loans transferred to mortgage banks do, however, have a significant impact on the ratios illustrating parent banks' financial services. The mortgage banking business has really got under way in the last couple of years. Mortgage banks' balance sheets are currently so significant that they can issue large collateralised bonds on a regular basis. Mortgage banks are indeed turning into a major channel of funding for mortgages in Finland.

Short-term liquidity has weakened

The combined funding deficit of the deposit bank sector expanded during the year by nearly 10 billion. Banking groups' aggregate claims on the public have long been increasing distinctly faster than deposits. Dependency on market-based funding has thus increased but at the same time the maturities of market-based funding have grown longer as a result of increased bond issues. The impact on deposit banks has varied, but the short term liquidity risk of the deposit bank sector has heightened somewhat. The current liquidity risk does not constitute a major problem, provided there are no disturbances in the financial market, but the risk must be accounted for in longer term planning of funding. A common contributor to the expansion of funding deficits was the growth in the volume of fixed-term deposits with short-term duration. For the most part, however, the volatility is due to increases in the maturities and launching of large bond issues by financial conglomerates.

The impact of mortgage banks is not reflected in banks' funding deficits due to the calculation method of the deficit. In calculating monthly deficits, the cash flows of all maturing items are accounted for, but claims from the public and sight deposits are expected to remain unchanged, ie they are not accounted for. The expansion of lending and developments in deposits payable on demand thus do not have an impact on the funding deficit.

The liquidity reserve can be subjected to conservative analysis by accounting for only debt securities eligible for refinancing with central banks that have not been lent to another party or given as collateral and that have maturities in excess of one month. Estimates of available debt securities eligible for use as collateral have remained almost unchanged ie at EUR 4.6 billion, because average maturities of debt certificates grew shorter.

The value of other debt certificates available for sale continued to be slightly less than EUR 3 billion, but the volume of liquid shares, ie listed shares and mutual fund units, grew to EUR 1.4 billion. Banks' funding programmes, credit limits and liquidity reserves have been accommodated to withstand sudden disturbances of varying degrees of severity.

Most supervised units have reported increases in funding deficits and slightly smaller surpluses. Average stock of collateral has increased, but growth in collateral in excess of one month has been slower. Short-term liquidity risk can thus be considered to have heightened, but it can still be regarded as moderate.

Deposits are the principal source of funding for European banks

Only minor structural changes have taken place in the acquisition of funding at European banks over the course of the 21st century. In its structural report, the European Central Bank evaluates changes in the structures of acquisition of funding by means of statistics and a survey conducted among supervisors and central banks. The report also evaluates the impact of structural changes on the stability of the banking sector. Deposits continue to be the principal source of funding for European banks.

The share of market-based funding has grown only slightly, and deposits have retained their place as the main source of funding for deposit banks. Deposits are characterised by increasingly wider geographical diversification, and bulk deposits by companies and other non-bank financial institutions have increased their share relative to retail deposits by the public, although households' share clearly continues to be the largest. Growth in the share of bulk deposits as well as new deposit products may subject banks to increasingly frequent market disturbances.

Average maturities of banking sector funding have shortened somewhat in the course of the 21st century. The share of money market funding in market-based funding expanded, as did the share of trading debts. Nevertheless, funding acquired from the capital market was much more significant. Of new types of funding, the stock of mortgage-backed bonds issued by European banks amounted to around EUR 1,700 billion at the end of 2005, while the share of securitised obligations ie asset-backed securities totalled approximately EUR 320 billion. The issuance of securities related to securitisation has increased substantially in recent years, with growth in 2005 amounting to more than 30%. Securitisation typically concerned mortgages and other fairly homogenic types of loans.

Future challenges in the banking sector

Changes in the structure of deposits and slight increases in market-based funding add to the diversification of banks' sources of funding, but dependency on monetary and capital markets continues to grow. However, as acquisition of bulk funding grows, market discipline improves. Competition over households' savings poses challenges on banks' planning of funding, and inexpensive deposit funding can no longer be taken for granted.

The share of deposits in Finnish banks' balance sheets corresponds rather well to the European average (approximately one third of the balance sheet), but in Finland, the importance of households is higher than in Europe on average. Finnish banks' deposits have not undergone structural changes, and companies and non-bank financial institutions account for only less than a quarter of all deposits. However, competition over households' savings is intensifying in Finland and shifting to deposits. Furthermore, the importance of market-based funding has also grown in Finland, with mortgage-backed bonds and possibly also securitisation continuing to be increasingly important channels of funding for banks in liquidity management.

The EU Banking Structures report (October 2006), prepared by the ECB Banking Supervision Committee, can be accessed on the ECB website at http://ecb.int/pub/pub/prud/html/index.en.html.

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 the funding of balance sheet assets and in particular lending through deposits and market-term sources of debt capital.

The measurement of short-term liquidity risk is based on the cash flow difference between income and expenditure, in each maturity class. Cash flow calculations also account for off-balance sheet items. The difference resulting from maturity imbalance shows the amount the bank has to invest or finance at the expiration of assets and liabilities in each maturity class.

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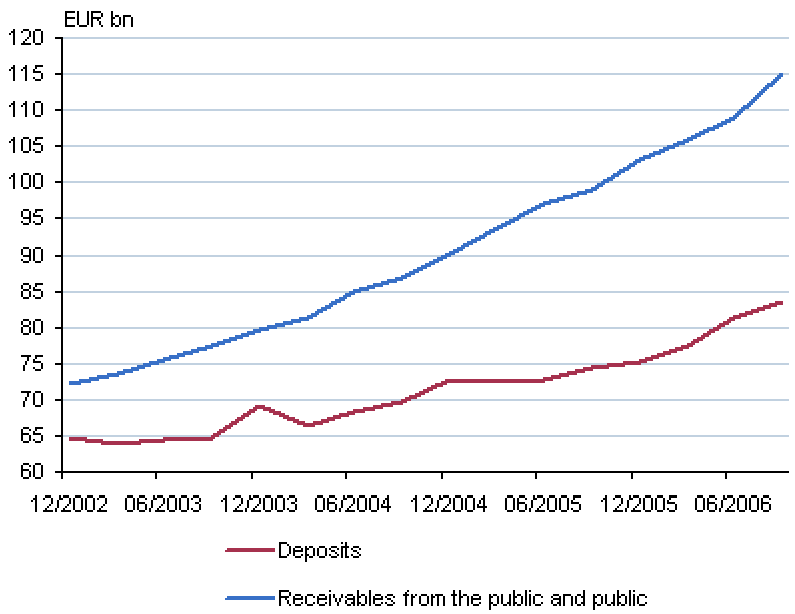
Deposit and receivables from the public and public sector entities

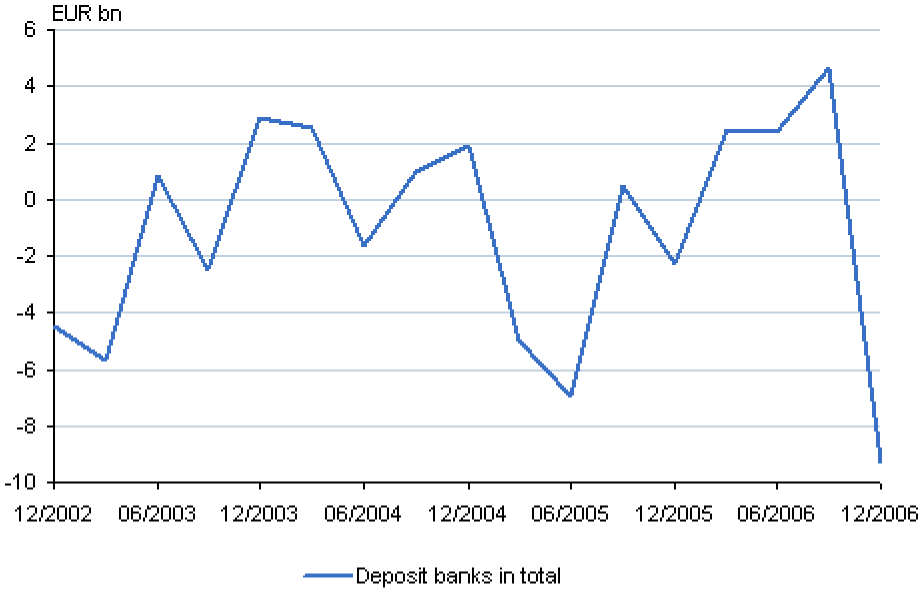


Source: Financial Supervision Authority.

Deposits as a percentage reveivables from the public and puclic sector entities

Source: Financial Supervision Authority.

Monthly funding deficit of deposit banks



Source: Financial Supervision Authority.

Only minor changes in banks' interest rate risks

Finnish deposit banks' absolute combined exposure to income risk heightened in 2006 and decreased in terms of the interest rate risk to net interest income. At the end of December 2006, exposure to income risk arising from an interest rate hike of one percentage point represented EUR 318 million and 11.7% (11.9%) relative to net interest income, which had increased during the year. When measuring the interest rate risk with the combined income and investment risk, banks' combined position is almost neutral to changes in interest rates.

Increased lending is not reflected in banks' interest rate risks

The continued strong growth in lending over a number of years is not reflected in higher relative income risk. This is partly due to increased net interest income, which reduces the relative income risk. Instead of heightened risk exposure, the growth in lending is reflected in higher balance sheet items in the calculation of the income risk.

Besides higher net interest income, banks' active hedging operations have contributed to containing the income risk. In hedging against the interest rate risk, banks' primary tools are opposite balance sheet items and, of off-balance sheet items, particularly interest-rate swaps.

Receivables from credit institutions and the public increased in both shorter maturities and longer maturities. In other words, growth in bank lending in 2006 was not as heavily dominated by longer maturities as it was in the previous year. This is due to the upward turn in the yield curve following expectations of rising interest rates, resulting in customer interest shifting, at least in the short term, to more inexpensive – from the customer's point of view – short-term interest rates and banks' own prime rates.

In analysing the ratio of reference rates to income risk it must be taken into account that loans tied to market rates in excess of one year – ie to fixed interest rates – do not have a major impact on banks' income risk. For fixed interest loans, income risk is only affected by instalments and interest paid over the following year.

Foreign currencies account for a significantly larger share of the income risk when comparing to the previous turn of the year. While at the end of 2005, foreign currencies accounted for a mere 4.4% of the income risk, their share had risen to as much as 43.7% by the end of 2006. The major currencies in addition to the euro and the Nordic currencies were the US dollar, British pound and Swiss franc.

The sensitivity to interest rates of investment risk for the financial account has continued to decrease

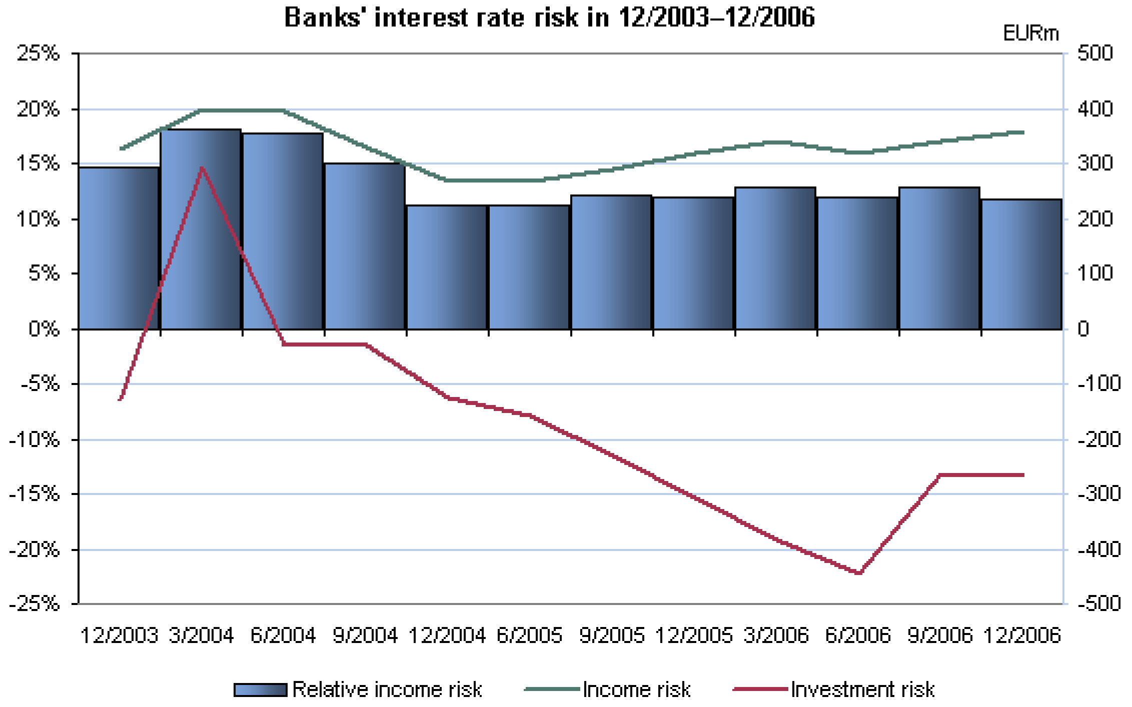
The financial account contains bonds and derivatives that carry investment risk. The sensitivity to interest rates of these items was EUR -104 million (EUR -137 million). A negative figure means that the value of the contracts in the bank's financial account will decline, if market rates increase by one percentage point in all the maturities of the yield curve.

In analysing exposure to investment risk of the financial account it becomes again evident that banks did not use derivatives to hedge against declines in bond prices. The impact of derivatives and bonds alike on exposure to investment risk was negative. Thus it can be concluded that the likely purpose of derivatives is to hedge against the income risk impact of changes in interest rates.

Exposure to investment risk of the trading book grew smaller

Exposure to investment risk of the trading book decreased from the end of 2005, amounting to EUR -268 million (EUR -306 million). The weaker risk is especially due to the decrease in foreign currency denominated investment risk. In fact, the size of investment risk of foreign currency denominated items has almost halved from the end of 2005.

The situation of derivatives in the trading book was the same as in the financial account in that they were sensitive to interest rate hikes. The derivatives positions in the trading book encourage to draw the same conclusion as in the financial account: Derivatives were not used to hedge against changes in bond prices, but positions were speculative, at least partially.



Source: Financial Supervision Authority.

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

Values in EUR m at a time of one percentage point rise in interest rates.

	31 Dec 2006	31 Dec 2005	Change
Banking book interest rate risk			
Income Risk	357,5	317,9	12,4%
Net interest income	3 049,7	2 669,8	14,2%
Relative income risk, % of net interest income	11,7%	11,9%	
Stress test 1; sight deposits < 1 mth	-156,7	-177,3	-11,6%
Stress test 2; foreign currency at absolute value	662,1	816,8	-18,9%
Investment risk	-104,4	-137,1	-23,9%
Interest rate risk of the trading book			
Investment risk	-268,1	-305,9	-12,4%
Trading book market value	10 524,7	9 137,7	15,2%

Risk relative to the value of the trading book	-2,5%	-3,3%	
Stress test 3; foreign currencies at absolute value	356,0	333,2	6,8%

What is an interest rate risk?

The Financial Supervision Authority employs two measures when analysing banks' exposure to interest rate risk: the income risk measure and the investment risk measure.

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

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

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Positive stock market momentum reflected in profitability and growth figures of investment firms

Financial position of investment firms

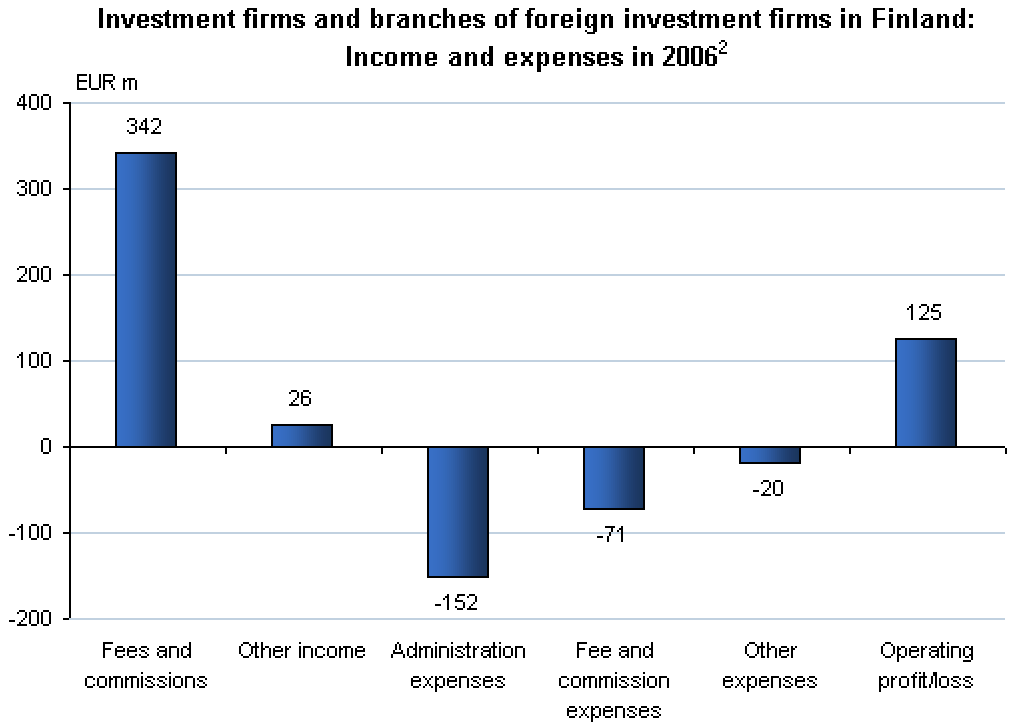
At the end of 2006, there were 40 domestic investment firms. In addition, investment services are provided in Finland by 4 branches of foreign investment firms. In 2006, five new investment firms commenced operation.[1] The business of investment firms consists of securities broking, asset management and other investment services.

1 Alexander Corporate Finance Oy, GreenStream Network Ltd, Ilmatar Asset Management Oy, OKO Corporate Finance Ltd and RAM Partners Oy.

Profitability of investment firms at good level

2006 was a particularly favourable year for the investment service industry. Conditions were in place for strong growth. The total trading volume in euro on the Helsinki Stock Exchange rose 30%, the OMXH all-share index rose 18% and the number of share transactions 50%. The economic situation in Finland was particularly good in general as well. In principle, the level of activity in the securities markets should be reflected linearly in the commissions and results of investment firms, but in practice, the linearity is not quite as direct.

Based on results, the profitability of investment firms was on excellent level. On the other hand, for six companies, investment service fees and commissions had decreased in terms of euro, and as many as 15 companies faced a decrease in operating profit.



Source: Financial Supervision Authority.

2 Other income includes net income from securities transactions and currency operations, return on equity investments, interest income and other operating income.

There have been many significant structural changes in the industry that complicate monitoring and comparison in the field. FIM Asset Management Ltd merged into its parent company FIM Group plc on 15 August 2006 and Opstock Ltd merged into OKOBank on 14 February 2006. In addition, among the foreign investment firms, Enskilda Securities AB Helsingforsfilialen merged into SEB's banking operations. The fees and commissions of these three investment firms in 2005 amounted to almost EUR 94 million, which has been eliminated from comparative figures for 2005.

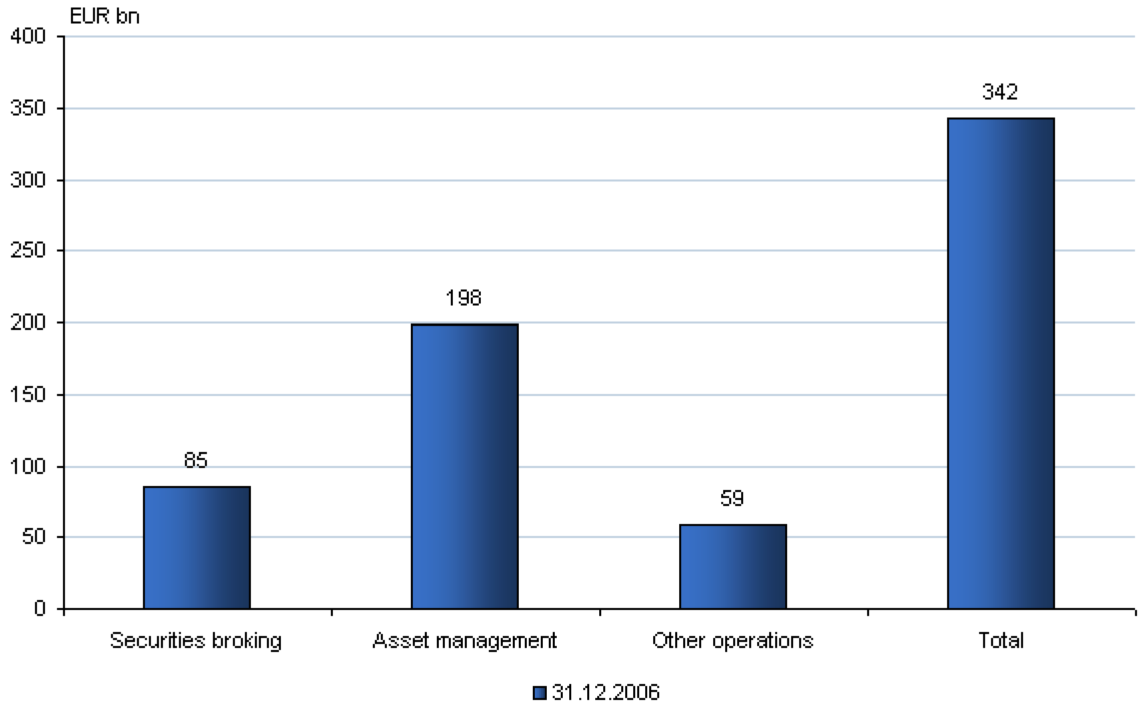
The financial position of investment firms remained solid in 2006. Fees and commissions grew by 46%, as the total amount increased to EUR 342 million (EUR 223.9 million), while operating profit stood at EUR 125 million (EUR 87.9 million). The profit margin (profit for the period / income from investment operations x 100) was a whopping 24.6%.

In reality, fees and commissions as well as other figures are larger, since the business operations of the merged companies have been carried on in the receiving company or another company within the group, and the figures have therefore been shifted entirely or partly to another reporting level. It can be stated that, on average, the industry has developed fairly linearly with the development in the securities markets. However, dispersion across individual investment firms is large.

Asset management in a significant role

The most lucrative form of service was asset management, which generated almost EUR 198 million of fees and commissions. A little less than one-third of income was generated in securities broking.

Finnish investment firms and branches of foreign investment firms in Finland: Fees and commissions in 2006[3]



Source: Financial Supervision Authority.

3 Fee and commission income from other operations include fees from market making, issue organisation and underwriting, arrangement of loans and finance, custody of securities and other service fees.

Assets under management increased at a rapid pace during 2006 and amounted to EUR 133.5 bn at year-end, which is 20.6% more than at the end of 2005. The amount of assets under management has been boosted particularly by the increase in asset values, so the amount of new funds has actually increased more slowly. The largest proportion, about 73% of the total amount, consists of discretionary portfolio management. The largest increase was seen in the proportion of domestic equity funds, where the amount of assets under management increased by 41%.

Special asset management expertise or distribution network is sought with the help of co-operation partners. The work of an asset manager is focused more and more on the selection of suitable mutual fund products for the customer. Some of the agents, however, specialise particularly on asset management based on direct investments.

According to the Mutual Funds Act, management companies may also provide asset management services. Four of the management companies are offering asset management services in addition to other operations. At the end of 2006, the amount of assets under management by management companies was EUR 3.1bn and is expected to increase.

Assets under management by banks in 2005–2006 (EUR bn)

	12/2006	12/2005	Change	
	EUR bn	EUR bn	EUR bn	%
Discretionary portfolio management	4,1	3,1	1,0	32,2
Whereof domestic mutual funds	0,9	0,3	3,8	1 120,4
Consultative asset management	18,9	14,6	4,3	29,7
Total	23,0	17,7	5,3	30,2

Source: Financial Supervision Authority.

Assets under management by investment firms in 2005–2006 (EUR bn)

	12/2006	12/2005	Change	
	EUR bn	EUR bn	EUR bn	%
Discretionary portfolio management	90,2	76,6	13,6	17,8
Whereof domestic mutual funds	48,7	39,0	9,7	24,9
Consultative asset management	17,2	16,5	0,7	4,4
Total	107,4	93,0	14,4	15,4

Source: Financial Supervision Authority.

Assets under management by management companies in 2005–2006 (EUR bn)

	12/2006	12/2005	Change	
	EUR bn	EUR bn	EUR bn	%
Discretionary portfolio management	3,1	0,0	3,1	
Whereof domestic mutual funds	2,6	0,0	2,6	
Consultative asset management	0,0	0,0	0,0	
Total	3,1	0,0	3,1	

Source: Financial Supervision Authority.

Total assets under management in 2005–2006 (EUR bn)

	12/2006	12/2005	Change	
	EUR bn	EUR bn	EUR bn	%
Discretionary portfolio management	97,4	79,7	17,7	22,2
Whereof domestic mutual funds	55,5	39,4	16,1	41,0
Consultative asset management	36,1	31,0	5,1	16,3
Total	133,5	110,7	22,8	20,6

Source: Financial Supervision Authority.

Corporate Finance: significant activity still in M&A

Due to the low level of share issues and IPOs, corporate finance operations are still weighted towards advisory involvement in M&A, which is not in itself subject to authorisation. The M&A market is still very active: target companies are consolidating and focusing on their primary business, there is ample capital and venture capitalists are active. The corporate finance industry is specialising further, and there is intense competition for personnel resources. Supervision by the FIN-FSA focuses mainly on prospectuses.

Automation of securities broking changes risks and risk management

Large brokers are seeking low-margin market shares through direct order routing trading systems and higher-margin revenue from the execution of customised and highly refined transactions for their customers, using their own balance sheet when necessary. Smaller agents specialise on eg unlisted, emerging market products or index loans.

As the degree of automation in broking increases, the risks related to the settlement of orders, equal treatment of customers, conflicts of interests, documentation of orders, settlement of transactions and other procedures become more controllable. However, automation brings about other types of system-related risks. The use of own balance sheet and the related market and settlement risks are concentrated on large agents that, however, have sufficient equity for the operation.

Non-profitability vexing five investment firms

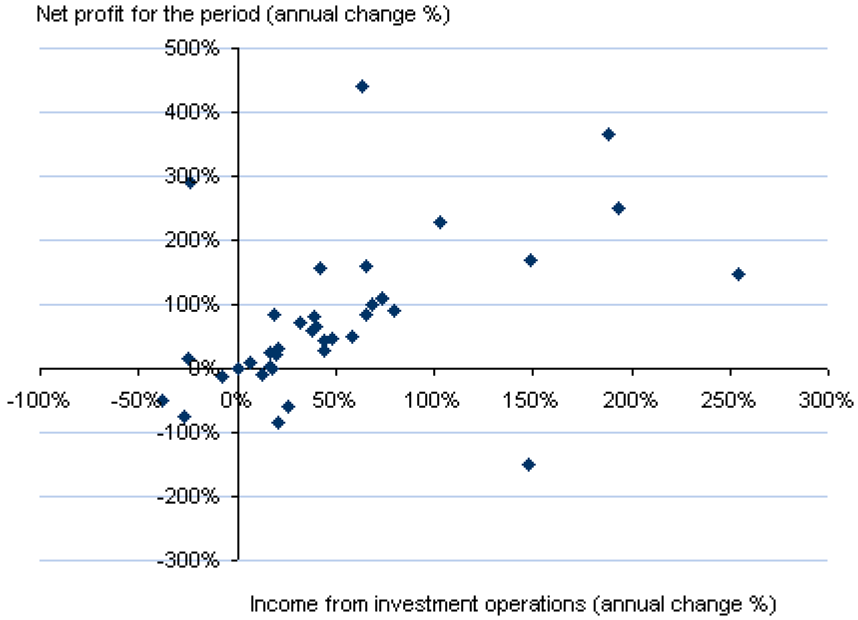
Among all investment firms, five made a loss for the period. Despite the losses, however, none of the companies is in a crisis due to weak profitability.

Surplus own funds of an investment firm reflects the loss buffer of the company. Domestic investment firms on average have an equity surplus that is more than double the minimum requirements. Hence, the risk-bearing capacity is good in the industry. On the other hand, some investment firms had a very low equity surplus, which means a weaker tolerance for loss. Then again, the size of the surplus makes no difference if the company makes a profit.

Interesting details in key figures of investment firms

The relationship between the net profit for the period and income from investment operations in an investment firm is not completely linear. The chart below illustrates the relationship between the annual change in profit and income from investment operations (2005 vs. 2006), in other words, whether the profit for the period increases in line with income. It is plain to see from the chart that the profit for the period does not increase in line with income. However, a certain degree of linearity can be observed. Among small investment firms, fees and commissions seem to grow rapidly but their profitability is not improving at the same pace.

Relationship between annual change in profit for the period and income from investment operations of investment firms as at 31 December 2006[4]



Source: Financial Supervision Authority.

4 The axles of the chart have been shortened so the largest changes are excluded.

It is also peculiar that operational efficiency varies significantly across investment firms if efficiency is measured by the cost/income ratio. The average cost/income ratio for all investment firms was 0.7 at year-end. The figures for individual investment firms vary between 0.3 and 1.3. However, the forms of business may vary significantly across investment firms, which explains part of the variation in efficiency.

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Capital inflows to mutual funds at record levels - rapid growth poses a challenge to both management companies and supervision

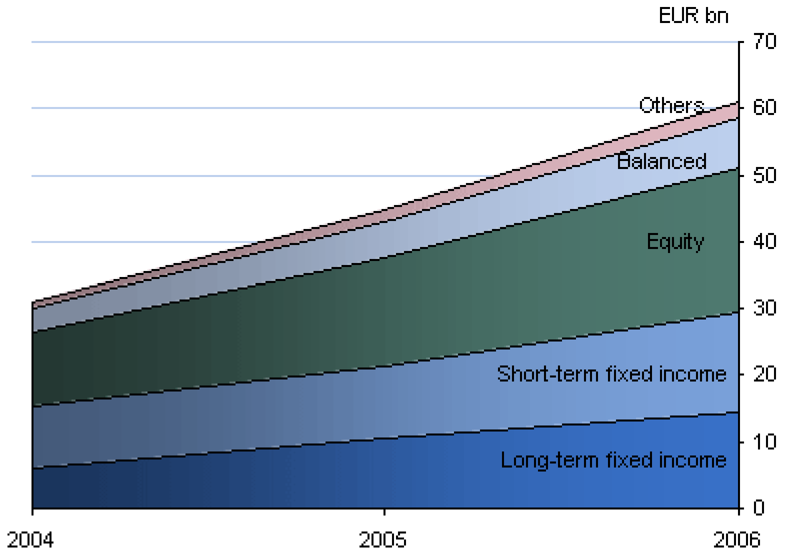
Record money inflows to mutual funds

At the end of the year, there were 27 Finnish fund management companies. Four of them are also offering asset management services in addition to mutual funds.

The combined capital base of mutual funds increased by as much as EUR 16.6bn during the year (EUR 13.0bn), the growth rate being 37.1% (41.0%). At year-end, the amount of assets under management was EUR 61.3bn (EUR 44.7bn). However, growth was not quite as rapid as in 2005. The rapid growth was supported by the positive momentum in the equity markets, favourable economic developments and increase in the supply and marketing of mutual funds. It is unlikely that similar growth figures will be reached in 2007.

The distribution of capital to different types of mutual funds shows that the share of fixed-income funds in the total base increased to 50%, while assets increased to EUR 29.4 billion. The proportion of equity funds decreased by a few per cent. A review of the mutual fund assets by owner sector shows that the largest individual sector consists of households with a share of 25 percent. The share of households has remained constant in 2004–2006. In contrast, financial institutions (share 13%) and foreign countries (13.3%) have increased their shares the most.

Mutual fund assets by type of mutual fund in 2004-2006[1]



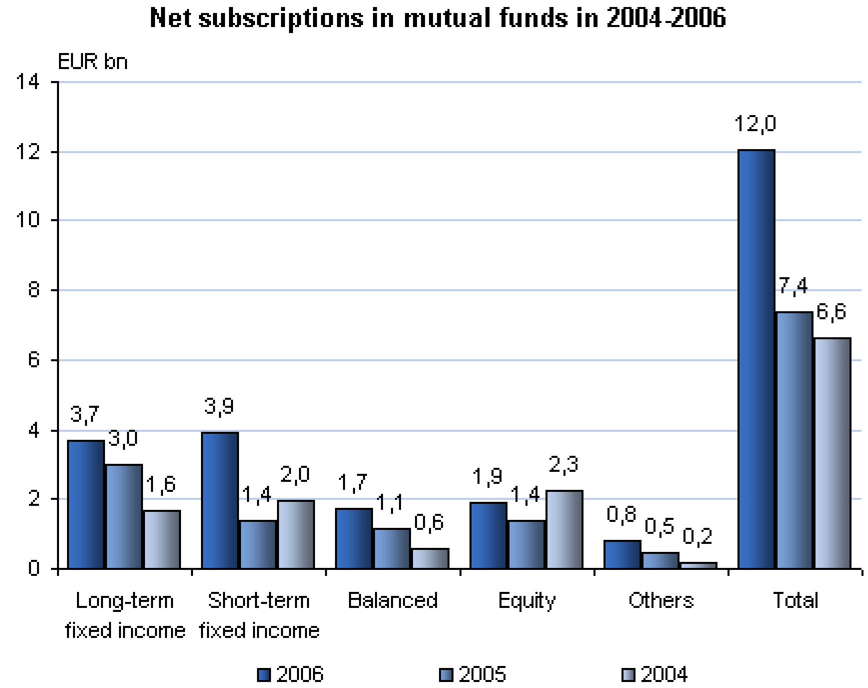
Source: Sijoitustutkimus Oy: Rahastoraportti.

1 The report by Sijoitustutkimus Oy excludes a few small management companies; to the total amount of mutual funds in the chart is EUR 60.8 billion, while the actual total amount at the end of 2006 was EUR 61.3 billion.

The number of mutual fund unit owners has not increased in proportion with new assets invested in mutual funds. At the end of 2006, domestic mutual funds had almost 2.3 million unit holders. The average assets of a unit holder invested in mutual funds[2] at the end of 2006 was about EUR 26,000, while the corresponding figure at the end of 2004 was EUR 20,100.

Net subscriptions in domestic mutual funds amounted in 2006 to EUR 12 billion, ie as much as 63% more than in the previous year. The most popular type of mutual funds was fixed-income funds, which indicates a low appetite for risk on the part of mutual fund savers. The most net subscriptions were made in short term fixed income funds, which grew almost threefold in comparison to year 2005.

2 One person may also have several mutual fund units in different mutual funds, which also inflates the number of unit holders.



Source: Sijoitustutkimus Oy: Rahastoraportti.

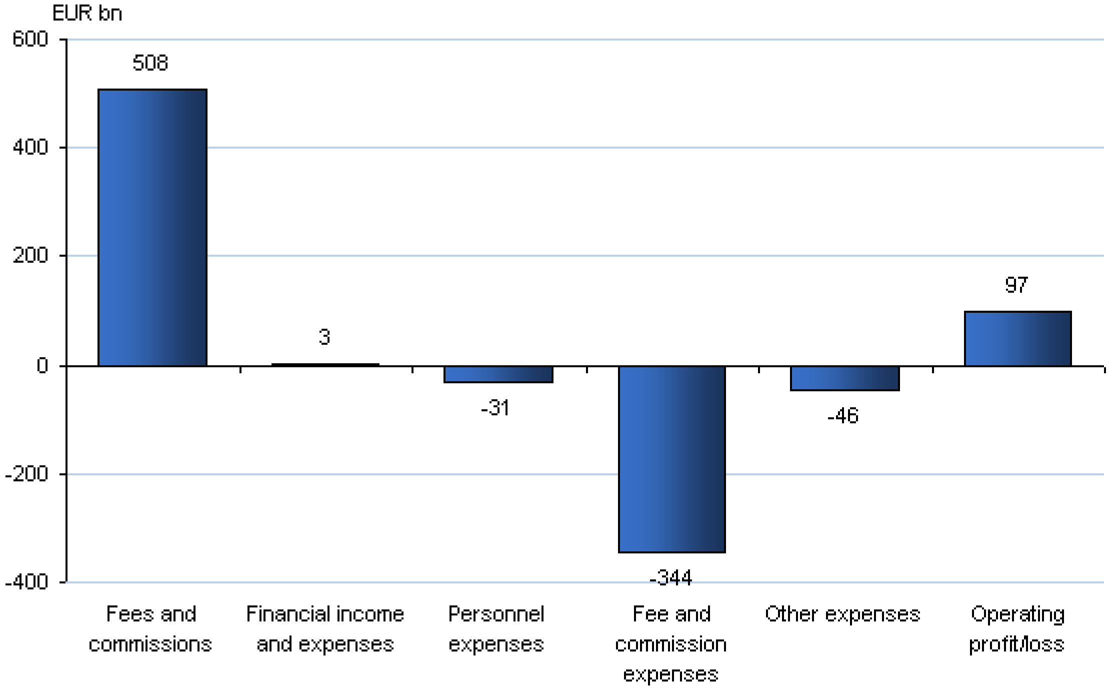
Management companies showing outstanding profitability

The increase of capital inflows to mutual funds shows clearly also in the fees and commissions as well as results generated by management companies. The combined fees and commissions of all management companies increased to EUR 508 million (up 33%). Assets invested in mutual funds increased 37.1%, so analytically there is a logical connection between fees and commissions and the development of assets.

Management companies' combined profit for the period increased as much as 58% ie significantly more than fees and commissions. Profits amounted to almost EUR 70 million (EUR 44 million in the previous year). The expense side of management companies has indeed grown more moderately in comparison to fees and commissions and assets under management. The profit margin[3] of management companies was on average 13.7%, ie 13.7% of every euro generated in fees and commissions remained with the owners.

3 Profit margin = profit for the period / fees and commissions * 100

Major items in combined income statement of management companies as at 31 Dec 2006



Source: Financial Supervision Authority.

The profitability of management companies was on average at a very good level. What stuck out was that variation across management companies was very large.

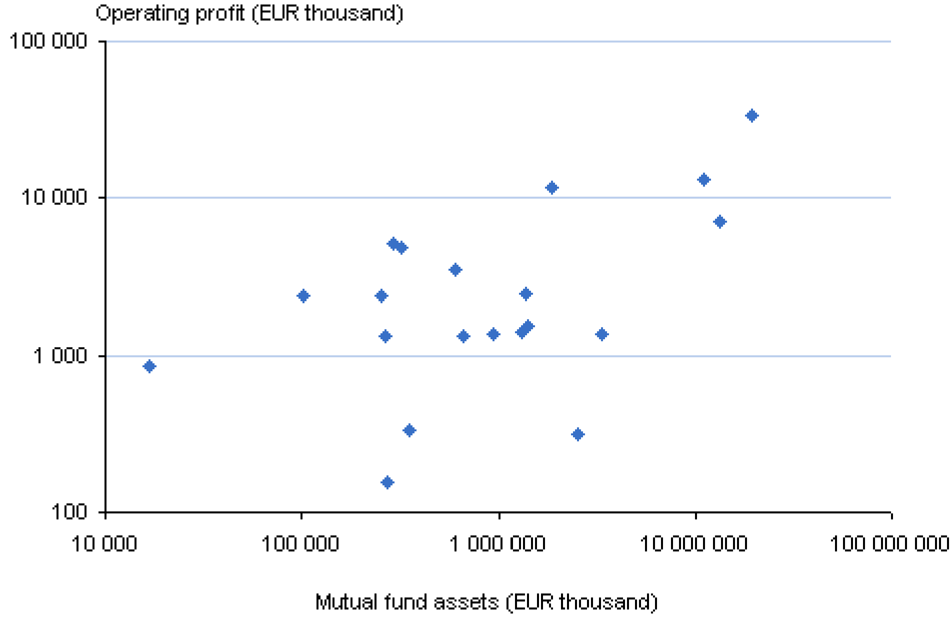
A total of four management companies also provide asset management services. Their profitability was at an excellent level. The amount of fees and commissions rose to EUR 57.2 million, and the average profit margin was as much as 23.3%.

Management companies charge an average of 0.83% of the assets under management in fees and commissions. On the other hand, the ratio varies greatly across management companies. Variations may be partly explained by different types of mutual funds. Special and equity funds include more work, reflecting in higher fee percentages in comparison to fixed-income funds.

Large assets do not guarantee higher relative profitability

The relationship between the fees and commissions of a management company and the assets in its mutual funds is very linear. Distribution increases considerably when analysing the relationship between management companies' operating profits and assets. Some of the management companies can reach same operating profits with much smaller assets. In simplified terms, it can be even argued that larger assets do not automatically guarantee relatively higher operating profits, which is surprising. The ratio is affected by the number and type of the mutual funds managed. Furthermore, the findings only concern a single year.

Link between operating profits and assets under management of management companies as at 31 Dec 2006 (logarithmic scale)



Source: Financial Supervision Authority.

Capital requirements were met

Management companies fulfilled the minimum share capital requirement under the Mutual Funds Act, stating that the share capital of a mutual fund must be at least EUR 125,000.

Is competition spreading to mutual funds?

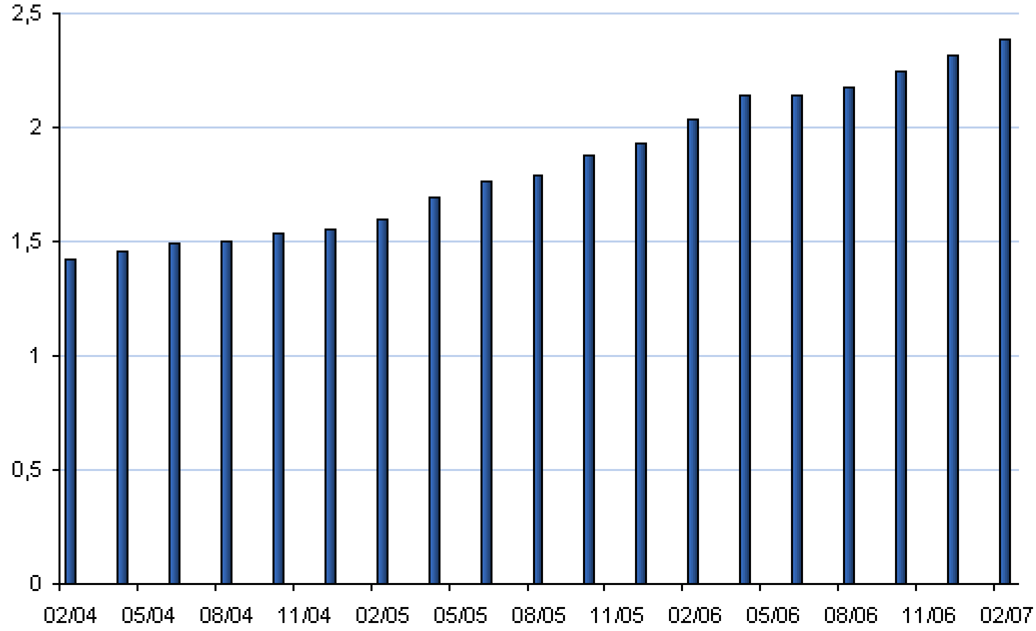
Mutual funds are marketed very actively at the moment. However, no public claims have been made that competition between mutual funds would have spread to management and subscription fees, which has been the case in eg loan margins. When analysing profitability, it would, however, appear that the profitability of mutual funds would withstand a potential downshift in fee levels, so there might actually be room for competition.

The investment industry is experiencing a very favourable period at the moment, which is reflected in an increase in the popularity of mutual funds. In good times, mutual funds make top results but on the other hand, during an economic slowdown similar results are unlikely achieved. From a risk management point of view, however, the earning logic of management companies is secured since management fees are tied to the size of the mutual fund. Subscription fees are compromised the most in an economic downturn, when there are likely fewer subscriptions.

Mutual fund markets growing rapidly

Rapid growth of the mutual fund market is a challenge to both management companies and supervision. Similarly to the assets in mutual funds, the number of Finnish mutual funds has experienced strong growth. At the moment, there are already 508 mutual funds, while the figure stood at 469 at the end of 2005 and 403 at the end of 2004. The number of unit holders has also increased steadily. In particular, mutual fund ownership of individuals has increased strongly.

Number of unit holders (millions) in Finnish mutual funds Jan 2004 – Feb 2007



Source: Financial Supervision Authority.

Rapid growth requires expertise and moderation in order to control the operational risks related to growth, so that eg the processes of NAV calculation and mutual fund unit register function without errors as the number of transactions increases. Similarly the sufficiency and expertise of personnel is put to the test amid rapid growth. From a supervision point of view it is important to pay attention to the capability of management companies to review their operating modes in line with their growth.

Increase in the number of unit holders increases the number of those investors in the markets with little knowledge about mutual funds as investments or even about the securities markets. Supervision must now focus on the supervision of the disclosure obligation, since the key processes and risk management in the industry have been inspected extensively in 2003 - 2006.

Popularity of emerging markets continues

Mutual funds investing in emerging markets have continued to attract a lot of investor attention due to their high returns. The abovementioned challenges related to strong growth are particularly highlighted with respect to mutual funds investing in emerging markets. The management of operational risk requires more efforts by management companies, since market conditions and trading practices in emerging markets differ from familiar. Supervision has paid particular attention to these mutual funds by requiring that they carefully find out in advance about the special characteristics of the target market. In addition, as part of the risk management inspection, the acceptance processes of management companies for new products have been assessed.

Investors must also now have above average knowledge when investing in a mutual fund investing in emerging markets. The management company must explain the key risks related to the mutual fund in its simplified prospectus. As regards developing markets, investors should understand that there is eg the risk that the value of a mutual fund unit may show stronger fluctuation than usual or that a redemption may not be exercised at the expected value. In the supervision of the disclosure obligation of management companies, the simplified prospectus plays a major role.

Exercise of redemption orders

Management companies prepare for the payment of redemptions with sufficient cash assets. There is no prescribed level of sufficient cash assets, but the assessment of the sufficiency of cash assets is part of the expertise of the management company. However, the amount of redemptions is hard to predict, and therefore cash assets may exceptionally prove too small. This was the case in many emerging market mutual funds this February and March and in spring 2006.

If a management company exceptionally lacks sufficient cash assets, the management company may draw a loan on FIN-FSA's permission, if the rules of the mutual fund allow for it. Six (22%) management companies have permission from the FIN-FSA to use loan. Otherwise, the management company obtains the funds need for redemptions by selling securities. If the funds needed to pay redemptions must be obtained by selling securities from the portfolio of a mutual fund, the unit holders may have to wait for their money up to two weeks, and with permission from the FIN-FSA, the period may be even longer. These exceptional rules on redemptions are poorly known by investors, and therefore debate always arises about the appropriateness of the conduct of management companies when the markets experience a dip.

Supervision has paid special attention on the payment of redemptions in 2006 eg by monitoring the level of cash assets of mutual funds investing particularly in emerging markets and the use of loan intended for the payment of redemptions in mutual funds. In order not to compromise investor confidence on the financial markets, supervision will continue to pay attention on preserving transparency as a principal characteristic of a mutual fund in practice as well, which means that management companies are able to process redemptions on time.

New co-operation partners

More and more management companies are seeking efficiencies in their operations through outsourcing also other core functions than investment operations, such as outsourcing of the maintenance of the mutual fund unit register. From a risk management point of view it is important that internal control also covers outsourced functions and that eg when outsourcing the maintenance of the mutual fund unit register, the management company retains the ability to exercise subscriptions and redemptions under special circumstances and to record them in the mutual fund unit register.

It is relatively easy for a management company to outsource its core functions, since similar operations are also carried out in other companies than management companies. For the management company, a more important question is that operations should at least remain at the management company so that it would not become a mere shell company. However, the management company is still needed since a mutual fund may only be established by a management company.

Finnish management companies have also directed the sale of their mutual funds to abroad. New co-operation partners as distribution channels have been found eg in Swedish mutual fund marketplaces. The procedures of foreign co-operation partners may differ from Finnish customs and therefore require new operating models from management companies. In supervision, the new operating models may lead to the need for new interpretations.

Asset management operations by management companies

Four management companies also engage in individual asset management. It can be foreseen that the number of these companies will increase, since the investment operations of a mutual fund and the individual asset management of investment firms are based on a similar process, and by combining these functions, economies of scale can be achieved at least in the fairly small Finnish market.

Since an investment firm engaging in asset management may not extend its authorisation to mutual fund operations, it is likely that some of these investment firms will transform into management companies in order to be able to engage in both asset management and mutual fund operations.

Investment operations of mutual funds have been inspected from the viewpoint of risk management, and efforts should be made in this respect in the future, too. Many management companies already have established traditional equity, fixed income and balanced funds, and product development will be focused on increasingly specialised mutual funds whose risks differ from traditional mutual funds.

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