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Financial sector profitability robust, but risk of varying results increasing

The economy of the entities supervised by the Financial Supervision Authority has generally been stable and they have kept their market risks under control. Tight competition in the housing market has anyway narrowed interest margins to almost non-viably low levels, causing FIN-FSA concern. Banks strive to increase their income by actively selling other financial services to their customers, although during an economic downturn fee income from financial services can dwindle. One of the future challenges that banks face is a growing sensitivity to fluctuations in the price and availability of financing. Banks are not able to finance the credit growth with deposits that are diminishing in size from one year to the next.

Economic growth expected to slow in near future

In the short-term, the economic outlook remains good. The growth rate for 2006 has been better than forecast. However, the rate of growth is expected to slow somewhat in the near future. From the point of view of the Finnish financial markets, the largest risks pertain to the shocks that are appearing in international financial markets. Due to Finland's sound economic base domestic shocks are less likely to occur.

Demand for credit remained strong

Rising interest rates and housing prices have not curbed households' demand for housing loans. The demand for consumer credit also gained strength, whereas the rate of growth of corporate loans declined even further.

Banking business and banks' ancillary services increasingly profitable

Economic growth, buoyant demand for credit and the long-continued upswing in the stock market have offered supervised entities good opportunities to perform well. The demand for housing loans has slowed slightly, but household credit on the other hand has gained in popularity. Banks’ net interest income has also grown as a result of rising interest rates. The quality of the lending stock is not yet a strain for the business performance in 2006. The stock market correction took its toll on the fee income of banks, but as a rule the insurance segments of financial conglomerates are more sensitive to external shocks than the banking segments.

Banks' capital adequacy remained strong, despite some deterioration

Capital adequacy in the banking sector weakened slightly as a result of risk-weighted assets and restructuring. Banks' own funds increased without any deterioration in their quality. The risk-bearing capacity of the banking sector remained strong in general.

Lending quality high, but risks for mortgage holders are increasing

The quality of banks’ outstanding credit stock is still high when measured by the relative share of nonperforming loans and impairment losses in the stock of lending. The indebtedness of younger households and households with children in particular has recently risen rapidly, as housing prices and housing loan sizes have increased. Taking this into consideration, banks should be active in making sure that mortgage holders understand the longer-term risks associated with housing loans.

Deposit banks’ liquidity risks decreased

Bank lending increased further in the first half of 2006. Owing to weak growth in deposits, growth in the stock of lending was increasingly financed through market-based funding, mainly bonds. Banks’ short-term liquidity improved compared with the situation at the turn of the year.

No changes in Finnish deposit banks' aggregate income risk

Finnish deposit banks' aggregate income risk remains unchanged from the levels of December 2005. At the end of June 2006, a potential interest hike of one percentage point would have had the effect of raising net interest income by EUR 318 million. Despite the lack of change occurring in the risk levels, there has been a notable structural change in the bank's position. Regardless of the unchanged income risk, changes were experienced in the investment risk of both the balance sheet and the trading book.

Financial sector profitability robust, but risk of varying results increasing

Following EU trends, the Finnish financial sector has seen a merging of banks and insurance companies, concentrating the markets still further. The financial markets are dominated by large financial conglomerates that place particular emphasis on offering fee income-generating financial services, meaning that developments in the securities markets take on greater significance. The results seen in the insurance side of the financial markets are also greatly dependant on developments in the securities markets, adding to the cyclical sensitivity of the financial conglomerates' income. Cyclical sensitivity is also amplified by the IFRS financial statement.

Alteration of the banks' income structure has the effect of altering the conglomerate's risk profile. In the future, evaluation of financial conglomerates' risks and capital adequacy will be further emphasised.

Economic stability for financial sector participants

The Finnish financial sector is experiencing economic stability at the moment. Banks are both efficient and profitable, risks are well-managed and capital adequacy is sound. Card companies have seen particularly brisk growth and, generally speaking, their profitability is good. The profitability level of finance companies has also remained good and they have expanded their scope of operations. The significance of mortgage banking as a source of funding has increased strongly over the year bringing with it a growth in their balance sheets. Investment firms have seen a further improvement in profitability, but a few of them have reported a loss. Also fund management companies have done well.

Over the last couple of years banks have clearly made better gains. In general, this positive development has been due to the favourable operating environment. As the economy has grown the demand for financial services has grown with it and this has been reflected in the improved returns recorded by parties operating in the financial sector. The rise in market interest rates has had the effect of improving banks' net interest income. Households' belief in their own economy has remained strong and this confidence has encouraged brisk lending – perhaps even to the point of overconfidence. Household lending trailed off slightly at the end of last year, as market rates started to rise, but despite that, lending continued to grow steadily.

Brisk competition continues in housing loan market

Competition in the housing loan market continues to be tight, as proved by the continuingly narrowing interest margins. At a rough estimate, already over half of new housing loans have been granted at less than 0.6 percentage points interest margin. Such narrow margins do not adequately take the uncertainty related to long-term loans into account.

Information from the markets regarding the dilution of housing loan competitiveness is contradictory at best. According to the opinion of some, competitiveness is diminishing, but opposing opinions also exist. Competition in the housing loan business continues to be tight, despite there being – from the risk management perspective – no more room for narrowing interest margins.

In its inspections, the FIN-FSA has observed signs of active selling of consumer loans connected to the granting of housing loans and is reflected in the steady rise in the stock of consumer credit. However, interest margins have not narrowed at the same rate as housing loans, which would appear to indicate that the competition for consumer loans has not tightened.

At present, households' capacity to service their loans is good and there do not appear to be any signs of banks' capital adequacy being threatened by unserviced loans. Long-term loans granted at a very narrow marginal rate may present a risk to banks' profitability.

Banks aim to make up for the profitability effects of narrow margins by selling other financial products, less subject to price comparison. In addition to consumer loans, at the point of applying for a housing loan, households are also being offered the option of investing in mutual funds. Repayment periods for housing loans are being extended, allowing monthly repayments to be reduced, and customers are left with the means to begin continuous investment in funds. Thereby, in practice, investment is being financed through housing loans. The "crazy years" of the 1990s was a highly dubious time when investments were financed through consumer loans – these days they are being financed through housing loans. On top of which, households are not necessarily aware that capital investment in funds can also be lost.

Managed weighting towards market funds in financing of lending structure

Fund savings have continued to grow in popularity in the last few years. There has been an equal increase in euro terms in both household deposits and investments in mutual funds in the last year, whereas mutual fund assets, overall, have grown at a greater rate than deposits. If this pace is to continue, total fund assets will reach the level of deposits in just a few years. It could be that deposits will also rise again, as there are already signs of an increase in competition over interest rates offered on deposits. Following a change in taxation, the rapid rise in insurance investment came to a halt and last year saw little growth.

Banks' dependence on market-based financing has continued to grow, as the transfer of funds from deposits to mutual funds has forced them to increasingly resort to market financing. While there has been an increase in banks' long-term, structural funding risk, short-term liquidity has improved. In the future, banks will be increasingly sensitive to fluctuations in the price and availability of financing.

Market risks under control

Last spring's, uncertainty in the financial markets increased and with it came an increase in trading volumes and demand for hedging instruments. Uncertainty concerning forthcoming interest rates hikes in particular has boosted the use of interest rate derivatives. Banks have actively limited interest income risks through the use of interest rate swaps, meaning that banks' income risk has remained unchanged. On the other hand, there has been an increase in the interest rate sensitivity of the trading book.

Changes in other market risks have also been only moderate. There has been a slight increase in foreign exchange risk following the growth in open FX positions. Currency trading has continued to grow at a steady pace, bring with it an increase in the respective earnings. During the past year, all financial conglomerates have reduced their equity risk sensitivity by cutting back on their investment in shares. The ratio of real estate holdings to own funds held by banks and financial conglomerates has also remained unchanged.

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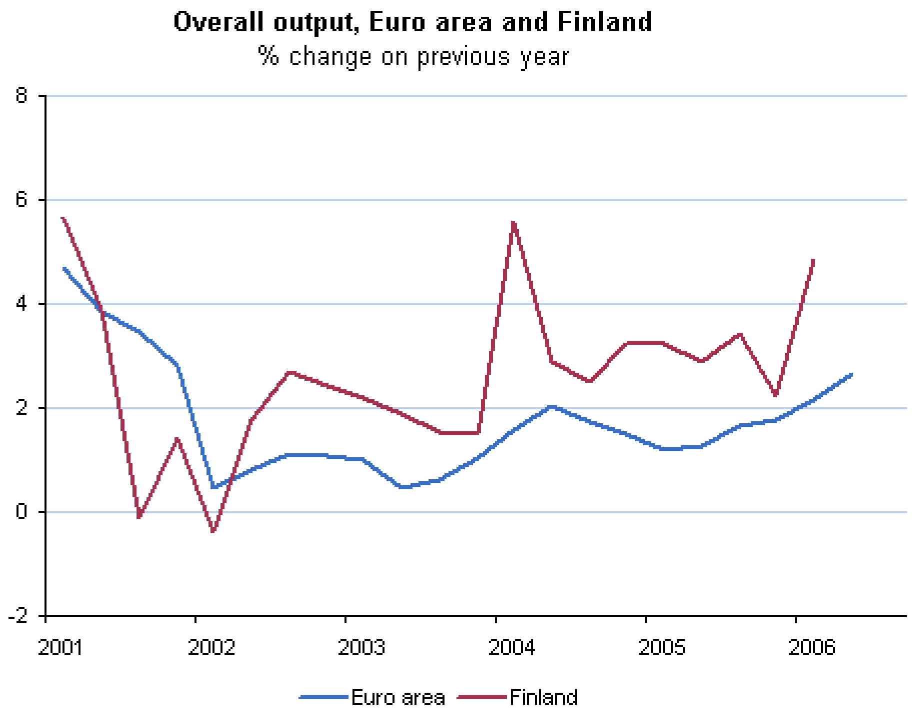
Economic growth expected to slow in near future

The growth prospects for the Finnish economy remain good and growth to date has even exceeded forecast levels. GDP forecasts for this year, so far, have fluctuated between 3.4–3.9%. Exports and consumer demand continue to be strong and the inflation rate is below the overall European level. Employment has improved – 50,000 new jobs were created in 2005 and over 30,000 this year, to date, – which has resulted in the unemployment rate dropping to 8.1%. However, rate of growth in production and employment is expected to slow towards the end of the year and into the coming year.



Sources: Eurostat, Bank of Finland and Statistics Finland.

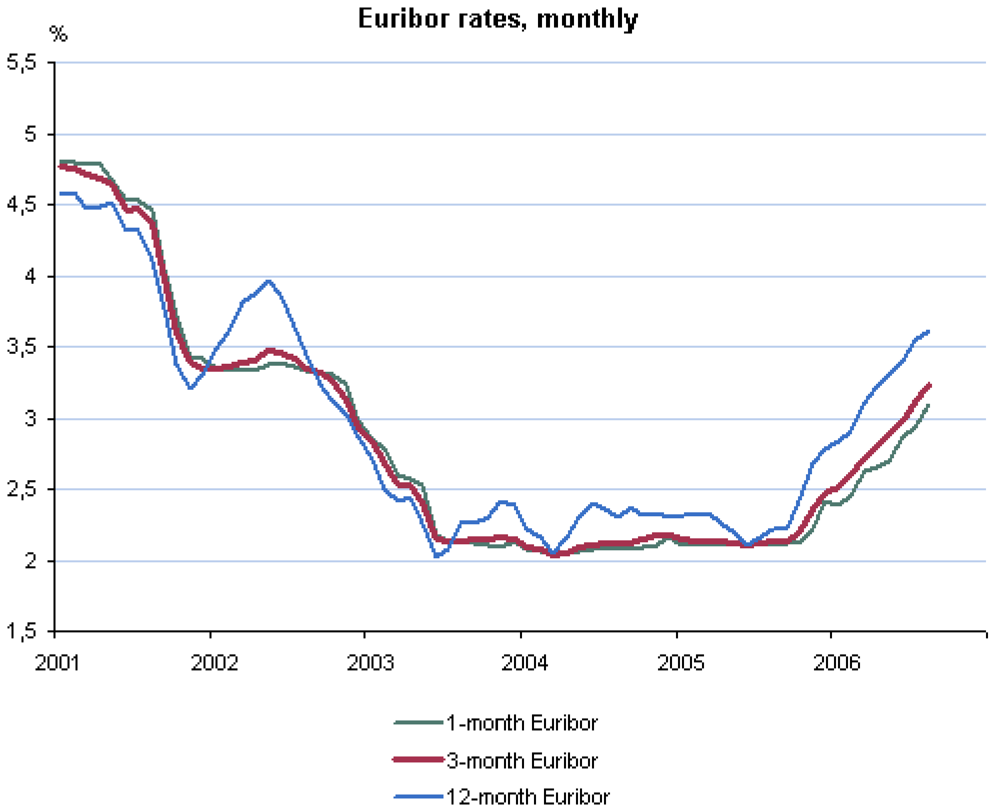
Economic growth has also been faster than forecast in Europe as a whole. It is forecast that growth rates will exceed 2% for the current year. Euro area countries' economic growth is dependant on exports – consumer demand is on uncertain footing. Euro area growth is anyway expected to slow next year with the tightening of taxation, weakening demand in the United States and the strengthening of the euro.

The operating environment in which banks find themselves is favourable, due to brisk economic growth. Risks related to corporate loans have remained under control. As a result of the strong employment situation households' economic outlook, overall, is rather good and their debt servicing capacity remains adequate. As asset prices have remained high, there hasn't been weakening in the collateral value of the loans either.

ECB interest rate increases have been moderate

Inflationary pressures still exist and the European Central Bank has pre-emptively responded to them by raising its policy rates this year. In August the key interest rate was raised to 3.0% and the markets still expect two or three rate hikes by the end of the year. Euribor has risen 1.0–1.5 percentage points since June 2005, when they were at their lowest.

The rise in the Euribor rate has been both expected and so moderate that impairment losses have not arisen from the resulting loan service charges. As expected, banks' net interest income improved, brought about by the rise in interest rates.

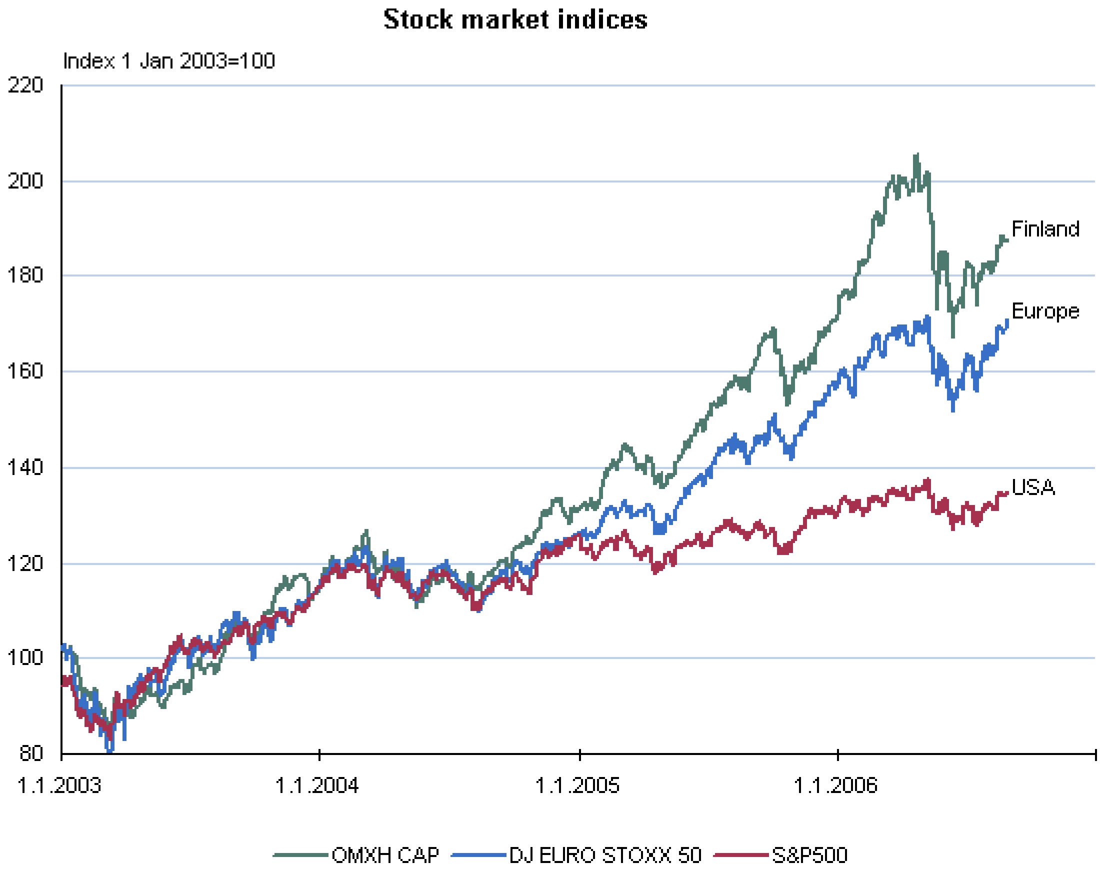


Source: Reuters.

Predicted change in course of macro economy reflected in wider price fluctuations on financial markets

There was an increase in uncertainty in the financial markets during the spring of 2006. Market participants showed signs of uncertainty in the macro economy – inflation and growth – as well as in the direction of monetary policy taken in the main economic regions. This can be seen in particular in the greater price fluctuations shown by higher risk-bearing financial products. For the banks, these movements in the market are not necessarily a bad thing. An increase in trading volumes and the growth in demand for hedging instruments has the result of boosting banks' profitability. On the other hand, Finnish banks are restrained in taking market risks, these days.

The fall in prices of financial market instruments, that began in May had the greatest effect on those products where price rises had been the most extreme, such as shares. Despite a certain increase in the volatility of market prices, they still remain below the prevailing level of the previous market disturbance at the turn of the new century. Recent falls in price would appear to be a matter of corrective moves, and as a result, investors' strategies or willingness to take risks do not seem to be noticeably affected. On the other hand, stock market fundamentals are sound. Companies are operating profitably and the economic outlook remains good. The fall in stock market prices did not lead to a wider over-reaction and prices are already returning to early 2006 levels.



Sources: OMXH and Bloomberg.

Financial market risks on the increase

The most likely and generally identified risks on the international financial markets have remained the same for a long period. These risks include:

- The growth in household indebtedness. Rising interest rates weaken the most indebted households' debt servicing capacity. This is typical to many EU countries, including Finland. Lenders' loan losses will increase in the long term.
- There is a weakening of the gearing ratio in companies' balance sheets. Rising interest rates weaken the most indebted companies' debt servicing capacity. Companies' gearing ratios have remained relatively high in Finland, but in some companies the ratio has weakened due to large distribution of profits, share buybacks and as a result of business acquisitions. Over the longer term there will be an escalation in lenders' loan losses.
- Banks' dependency on wholesale trading has increased. It has been increasingly necessary to finance the brisk rise in lending stock by means of market-oriented funding. Banks are increasingly sensitive to liquidity risk, ie the price and availability of financing.
- Unusually low pricing of risk. A sudden rise in the risk premia would result in a plummet in asset prices. A tightening of liquidity also has an influence on speculative investment and can lead to a fall in asset prices with the increase in the supply of shares and other assets.
- Global imbalances in funding deficits. The uncontrolled dissolution of imbalances would initiate a downward credit risk and market risk spiral on the international markets. The US situation has weakened, which could lead to an increase in disturbances on the financial markets.

Although the list of financial market risks remains unchanged, the situation cannot be considered stable. Both lenders' and borrowers' sensitivity to changes in the financial markets has gradually intensified. Some of the risks mentioned could affect banks' profitability in the longer term, while some of the risks could even have a weakening effect on banks' capital adequacy, if realised on a broader scale. Financial market or cyclical changes could occur gradually, allowing market participants time to adjust. However, sudden change could create problems.

Over the short term, the most probable risks affecting Finnish banks are likely to be the threat of external shocks, emanating from international financial markets. Because of Finland's sound economic base domestic shocks are less likely to occur. The disturbances experienced on the stock market in the spring were a sober reminder of how changes globally, in investment terms, can be rapidly reflected in banks' and investment firms' profitability.

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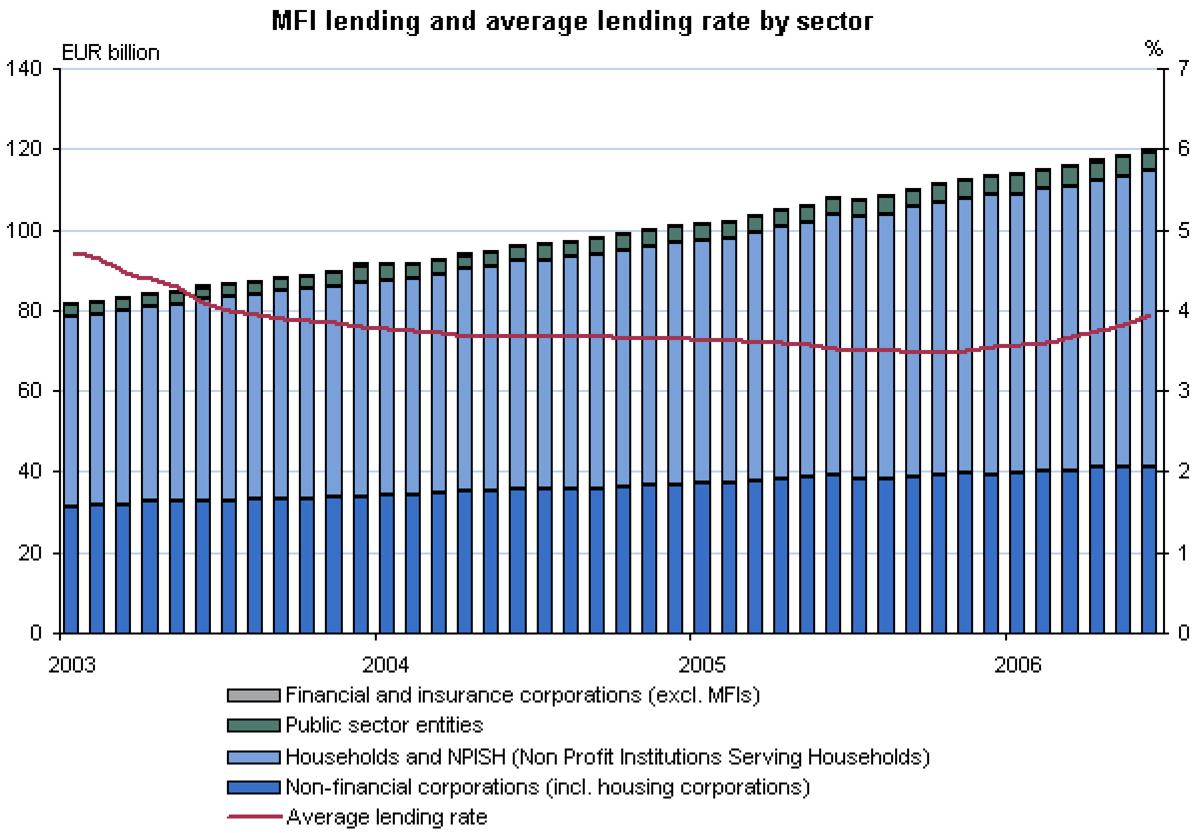
Demand for credit remained strong

The long-continued demand for credit in the financial market has shown little sign of slowing. In the twelve months up until June 2006, the lending stock of Finnish monetary financial institutions (MFIs) grew by 10.9%, to EUR 120 billion. At the end of June last year, the corresponding annual rate of growth was 12.5%.

Even though the rate of growth of MFI loans declined to a degree, the demand for household credit continued to grow briskly. Households have become an increasingly important group of customers for banks: in June loans to households represented about 61% of the banks' lending stock. Corporate credits accounted for about 34% of MFI lending.



Source: Bank of Finland.

Rapid lending growth is typical during a cyclical upswing. Recently, the rate of lending growth in Finland has clearly been faster than GDP growth. However, when lending growth subdues banks may run into problems, especially if good lending practices have been stretched and the quality of the loan portfolio has hence deteriorated.

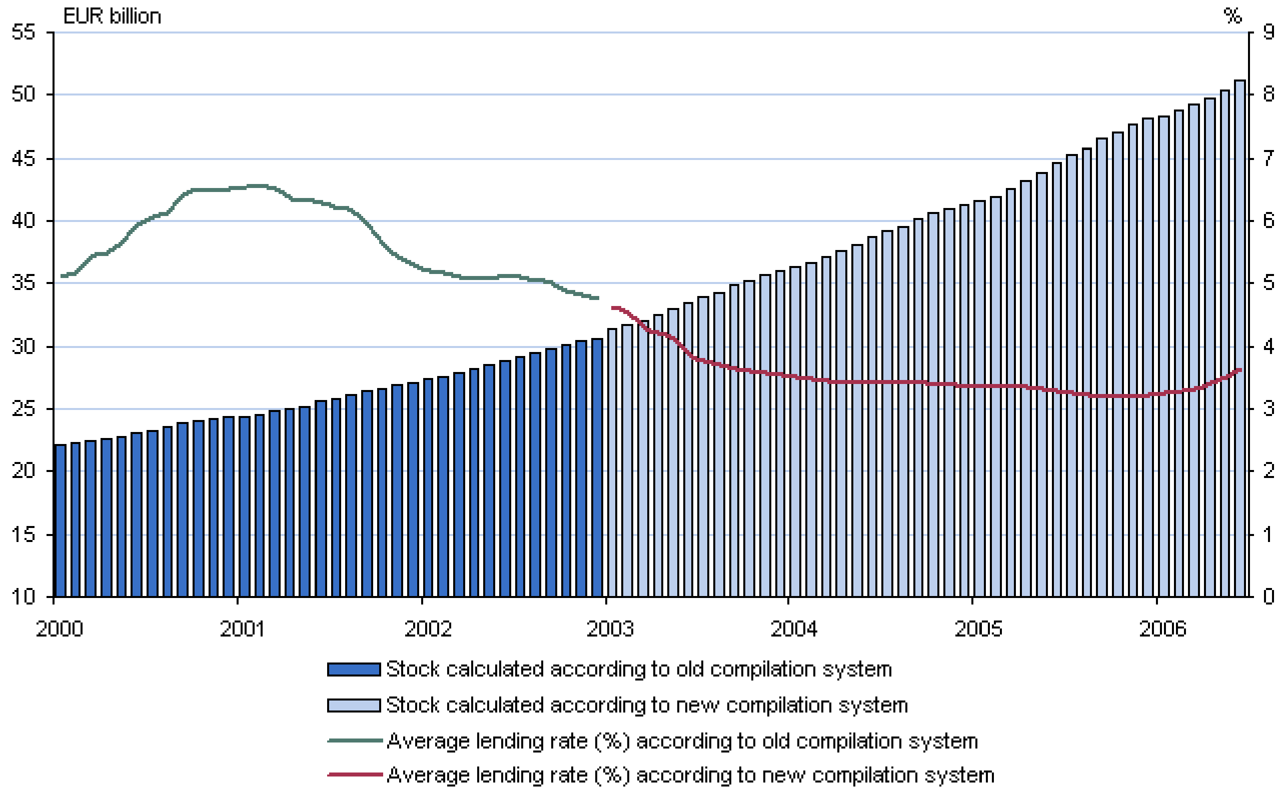
Outstanding housing loans reached a record high

Household borrowing continued to grow strongly. The buoyant demand for credit continued to be fuelled by the low level of lending rates. Lending rates are still unusually low despite the fact they started to go up towards the end of last year. The growth of household credit has also been boosted by the reasonable servicing costs of fairly large loans due to long repayment periods.

At the end of June 2006, outstanding loans granted to households amounted to EUR 73.2 billion, of which housing loans accounted for the record high amount of EUR 51.7 billion. The rate of growth of housing loans remained high in June 2006, ie 15%, which is one percentage point less than in June 2005.

It is likely that lending to households continues to grow markedly also in the near future. According to Statistics Finland's consumer confidence indicator 7/2006, over 9% of Finnish households had plans in the second quarter of 2006 to purchase a house or apartment within a year. This is an unprecedented figure. Furthermore, consumers' confidence in their own economy was stronger than at the same time last year and also slightly above the longer-term average than before.

MFI stock of housing loans and average lending rate



Source: Bank of Finland.

House prices have continued to rise

The continuing house price inflation has not curbed the demand for housing loans. Rising prices have in turn led to larger loans and longer repayment periods. According to Statistics Finland, the average price of old apartments rose by 1.8% in the country as a whole and by 1.9% in the Helsinki region from the third to the fourth quarter of 2005. At the end of June, the year-on-year price increase was 8.8% for the entire country on average and 9.8% for the Helsinki region.

However, house price inflation has slowed: fewer housing transactions were made than in the same period 2005. In addition, there are indications that selling periods have become longer. In the Helsinki region, the real house price index has now reached the level of the previous housing boom at the turn of the 1990s.

Demand for consumer credit strengthened

Households have, to an increasing degree, started to finance their acquisitions by consumer credit, which is actively offered by banks in connection with housing loans. In June 2006, the year-to-year increase in consumer credit and other credit to households amounted to 12.0% compared with 8.9% in June 2005. In the first half of 2006, 12.6% more consumer credit was granted than in the first half of 2005.

At the end of June 2006, the stock of consumer credit and other credit amounted to EUR 21.4 billion. EUR 9.9 billion of the total was granted as consumer credit and EUR 11.5 billion as other credit, such as holiday-home loans, study loans and entrepreneurial loans. At the end of June, consumer credit accounted for nearly 18% of the total MFI lending stock.

The rate of growth of corporate lending continued to slow down

Although the level of corporate indebtedness is clearly lower than in the early 1990s, the year-to-year rate of growth of corporate lending has clearly slowed further. At the end of June, the year-to-year rate of increase in corporate lending amounted to just 4.9% compared to 7.8% at the end of 2005.

According to the 2005 Survey on Business Finances, the subdued level of new external financing by non-financial corporations' show little sign of picking up this year either. According to the 2006/II Bank Barometer of the Finnish Bankers’ Association, non-financial corporations' external financing plans for the year ahead are showing a downward trend.

Average lending rates rose and margins narrowed further

The average lending rate on new MFI housing loans was 3.66% in June 2006 compared to 3.27% in December 2005. Banks continue to seek competitive edge for housing loans through credit pricing. Despite the rise in the average lending rate, interest rate margins on housing loans narrowed to unprecedented levels.

Prime rates have gained in popularity

In Finland over 90% of housing loans continue to be tied to variable market rates (Euribor or prime rates). In the first half of 2006, drawings on fixed-rate loans decreased by about 2%. In the rest of the euro area, about half of housing loans are fixed-rate loans. In part, the difference between Finland and the other euro area countries is explained by the fact that less fixed-rate housing finance has traditionally been offered here than elsewhere.

In the twelve months up until end-June 2006, the share of Euribor-linked bank loans in the total stock of loans to households has shrunk from 81% to 58%. By contrast, loans linked to reference rates (prime rates) offered by the various banks have gained in popularity. At the end of June, these loans accounted for about 38% of housing loans, compared with 15% one year earlier.

The growth of prime-rate loans has been very fast, since customers tend to chose to tie their loans to the most advantageous reference rate at the time of borrowing. Before long, however, the prime rates will in practice follow the movements and developments of the Euribor rates. This is a fact worth considering when households with outstanding housing loans draw up their long-term loan servicing plans.

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Banking business and banks' ancillary services increasingly profitable

The total net interest income of Finnish deposit banks has increased despite narrowing interest rate margins due to fierce competition for housing loan customers. Housing loan 'sales' have been compensated for by other increasingly popular and more profitable household credit, as the rate of growth of housing and corporate lending has subdued. In the second half of this year, net interest income is likely to continue to grow although interest expense on deposits and other funding costs are due to rise.

Growth in net fee income slowed in the second quarter of 2006

Over the past few years, the subscription and management fees charged to mutual fund units have become an important source of income for banking groups. In the first quarter of 2006, net fee income continued to grow at a record pace.

The stock market correction in May curbed the rate of growth of mutual fund assets and fee income in the second quarter of the year. The correction was immediately followed by a shift of mutual fund assets to bond funds that carry less risk than equity funds. But again in July, net subscriptions for Finnish equity funds were already approaching the heights of January 2006. In the light of the quick recovery of net subscriptions and stock indices, it is probable that fee income for the accounting year as a whole will be at a record high.

Steady trend in banks' expenses

Banks' aggregate expenses continued to grow a steady rate. Upward price pressures have mainly been exerted by staff expenses since not only the increase in lending volumes but also the sale of savings products has prompted new recruitments. The staff expenses of smaller banks, in particular, grew in 2005: more staff was required and salaries went up. Staff expenses continued to grow also in the first half of 2006.

Negligible impairment losses

The impairment losses on assets have remained extremely low, nor are there any signs of deterioration in the second half of the year, since the quality of credit portfolios have remained exceptionally high. However, rising interest rates may, in the longer term hamper the debt servicing ability of households that have incurred most debt.

Enhanced profitability and efficiency

In 2005 the combined net income of banks grew faster than the combined expenses. The enhancement of cost efficiency was mainly due to net income growth and negligible impairment losses. The profitability of the banking sector also improved. In January–June 2006, efficiency and profitability had again reached slightly higher levels than a year earlier. It is probable the positive developments in respect of banks will continue in the second half of the year.

A fall in the stock market may impair performance

For banks focusing on traditional lending and deposit-taking activities, the rise in interest rates has been most welcome and fluctuations in the stock market has had little impact on their financial performance. However, it is likely that the rate of growth in securities-related fee income will decline if stock market uncertainty increases. As financial conglomerates are concerned, a correction in share prices is normally more clearly reflected in the income statements and balance sheets of the insurance segments than in those of the banking segments, and as a rule insurance operations are also more sensitive to changes in security prices.

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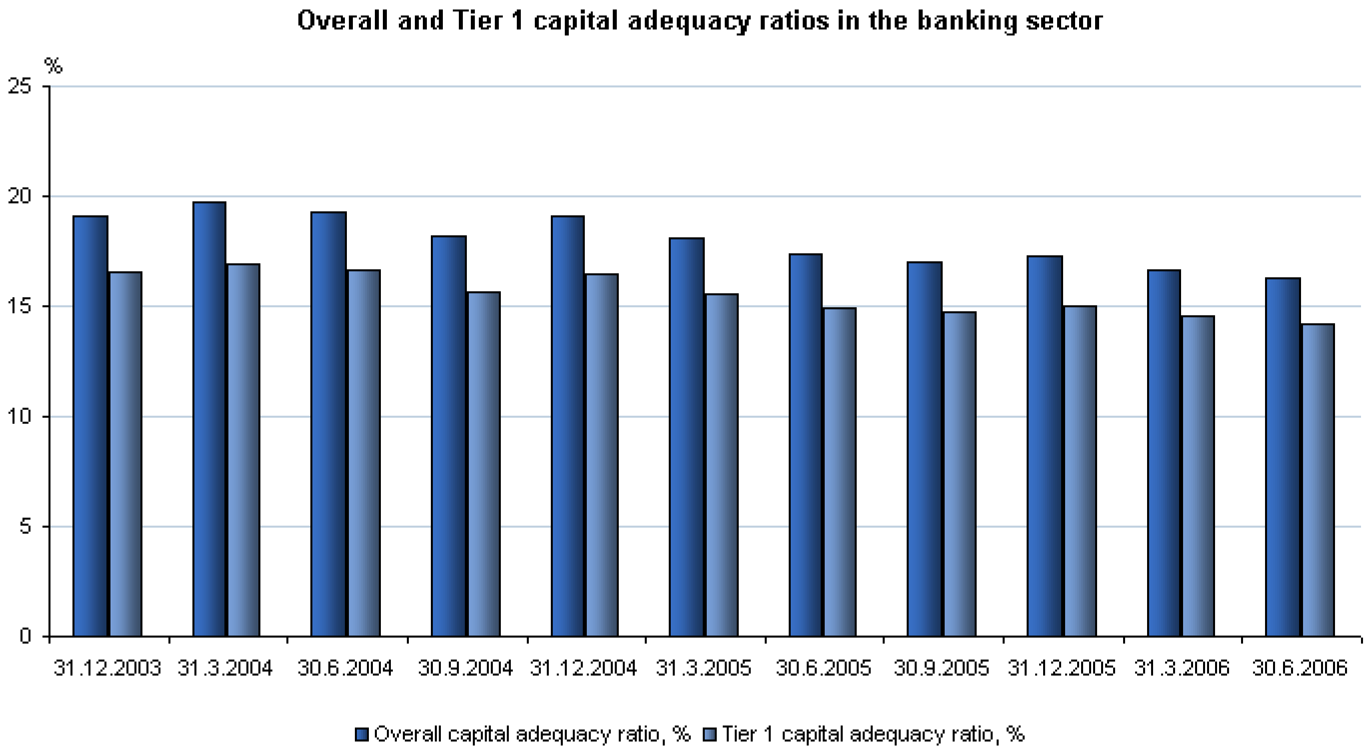
Banks' capital adequacy remained strong, despite some deterioration

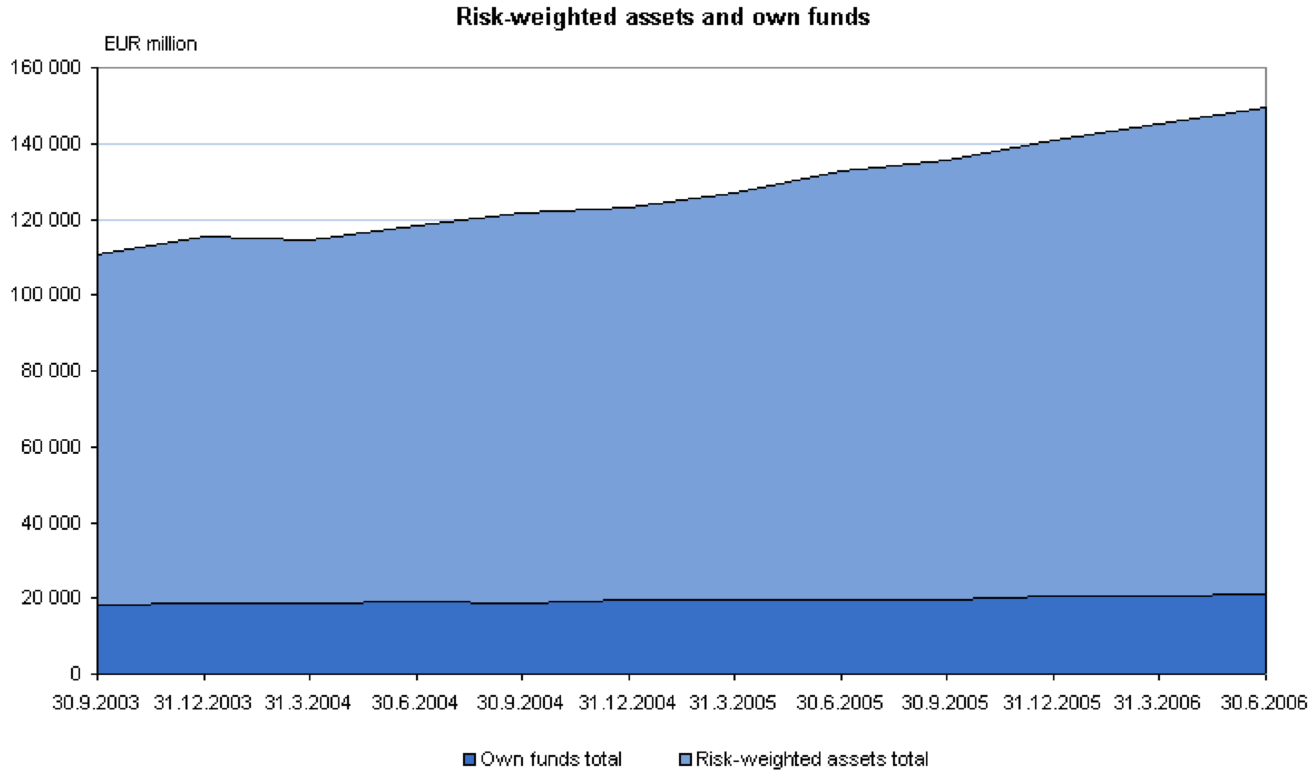
At the end of June 2006, the average capital adequacy ratio in the banking sector was lower than at the end of both December and June last year. Restructuring in the banking sector and a long-continued growth of risk-weighed assets are the main reasons for the decline. At the end of June, the following capital adequacy ratios were recorded for the banking sector as a whole: overall capital adequacy amounted to 16.2% and Tier 1 capital adequacy, calculated on the basis of original own funds, amounted to 14.2%.



Source: Financial Supervision Authority.

Continued fast growth of risk-weighted assets

Over several years, banks' combined risk-weighted assets have clearly grown faster than their combined own funds. These developments have also been reflected in the banking sector's capital adequacy ratio, which has followed a downward trend. Over the twelve month period up until June 2006, risk-weighted assets have grown at an annual rate of 14% as a result of the continued strong growth of lending.



Source: Financial Supervision Authority.

Own funds grew slightly, their quality remained sound

At the end of June 2006, the own funds of the banking sector totalled nearly EUR 21 billion. The major part of these funds, about EUR 13 billion, has belonged to the consolidated balance sheet of the Nordea Bank Finland Group.

The quality of the banks' own funds did not undergo any major changes in the first half of 2006. At the end of June, original own funds accounted for 87% of the own funds total compared to 86% one year earlier. Equity or non-restricted reserves make up the bulk of banks' own funds. Capital loans remain concentrated in just a few banks. All in all, they amounted to EUR 570 million at the end of June. No new capital loans were raised in the first half of 2006.

Banks' aggregate risk-bearing capacity fairly strong

The theoretical aggregate loss buffer[1] of the banking sector remained virtually unchanged at about 10.5 bn. Naturally, loans buffers vary from bank to bank both in value and relative terms. The FIN-FSA does not publish assessments of the risk-bearing capacity of single banks other than in exceptional cases.

1) A loss buffer is a bank's own funds less the minimum own funds requirement, ie 8% of risk-weighted assets and exposures.

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Lending quality high, but risks for mortgage holders are increasing

The quality of Finnish banking groups' credit portfolio can be considered high on the basis of the very low proportion of nonperforming assets and impairment losses in the credit stock.

Banks' nonperforming assets totalled EUR 394 million in June 2006 (EUR 407 in June 2005). Their relative share of the stock of lending and guarantees has shrunk to 0.31% from 0.36% in 2005. This reflects the fact that companies' and households' overall situation has remained fairly good amid continued favourable macroeconomic environment. In addition, there have been no important sectoral problems.

Banks' net impairment losses totalled EUR -30 million in June 2006 owing to recoveries and reversals. In the corresponding period of the previous year, deposit banks' impairment losses weakened the financial result for the entire sector by about EUR 13 million. Banking groups' gross impairment losses have decreased and were approximately EUR 66 million in June 2006 (EUR 124 in June 2005). They accounted for 0.05% of the stock of lending and guarantees (0.07% in June 2005).

No problems in view for the household sector yet

Measured by nonperforming assets, there are not yet any signs of weakening in the debt servicing ability of banks' household customers. However, this weakening would not immediately appear as growth in nonperforming assets, as banks are flexible in altering customers' loan repayment plans and establishing new arrangements for the amortisation of the loan or rescheduling interest payments.

Nonperforming assets consisting of credit to households amounted to EUR 232 million in June 2006 (EUR 236 million in June 2005), accounting for 0.34% of household stock of lending and guarantees (0.40% in 2005). Nonperforming assets have decreased despite an increase of about 14% in credit to the household sector. The share of household's gross loan losses in the stock of lending for the sector was only 0.03% in June.

Quality of corporate sector credit stock high

The share that the corporate sector's nonperforming assets represent of its exposures shrank to 0.33% from 0.38% in the previous year. The annual growth in corporate sector credit stock slowed to half of the rate observed in the corresponding period a year earlier. According to the report on the 2005 Survey on Business Finances[1] the acquisition of new external financing by companies does not appear to be recovering in the current year either.

The corporate sector's gross impairment losses fell by half to approximately EUR 39 million from the previous year. At the same time, the sector's stock of loans increased by EUR 2 billion. The impairment losses' share of the sector's stock of loans and guarantees was only 0.09% (0.22% in 2005).

Larger loans and longer maturities generate risks for housing loan customers

The rise in housing prices has jacked up the size of housing loan, and housing loan maturities have lengthened to as much as 30 years. Although economic projections suggest that there are no major changes to be expected in customers' debt servicing ability, loan service costs of large loans that are fixed to short-term market rates can rise considerably, should interest rates increase. According to the Finnish Bankers' Association, the proportion of loan service costs of mortgage holders' net income has increased slightly in two years. The possible effects of interest rate rises on mortgage holders' debt servicing ability do not show until in longer term.

However, relative to the number of lenders, the number of persons with payment defaults has not increased recently. Anyhow, by international standards, Finland does not show very high figures as to the numbers of persons with excessive debt or payment defaults. Nevertheless, it is expected that there will be an increase in the number of debt counselling services clients that have taken instant cash loans and already face payment difficulties.

Competition continues in housing and consumer loan market

Credit risk inspections conducted by the FIN-FSA have revealed that competition will remain tight in the credit market. Margins on new housing loans have narrowed further. Competition may more often determine the price of a loan than the customer's risk. Inspections also revealed a loosening of and shortfalls in collateral requirements.

Mortgage customers are also offered other products such as consumer credit, fund investment agreements, credit card credit and insurance coverage for their loan. The active proffering of consumer credit in addition to housing loans can lead to over-indebtedness of customers with weak payment capacity.

Banks' responsibility increases in granting housing loans

As the stock of housing loans continues to grow, when making credit-granting decisions banks must ensure that mortgage holders understand the risks connected with housing loans and the various means of hedging against interest rate fluctuations. Hedging options include interest rate ceilings and fixed-rate loans. Banks have actively marketed loan insurance policies for a long time already. Customer's payment capacity should be checked particularly when granting large credits.

The concentration of large housing loans on young families and households that are at the beginning of their working career will also increase banks' housing loan risks. In its supervision the FIN-FSA increasingly places emphasis on the expediency of the banks' credit risk management and their compliance with the existing guidelines in the granting of housing and consumer loans.

1) Bank of Finland and the Ministry of Trade and Industry on 16 March 2006 (available in Finnish only).

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Deposit banks' liquidity risks decreased

The demand for credit, and household credit in particular, remained strong in January–June 2006, with banks resorting to market-based funding as growth in deposits dried up. The ratio of deposits to lending, describing the structure of funds acquisition, began to weaken after modest deposit growth in the early part of the year. The share of deposit funding from claims on the public fell to 75% from 85% three years earlier. The structural change in funding has occurred gradually and in a controlled manner.

Banks financed lending by issuing debt securities. In the first half of 2006 the stock of long-term debt securities grew by almost 40% to EUR 14 billion and the stock of short-term debt securities by 15% to EUR 32 billion.

Importance of new funding sources has increased

Banks have been faced with the need to look for alternative channels for funding in response to the continued strong demand for housing loans in the first half of 2006, with only a small proportion of lending growth being able to have financed by growth in deposits. The importance of market-based funding clearly grew during the period.

The volume of structured financing grew in the first half of 2006 and 2005. Debt tied to a derivative separated from the main contract, ie debt in which the yield has been fixed to some other factor than the interest rate level (mostly to shares or share indices), amounted to EUR 3.7 billion at the end of June. In June 2005 they only totalled EUR 1.1 billion. The bulk of structured financing consisted of debt securities.

Banks have actively started to use mortgage bonds offered by mortgage banks in funding housing loans. Deposit banks have acted either through mortgage banks owned by them or entered into cooperation agreement on the offering of mortgage banks' mortgage loans. Finnish mortgage banks have good credit ratings and international investors have been attracted by their issues. Mortgage banks' stocks of bonds are still fairly small relative to deposit banks' stocks of lending, but their significance is increasing. Balance sheets of mortgage banks operating in Finland totalled EUR 2.5 billion at the end of June 2006.

Banks' short-term liquidity improved from the turn of the year

Deposit banks' combined monthly funding deficit turned from deficit into surplus in the first half of 2006. The combined deficit at the end of June was EUR 2.4 billion. It has fluctuated strongly in recent years, but showed now a clear surplus for the first time since the end of 2004. Behind the strong fluctuation were large emissions of financial conglomerates and intra-group items. In general, funding deficits have decreased and surpluses increased slightly.

The amount of debt securities eligible for refinancing with central bans increased in January–June to EUR 9 billion (EUR 7.6 billion at the turn of the year). The amount of available-for-sale debt securities (EUR 3.5 billion in June) and listed shares and mutual fund units (EUR 1 billion in June) was slightly higher than at the turn of the year. Banks' short-term liquidity remained good as, in addition to the surplus in monthly funding deficit, the amount of liquid assets used as buffers was higher than at the turn of the year. Moreover, if market and deposit funding due to mature within a month were to continue, ie the contracts were to be renewed, the liquidity situation can be considered to be better than in the previous year.

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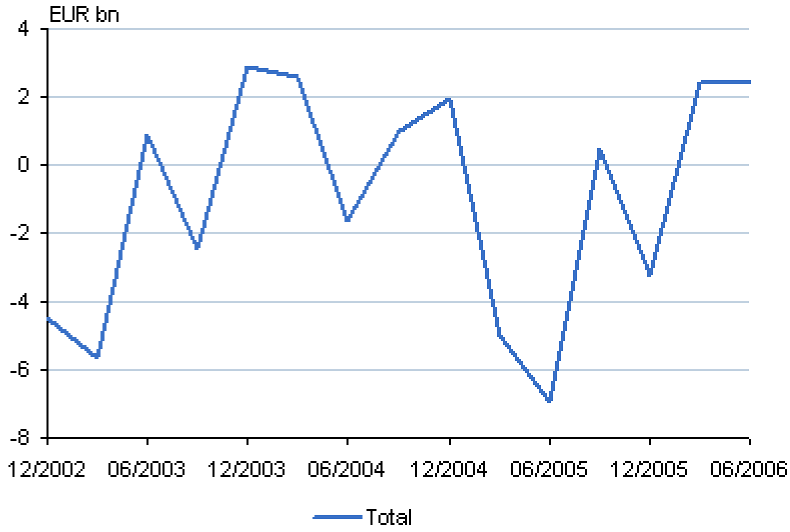
Funding risk

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 degree to which balance sheet assets and lending, in particular, are funded 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.

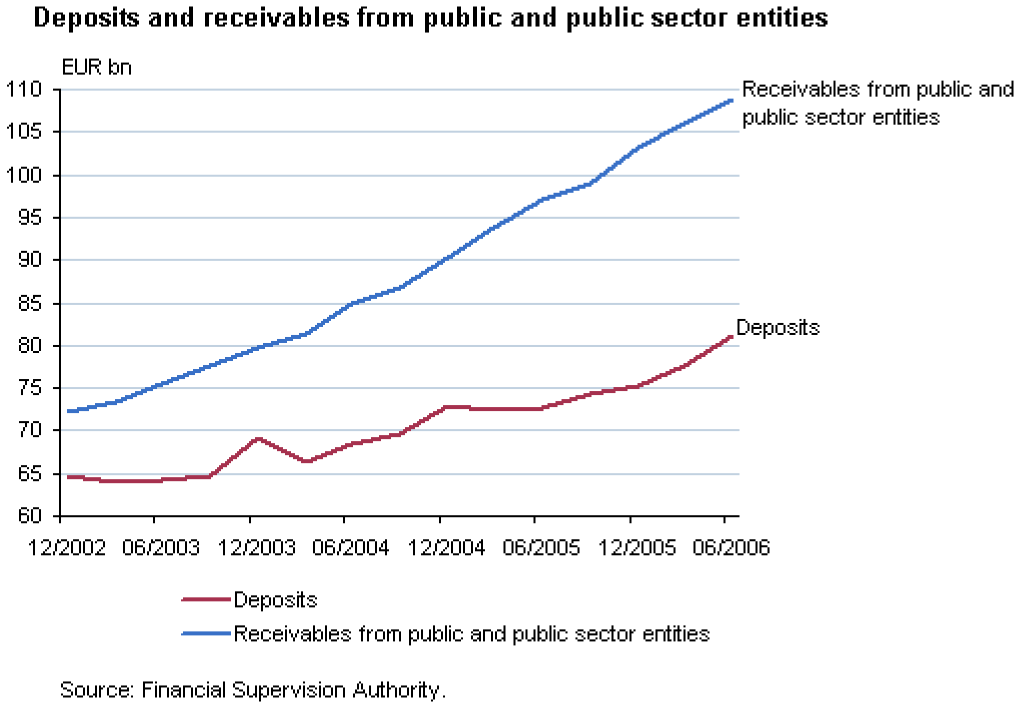
Monthly funding deficit of deposit banks



Source: Financial Supervision Authority.

Deposits as a percentage of receivables from public and public sector entities

Source: Financial Supervision Authority.



No changes in Finnish deposit banks' aggregate income risk

Deposit banks' aggregate income risk remains unchanged from the levels of December 2005. At the end of June 2006, a potential interest hike of one percentage point would have had the effect of raising net interest income by EUR 318 million, equivalent to 11.9% of net income from net income from financial operations. However, considerable structural changes have been made to the positions used in calculating income risk, although their effects netted each other out of the final risk figures. The income risk calculated using balance sheet items has increased, but the hedging effect from derivatives abrogates most of this growth.

Limitation of interest risk through derivatives

The effect of interest rate increases on the consolidated position is mostly seen as growth in the number of derivatives used for hedging. In particular, the number of interest rate swaps used in the lowering of income risk has grown substantially. By the end of 2005 the total influence of these swap contracts had increased one and a half times. In terms of the maturity breakdown, banks have swapped short-term floating rate receivables to longer-term interest rate bounded receivables.

The number of interest rate options, hedging against increase and decrease of interest rates, (generally cap and floor agreements) has also risen. However, the maturity structure of these instruments is almost identical and therefore do not have an influence on income risk.

Growth in lending to the public is most clearly visible in two maturity categories. The more expected of these is the 9–12 month category. That growth illustrates loans with the 12-month Euribor reference rate, granted in the last quarter of the year. The other category, which has grown even more strongly, is the short-term 1–2 month maturity bracket. In this category can be seen the households growing interest to use banks' Prime interest rates as housing loans reference rate. The shift in emphasis of new loans from 12-month Euribor rates to Prime rates has the effect of increasing banks' income risk.

In addition, to receivables from credit institutions are weighted towards the shorter maturity categories, in which the income risk effects are greatest of all. On the other hand, this concentration of growth in the short-term maturity category is not surprising, as over 80% of receivables from credit institutions are already in this category.

Significant changes between euro and foreign currency denominated income risk can be seen. In particular this reveals changes in income risk brought about by foreign currency derivatives and the cancellation of these effects through the adverse sign growth in euro-denominated derivatives.

Deposit banks' aggregated trading book would generate profit if interest rates fall

The market value of the deposit banks' aggregated trading book has increase approximately 19% since the end of 2005. At the same time this portfolio's interest rate sensitivity has increased approximately 25%. After all deposit banks' aggregated trading book would generate profit in situation where interest rates fall.

The raise in interest rate sensitivity is generally caused by a manifold increase of the euro-denominated position. There is also a considerable increase in investment risks denominated in other Nordic currencies.

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What is an interest rate risk?

Income risk is a measure of the impact that a maturity mismatch between a bank's assets and liabilities may have on net interest income accrued during a year, when market interest rates rise.

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

Banking sector's aggregated interest risks

(EUR m, gain as a result of a one percentage point rise in interest rates)

Banking book interest rate risk (incl. derivatives)	**30.6.2006**	**31.12.2005**	**Change**
Income risk	318,3	317,9	0,1 %
Euro	174,1	333,2	
Other currencies, total	144,1	-15,2	
Balance sheet items	384,9	345,8	11,3 %
Derivatives	-66,6	-27,9	138,8 %
Net income from financial operations 31 Dec 2005	2 669,8	2 669,8	
Relative income risk, % from net income from financial operations	11,9 %	11,9 %	
Stress test 1, Demand deposits < 1 month	-189,3	-177,3	6,8 %
Stress test 2, Currency as absolute value	557,4	816,8	-31,8 %
Investment risk of Banking book	-146,4	-137,1	6,8 %
Trading book interest risk (incl. derivatives)	**30.6.2006**	**31.12.2005**	**Change**
Investment risk	-444,0	-305,9	45,1 %
Euro	-403,1	-154,3	161,2 %
Other currencies, total	-40,9	-151,6	-73,0 %
Trading book market value	10 900,8	9 137,7	19,3 %
Relative investment risk, % from market value of trading book	-4,1 %	-3,3 %	
Stress test 3, Currency as absolute value	545,7	333,2	63,8 %