Contents

Operating environment of financial markets in 2003

In the first half of 2003, global economic developments were clouded by various uncertainties, such as the Iraq war and the SARS epidemic. However, economic growth picked up considerably after early autumn, mainly on the back of improved outlook for the US economy. Expectations of a pick up in economic growth also strengthened in the euro area and Finland. Both money market rates and bond yields started to rise again following a decline in the beginning of 2003. Interest rates are expected to remain at last year's levels in 2004 and to increase in 2005–2005. In the foreign exchange markets, the euro appreciated considerably against the dollar in 2003.

Outlook positive for supervised entities

Banks' profitability is strong and capital adequacy solid. Profitability of investment firms has bottomed out and the situation of the sector is likely to improve on back of the market's recovery. Outlook for supervised entities is bright as long as economic growth develops as expected.

Share markets downward trend shows signs of a turnaround

Share markets have shown signs of improvement.Prices have risen and trading volumes have increased. Cautious sense of optimism is felt about market expectations.

Fund saving increasingly popular

Fund savings have continued to increase their share of household savings. Net assets of mutual funds increased considerably in 2003, with total fund assets accounting for as much as one-third of total bank deposits.

Bond yields turned up in the second half of 2003

In the second half of 2003, investors started to reallocate fixed-rate assets into equities. The change in investment behaviour is explained by the improved economic outlook and stock market recovery. In the light of the expectations of economic growth, share prices did no longer appear too high to investors. The decline in the popularity of fixed-rate assets was reflected in higher returns on, for example, benchmark bonds.

Lending by monetary financial institutions (MFIs) continues to grow briskly

The rate of growth of MFI lending has accelerated. At the end of January 2004, the fastest annual growth rate of 15.6% was recorded in housing loans. The low level interest rates has sustained households' propensity to borrow.

Bank profitability nearly on a par with the 2002 level

Banks' profitability in 2003 remained nearly on a par with the reference period 2002. Total income fell after decreased net income from financial operations, due to narrower interest rate margins. However, banks succeeded in cutting their costs resulting in only a small deterioration in cost efficiency. The profit impact of loan and guarantee losses was very low.

Bankig sector capital adequacy strengthened

At the end of December, the capital adequacy of the banking sector was 18.9%. The legal restructuring of Nordea showed itself in improved the banking sector's capital adequacy ratios.

Decrease in investment firms' income stopped

Investment firms' income and operating profit have decreased for three years. In late 2003, a turn for the better occurred and the decrease in income stopped. There was also a growth in assets managed.

Low level of non-performing assets and loan losses

Non-performing assets continue to be at a low level. Recoveries of previous loan losses and loan loss provisions exceeded recorded loan losses and loan loss provisions.

Banks’ liquidity improved

Deposit banks’ combined funding deficit turned into a surplus during 2003. The growth of lending was mostly financed through deposits.

Banks' income risk increased in relation to net income from financial operations

According to the FSA's estimate, a 0.5 percentage point rise in interest rates would cause an increase of 7.3% in net income from financial operations by the end of 2004. At the same time, a decrease in the value of bonds as a result of an interest rate rise would partly diminish the growth of operating income caused by the increase in net income from financial operations.

Operating environment of financial markets in 2003

US economy is growing but deficits and unemployment create uncertainty

In the United States, economic growth picked up clearly towards the end of 2003, reaching roughly 3% for the whole year. Growth was driven mainly by consumption, thanks to low interest rates and increased purchasing power due to tax cuts. In addition, stock price increases strengthened consumer confidence in the future and boosted consumer demand. Industrial production picked up from June, leading main industrial confidence indicators to improve markedly towards the end of the year, although they sagged somewhat at the beginning of 2004.

Despite signs of recovery, US corporate investment remained weak owing to the low level of capacity utilisation. Investment in ICT technology increased, whereas investment in machinery and equipment had not yet started to recover. Housing construction was also seen to increase. Investments are expected to grow more rapidly in the new few years. Competitiveness of the US remained strong. The dollar declined, productivity growth increased and unit labour costs decreased. This did not, however, contribute significantly to US exports. Export volume is expected to grow on the back of the weak dollar, though.

Economic growth is expected to rise in 2004 to about 4.3% and to decline to slightly below 3% in 2005–2006. The main risks to the sustainability of the US economic growth stem from employment developments, households' indebtedness and the notable fiscal and current account deficits. Job vacancies increased towards the end of the year and the unemployment rate started to decline. However, job growth was more sluggish than was hoped for. The ratio of households' debt to disposable income was highest among industrialised countries. Fiscal and current account deficits worsened during the year, contributing to a weakening of the dollar and a rise in interest rates.

Economic growth in the euro area remains sluggish

Economic growth in the euro area was only about 0.5% in 2003. Some minor signs of strength were seen in the second half of the year. The moderate improvement in economic growth was reflected in consumer and business indicators. Consumer confidence started to improve in early 2003 and has continued to rise until today. In historical terms, however, consumer confidence is still weak. In contrast, business indicators were seen to improve more clearly. Economic growth in the euro area is expected to rise this year to about 1.4% and to 2.3% in the two following years.

Private consumption growth was sluggish in 2003. In the last two years, private consumption has grown at an annual rate of a good 1%, while long-term average has been about 2%. Private consumption has important implications for economic growth since it accounts almost for 60% of the euro area GDP. The recent slight improvement in confidence and real wages support private consumption, but on the other hand, the weak employment situation sustains higher saving. Euro area unemployment remained relatively high, slightly below 9% in 2003.

Finland's economic growth followed world economic developments

As expected, the growth of GDP in Finland was sluggish at the beginning of 2003, owing to weak global economic developments reducing exports and to decreasing investments. Growth accelerated somewhat in the latter year half and GDP growth for the whole year amounted to 1.9%. GDP is expected to grow 2.6% annually in the next two years. Thus, the Finnish economy is expected to grow faster than the rest of the euro area. Export prices fell markedly during 2003 and, at the same time, exports remained weak. However, exports are expected to grow about 5% in 2004 and about 6% in the next two years. Companies also invested cautiously in 2003; investments were mainly directed at sustaining output, rather than at increasing capacity. Investments are expected to contract by about a further 0.5% this year but to grow from 2005 onwards.

Despite the acceleration in economic growth towards the end of 2003, employment fell slightly. Unemployment did not increase, however, as people left the labour force and became students, for instance. In 2003 the unemployment rate was 9%. Labour demand in the private sector was restricted by low product sales and higher-than-expected real wage increases Unemployment is expected to remain at present levels in 2004 and to decrease next year to about 8.8%.

Households' confidence in their own financial situation remained high in 2003, which supported private consumption. Households' confidence improved further to record levels in March 2004. Housing demand continued to be robust in 2003, driven by low interest rates, stable income developments and banks' competition on lending rates. The increase in house prices moderated only slightly from 2002. In 2004, house prices are expected to rise about 6%. Household indebtedness rose somewhat in 2003 and is expected to rise further during the next three years.

Industrial production developments were subdued, largely due to problems faced by exports. Output in the electronics industry continued to fluctuate significantly, in turn affecting overall industrial production figures. According to the Business Outlook Indicator of the Confederation of Finnish Industry and Employers, industrial companies' business outlook has improved somewhat since autumn. There are, however, significant differences between industrial branches.

Corporate lending increased a good 7% in 2003. However, corporate indebtedness was significantly lower than at the beginning of 1990s. According to the Bank Barometer of the Finnish Bankers' Association, banks expect the amount of corporate lending to rise further in the near future. Banks' credit risks are expected to remain low. In 2003, the number of bankruptcies filed decreased slightly from the previous year.

Long money market rates decresed at the beginning of 2003

Money market rate developments showed an uneven pattern in 2003. Short-term money market rates were higher than longer-term money market rates at the beginning of the year. Until June, both short and longer-term money market rates fell smoothly. The fall came to a halt in the last half of 2003 as a result of favourable economic outlooks. Short-term money market rates remained broadly unchanged during the rest of the year, whereas the longer-term money market rates started to rise. The slope of the money market yield curve turned positive in August.

The rise of long money market rates came to a halt in December, and since then these rates have declined for three months. The money market yield curve edged down to 11 basis points in the beginning of March from the highs of 35 basis points in December. This was due to market expectations of policy interest rates remaining low for a longer time than previously expected. These developments were similar in the US and the euro area. Interest rates are expected to remain low in 2004 but to turn upwards from there on. The three-month Euribor is expected to be about 3.0% in 2005 and 3.6% in 2006.

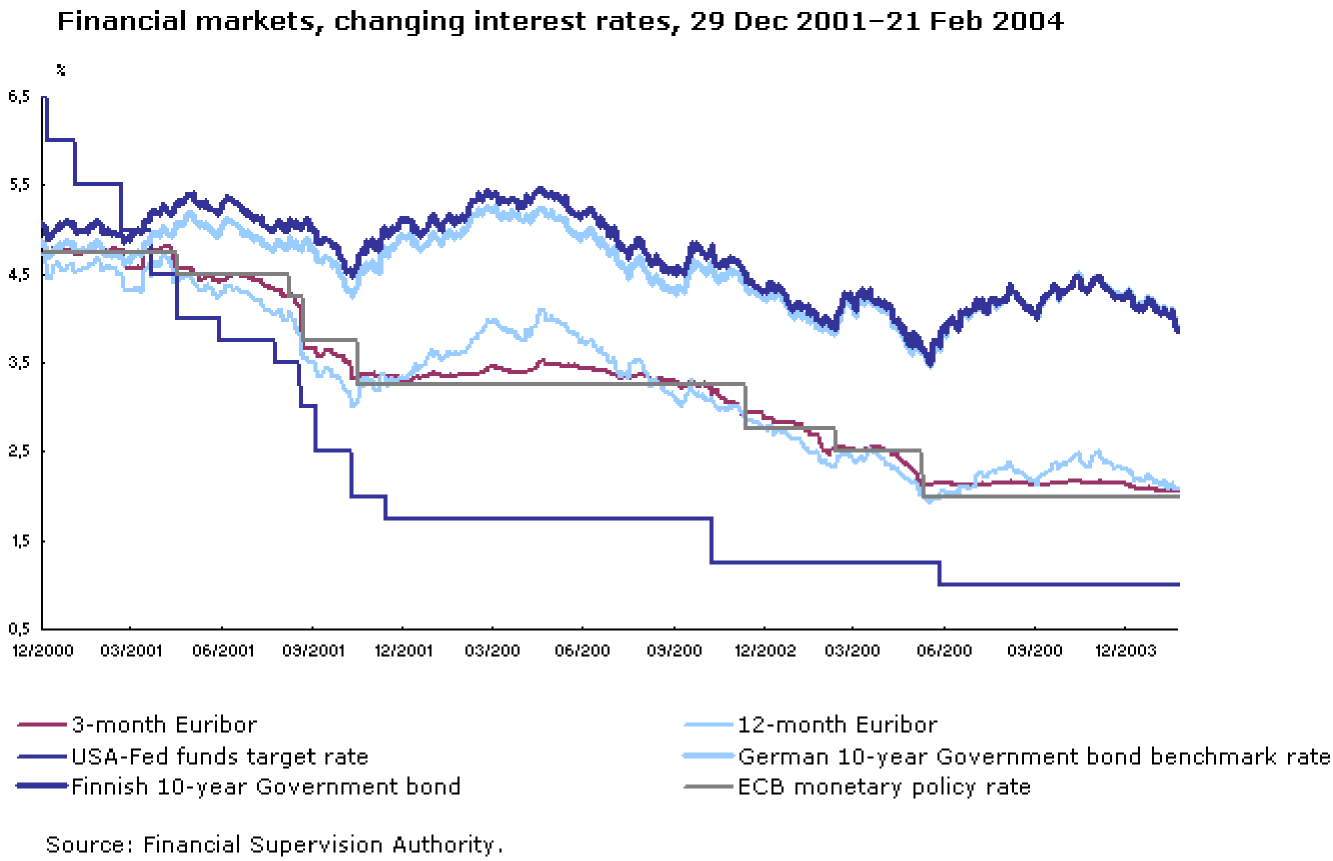
Owing to reduced inflationary pressures, the European Central Bank lowered its key interest rates twice during 2003. At the beginning of March they were reduced by 25 basis points to 2.50%, and a further reduction of 50 basis points followed in June. After the reduction in June, the key ECB interest rates have remained unchanged at 2.00%.

Bond yields fluctuated in early 2003

As with money market rates, two distinct phases in the development of long-term bond yields became apparent in the euro area and the US in 2003. Except for a short-lived increase from March to April, ten-year bond yields declined at the beginning of 2003. From June onwards, long-term interest rates rose, as the global economic growth showed signs of improvement. In the last three months, bond yields have fluctuated heavily and yields have declined. This is the result of a change in market participants' monetary policy expectations and more conservative expectations of economic growth than previously.

Appreciation of euro against dollar came to halt in early 2004

The euro appreciated by 20% against the dollar in 2003. This was associated with market concerns regarding growing US fiscal and current account deficits. The strong exchange rate of the euro weakened corporate price competitiveness in the euro area relative to the US. In early 2004, the euro has depreciated somewhat against the dollar due to improved economic outlook in the US. The euro/dollar rate is expected to be 1.24 this year and the next. The euro appreciated also against the Japanese yen, particularly in the second half of 2003, despite an improved outlook for economic growth in Japan. Exchange rate developments have continued to be volatile in early 2004.



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Outlook positive for supervised entities

Finnish banks remained resilient during the recent period of slow economic growth. Profitability of the banking sector remained strong and capital adequacy was solid. In spite of the economic downturn, banks' credit losses remained at a very low level. Low interest rate levels helped the repayment of loans but on the other hand, reduced banks' net income from financial operations. At present, banks' equity portfolios are relatively modest but fluctuations in share prices have been reflected on financial conglomerates through life insurance companies' equity holdings. Hence the strong stock market performance in 2003 improved the profitability of financial conglomerates. In contrast, all investment firms have not thus far recovered from the difficult market situation. The sector continued to have problems but the situation is likely to improve as markets recover.

Mutual fund investing gained popularity

Among different savings products, mutual fund investing in particular has gained popularity. Mutual fund investing is also growing along with the popularity of investment-linked insurance products, since part of the funds invested in insurance products are channelled into mutual funds. As a whole, mutual funds related to banks gained market share somewhat.

Competition narrowed margins on housing loans

Lending by banks grew rapidly last year. Interest rates that are low even by European standards, households' solid confidence in their economic outlook and an increase in real income have all boosted the demand for housing loans in particular. Competition between banks for housing loans has narrowed margins on these loans even too significantly from a stability point of view. Long loan periods and the use of short-term market rates as reference rates should also encourage careful consideration by borrowing households.

Financial sector benefits from potential economic recovery

At the beginning of 2004, development of the operating environment of supervised entities seems brighter than a year ago. Economies have shown signs of picking-up, both in the United States and the euro area. The Finnish economy is also on an upward trend. The rise of stock prices also supports the scenario of a cyclical turnaround. Naturally, the financial sector benefits from the recovery of the economy, since its customers' debt-servicing ability improves and the demand for financial services increases during economic upswing. The outlook for supervised entities can be considered positive if economic developments meet the present favourable forecasts.

According to the European Central Bank[1], EU banks are in an adequate financial condition. Looking forward, the key factor for banks' profitability is economic recovery. The expected gradual increase in economic activity will also strengthen the condition of the EU area banking sector. Furthermore, if cost containment continues, it will support the stability of the banking sector in the medium and long term. In the past few years, there have been structural reforms in the EU area and especially in the German banking sector. Banks have reduced the number of offices and personnel, and their cost-effectiveness has improved as a result.

1) European Central Bank; EU banking sector stability, November 2003.

If economic growth turned out slower than expected, it would affect the important sources of income in retail banking. Banks' credit portfolios are not considered particularly problematic in the EU area but the rapid growth of housing loans in some countries nevertheless includes risks. In addition, credit risk has increased in some sectors. According to the ECB, however, the stability of the EU banking sector is not at risk in the medium term.

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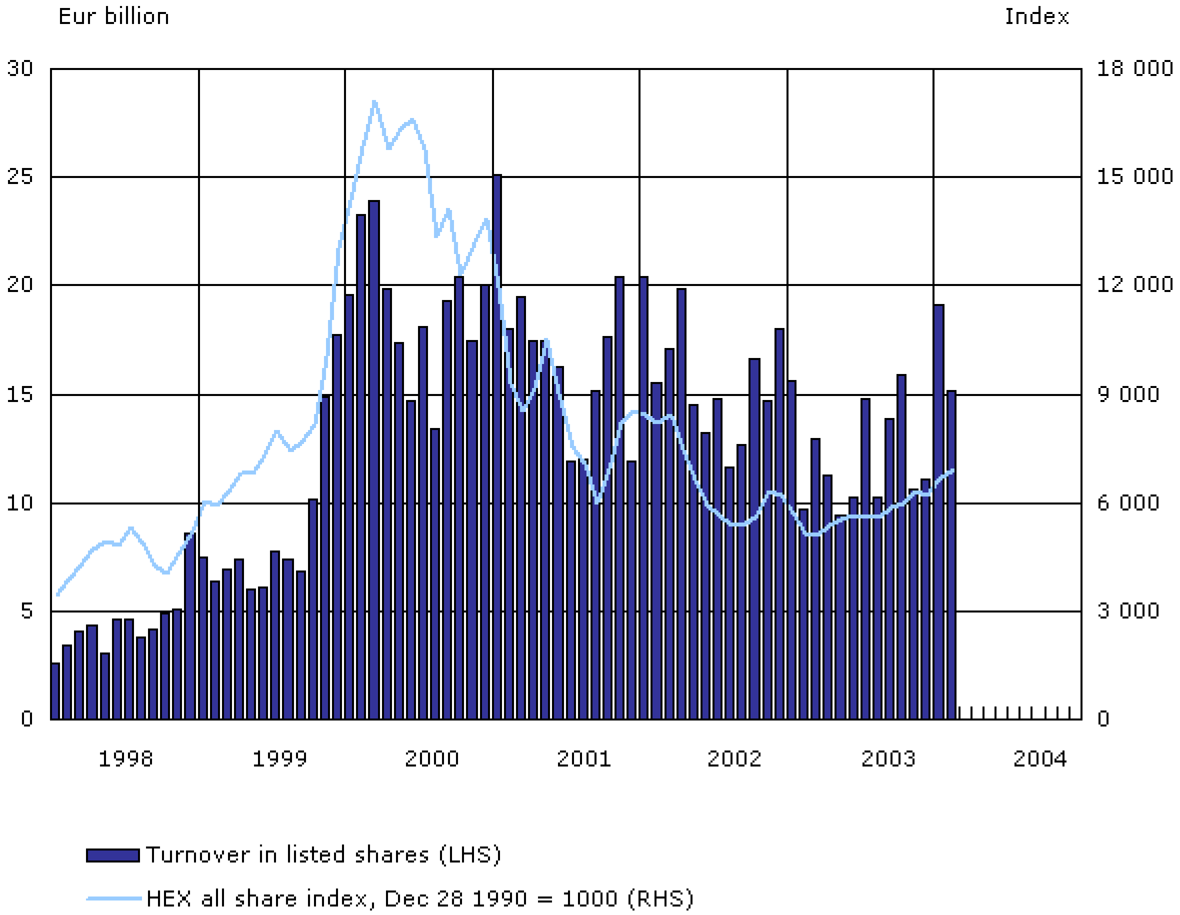
Share markets downward trend shows signs of a turnaround

It seems that the sluggishness of the share markets felt during the past three years has come to a halt. Recovery of the European share markets began in spring 2003. Markets have responded to companies' improved results and enhanced efficiency, achieved through restructuring. A decrease in the number of bankruptcies is also seen as an indicator of economic recovery.

Despite these positive developments, expectations to the contrary can also be felt. Markets suspect that European economic growth has not yet truly begun. Recent financial indicators suggest that US and Asian economic growth has outperformed that of Europe, with euro area GDP growth remaining below 1% in 2003. However, the most popular stance taken in economic forecasts is that euro area economic growth has begun, albeit at a slow pace.

Share turnover on the Helsinki Exchange



Source: Helsinki Exchanges.

European share markets have thus far shown signs of a turnaround. Share prices have increased both in Finland and the rest of Europe and trading volumes have improved. In fact, share prices have reached their mid-2002 level. Furthermore, reduced share price volatility also supports the view that the trend has turned upward. In an upward swing, volatility typically declines as investors agree on market outlook. Just a year ago, share price volatility was high when the share markets nearly hit the bottom.

As share market recovery was just beginning in 2003, share issues were not yet targeted at a wider audience. Instead, all share issues were private placements. However, shares and equity funds are increasingly popular, and market analyses showed that, 2003, the yields calculated from share indices exceeded the yields obtained from long-term interest rates for the first time in three years.

There have been fears that the government proposal to tighten taxation on dividend income would discourage investment in shares. However, the proposal of the so-called SIVA working group could, if implemented, have a positive impact on direct investment in shares.

In May 2002, the Ministry of Finance and the Ministry of Social Affairs and Health set up the SIVA working group to develop long-term saving. According to the memo of the working group, published in December 2003, long-term saving could be promoted by retaining the tax incentive linked to the voluntary pension insurance contributions and increasing competition among the various products offered for long-term saving. The tax incentive related to voluntary pension insurances could be extended to mutual fund units, direct share and bond investments as well as to bank deposits. The minimum saving period would be 5 years, and the savings could be withdrawn when the person reaches the agreed retirement age. Its aim is to give all forms of investment equal taxation treatment. In addition, those investing in pension insurances would be entitled to switch both the underlying instrument and the service provider during the investment period.

The proposal to promote long-term saving would enhance the attractiveness of securities as savings assets, although already voluntary pension insurances have been channelled to the securities markets in the form of investments by life insurance companies. However, population ageing, growth of wealth and improved education will have a more profound impact on the growth of securities as savings assets. Concerns over pension security further increase voluntary savings for old age.

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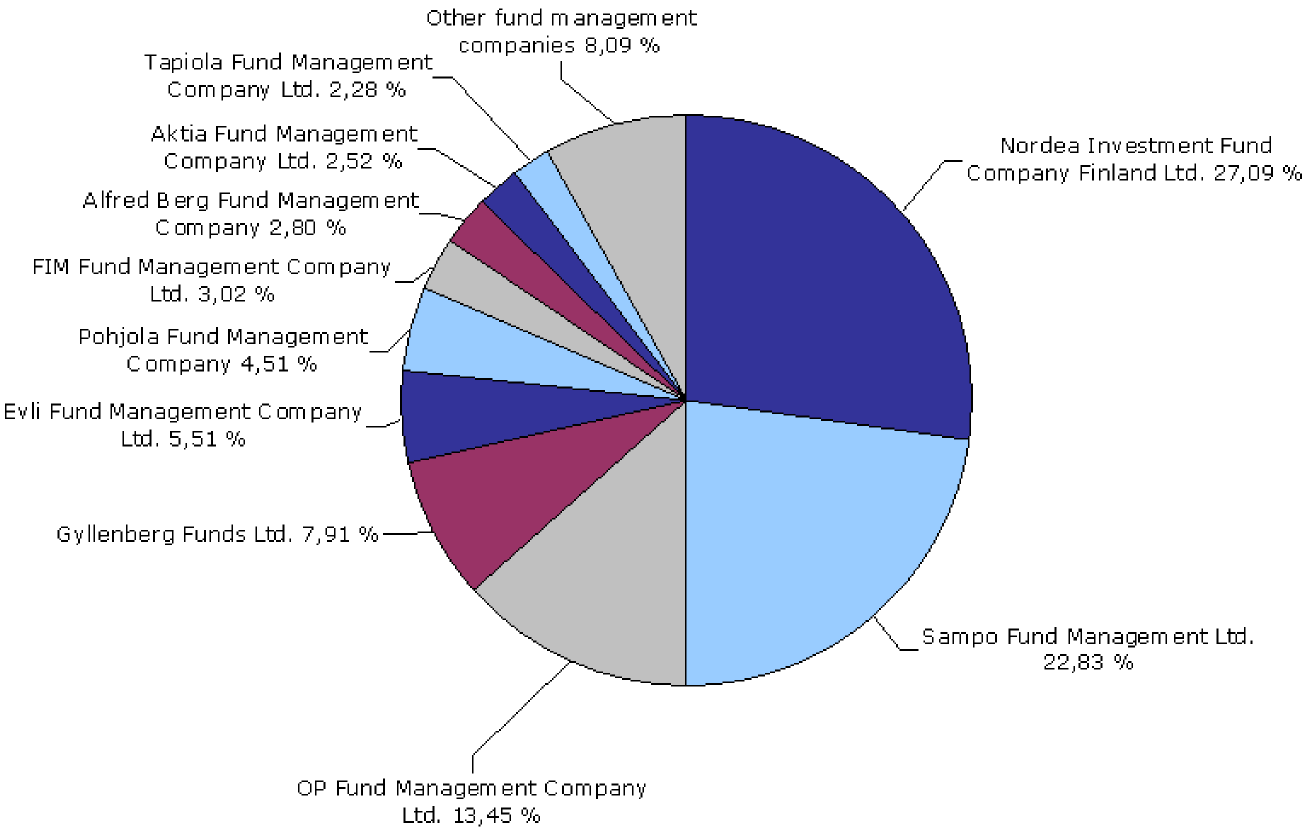
Fund saving increasingly popular

At the end of 2003, net assets of mutual funds stood at EUR 23 billion[1]. Over the year, total net assets increased as much as 40%, with net subscriptions[2] amounting to approximately EUR 5 billion and the increase in value to about EUR 2 billion. At the end of 2003, a total of 26 fund management companies and 362 mutual funds were supervised by the Financial Supervision Authority. The banks' fund management companies were among the largest, with the three biggest fund management companies (Nordea Investment Fund Company Finland Ltd, Sampo Fund Management Ltd and OP Fund Management Company Ltd) accounting for more than 60% of the net assets of mutual funds.

1) Mutual funds supervised by the Financial Supervision Authority. The net assets of mutual funds supervised by the Financial Supervision Authority exceed those of the member funds of the Finnish Association of Mutual Funds.
2) Net subscriptions denote mutual fund subscriptions less redemptions.

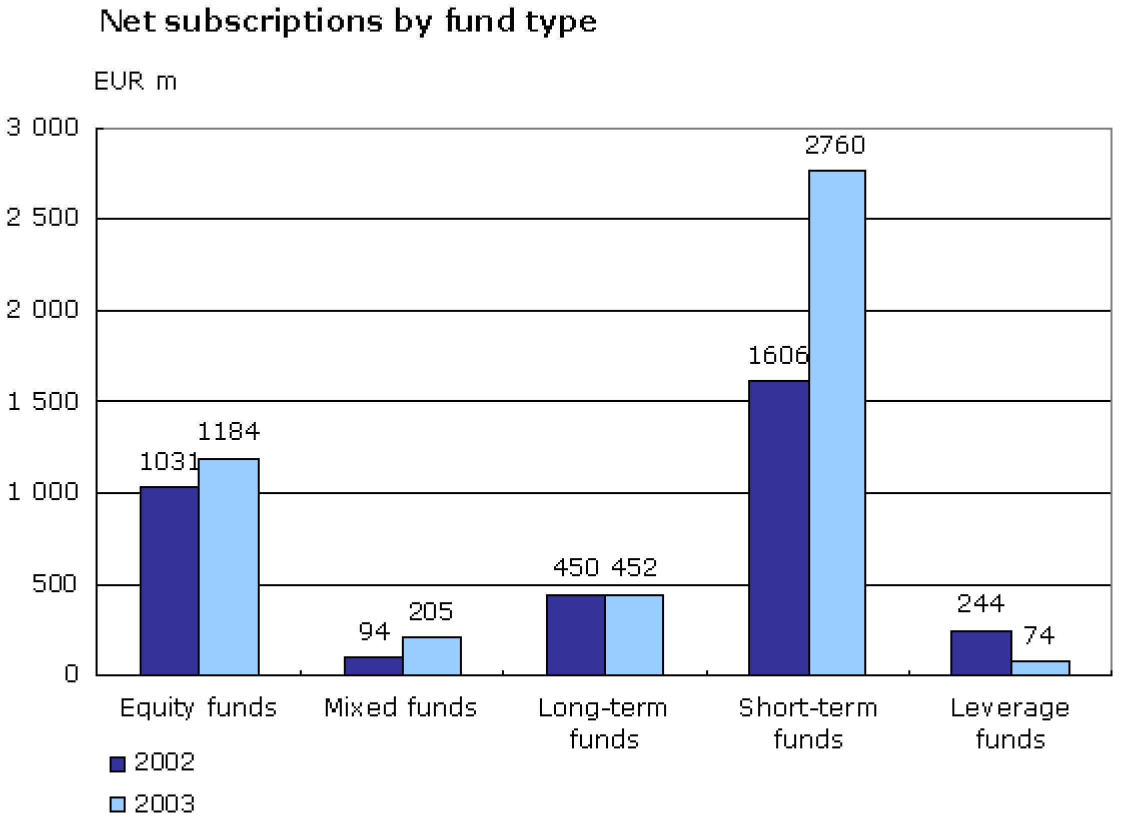
Market shares of fund management companies, by net assets of mutual funds, 28 February 2004



Source: Fund management companies' monthly reports to the Financial Supervision Authority.

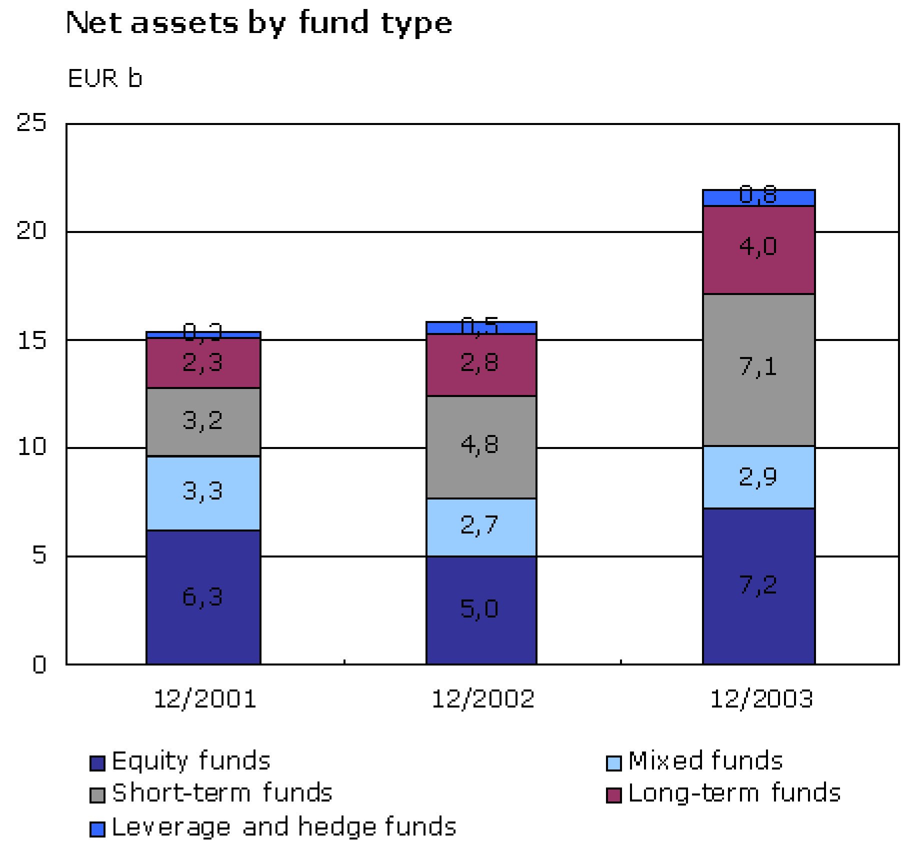
Record growth in Short-term funds

As in the previous year, short-term funds attracted most assets. Net subscriptions in short-term funds were considerable as compared to other types of mutual funds, and more than double the net subscriptions in for example equity funds.



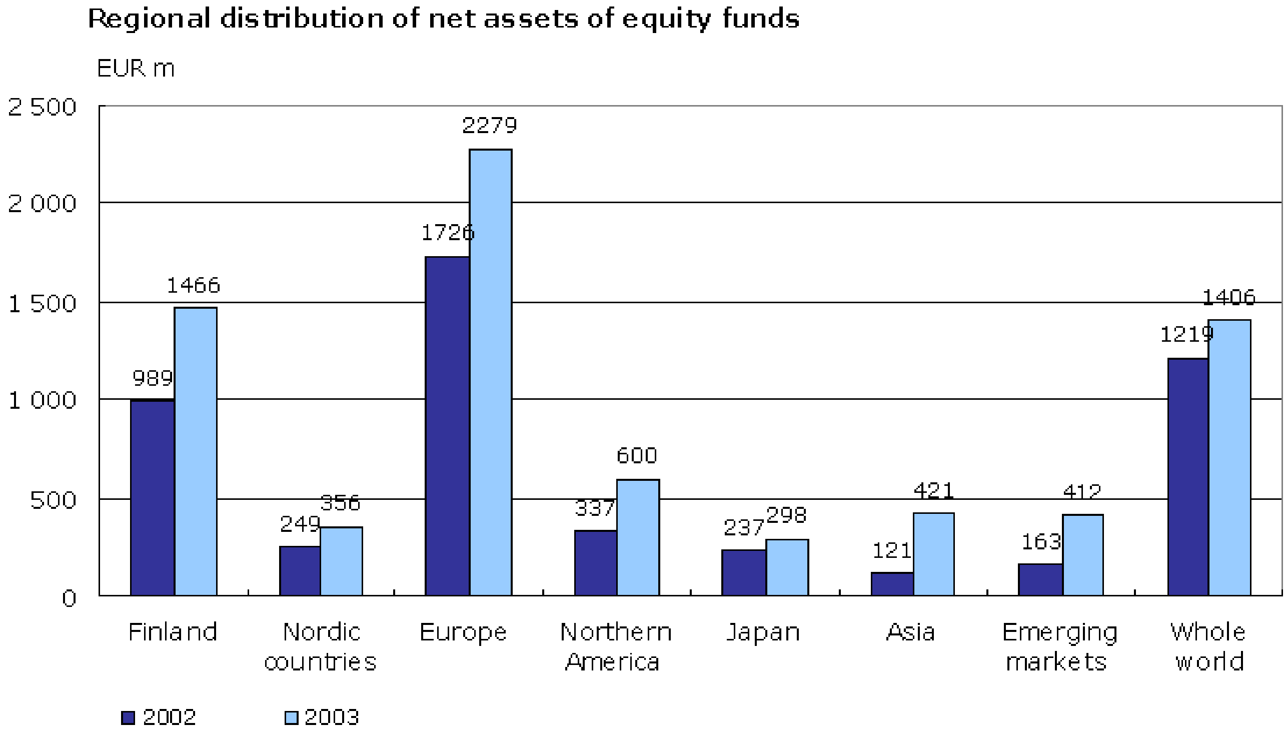
Source: Rahastoraportti (Mutual funds report), Finnish Association of Mutual Funds.

As a consequence of the large volume of net subscriptions, net assets of short-term funds have grown as large as net assets of equity funds. If the recovery of the stock market continues, the flow of savings is likely to be redirected into equity funds.



Source: Rahastoraportti (Mutual funds report), Finnish Association of Mutual Funds.

Of the equity funds, the European, Finnish and global equity funds are the largest in terms of net assets. In the course of 2003, in addition to European funds, major net subscriptions concerned Asian and North American funds, as economic growth has been stronger in these regions. The equity funds of emerging markets also attracted investor interest. The increase in the value of equity funds was considerable in the course of 2003. Half of the increase in net assets totalling EUR 2 billion represented an increase in value, whereas the other half was net subscriptions.



Source: Rahastoraportti (Mutual funds report), Finnish Association of Mutual Funds.

Mutual funds act brings changes to provisions on special mutual funds

The special mutual funds originated in the late 1990s when the provisions on investment of assets set out in the UCITS Directive were too restrictive for the needs of emerging markets. In Finland and elsewhere in Europe, national legislation had to be introduced to respond to the product development needs in the mutual funds business, and so the market saw the emergence of special mutual funds authorised in the home member state only. At the end of 2003, there were 102 special mutual funds in Finland, with net assets amounting to a little less than 12% of the combined net assets of mutual funds. The amendments to the new UCITS Directive concerning investment of assets will be transposed into Finnish legislation in spring 2004. Following the amendments to the UCITS Directive, some of the special funds may be converted into mutual funds under the UCITS Directive and hence become marketable elsewhere in Europe under the single licence principle.

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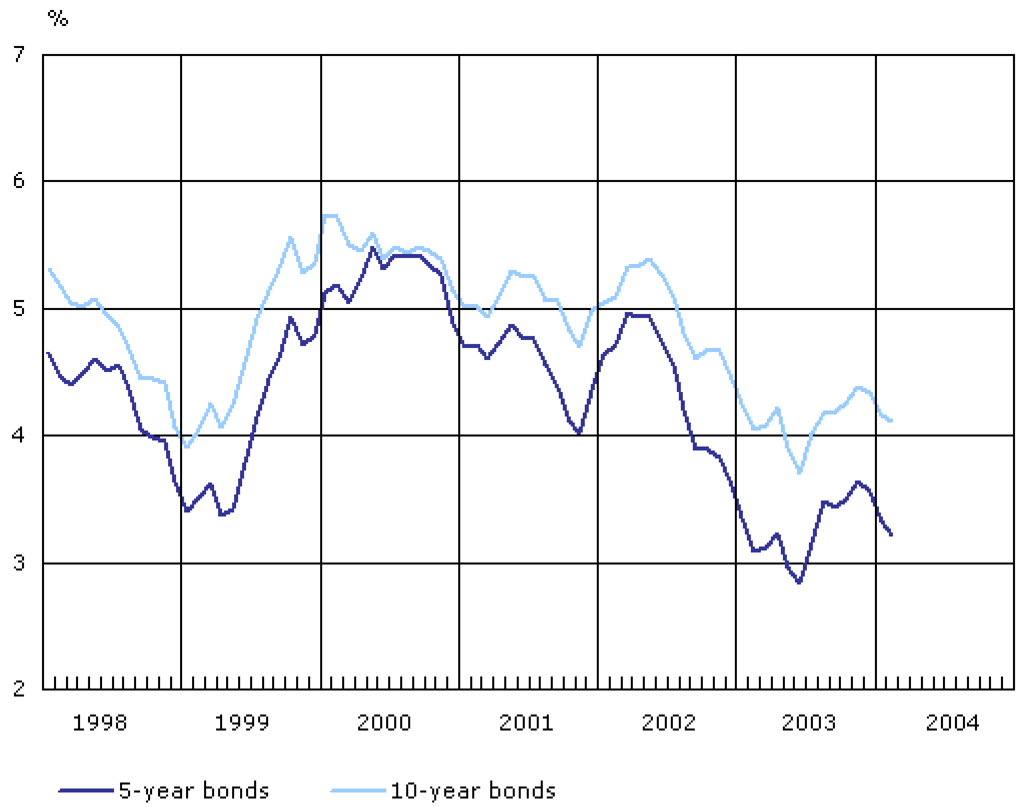
Bond yields turned up in the second half of 2003

After having reached a low point in the summer of 2003, the yield curve rose sharply in the second half of the year. Investors started to exchange fixed-rate assets for equities, since share prices no longer appeared too high in the light of expectations of economic growth. Recent developments in benchmark bond yields suggest that equity markets had overpriced the late autumn signs of economic recovery, since the yield on benchmark bonds has fallen sharply.

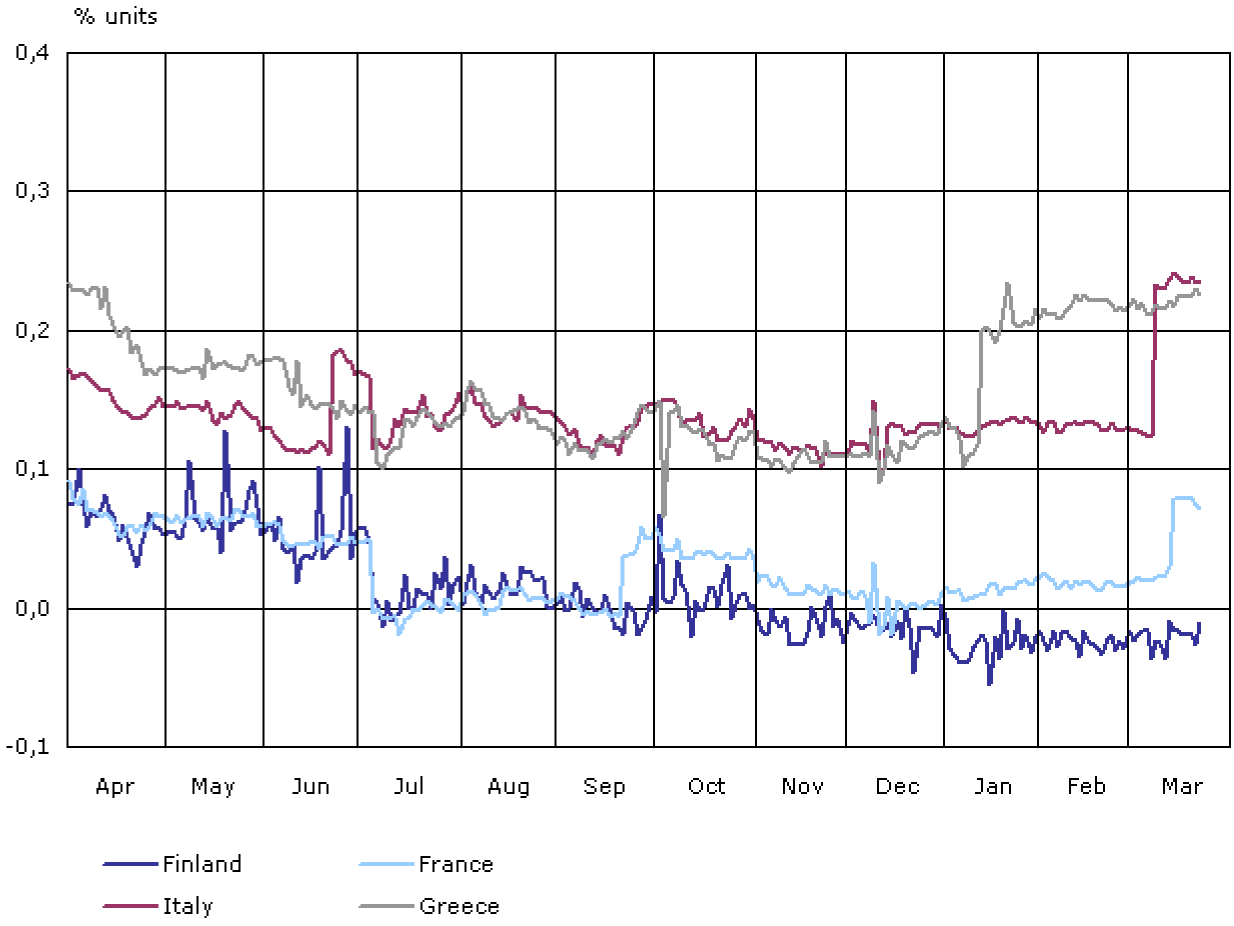
Interest rates of 5 and 10 year Finnish government bonds



Source: Reuters.

The spreads of government bonds issued in euro area countries have been extremely narrow. However, it is expected that the countries with the best economic performance and smallest number of issues will distinguish themselves from the core countries, Germany and France. This has, in fact, already started to happen. Yields on Irish and Finnish benchmark bonds have been slightly smaller than the yields on German and French benchmark bonds. However, spreads are not likely to widen much in the future, since all euro area countries have the same structural problems to solve, ie an ageing population, unemployment and globalised output.

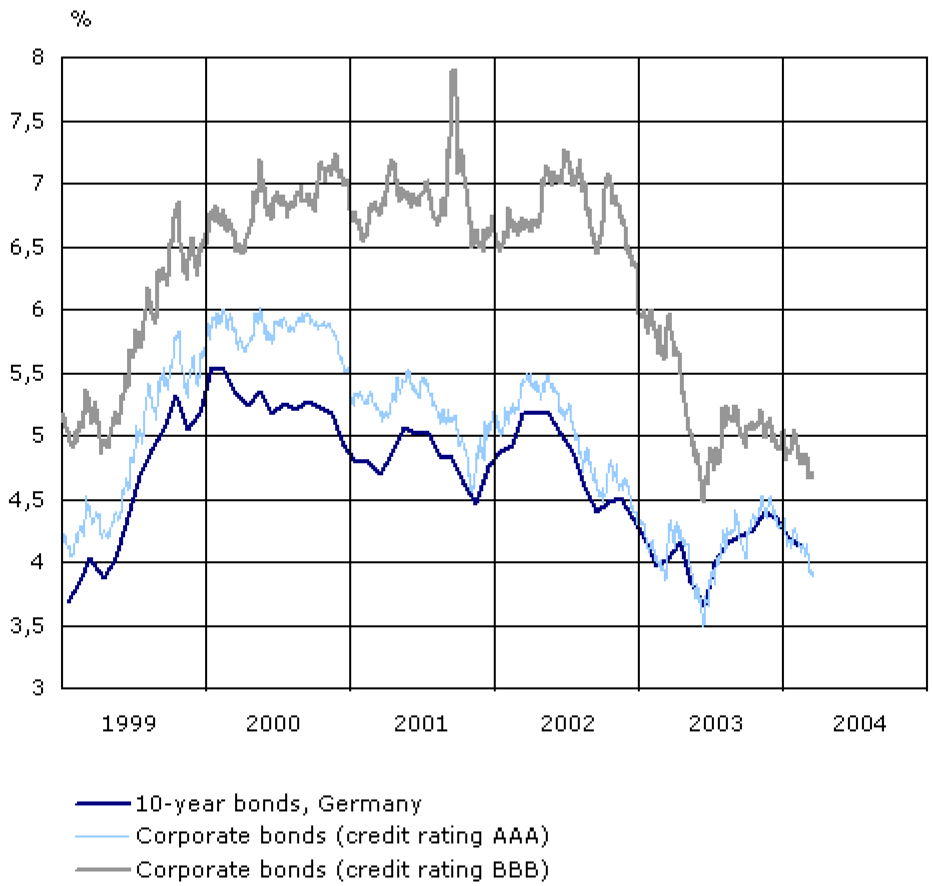
10-year bond spreads in some euro area countries in relation to Germany



Source: Reuters.

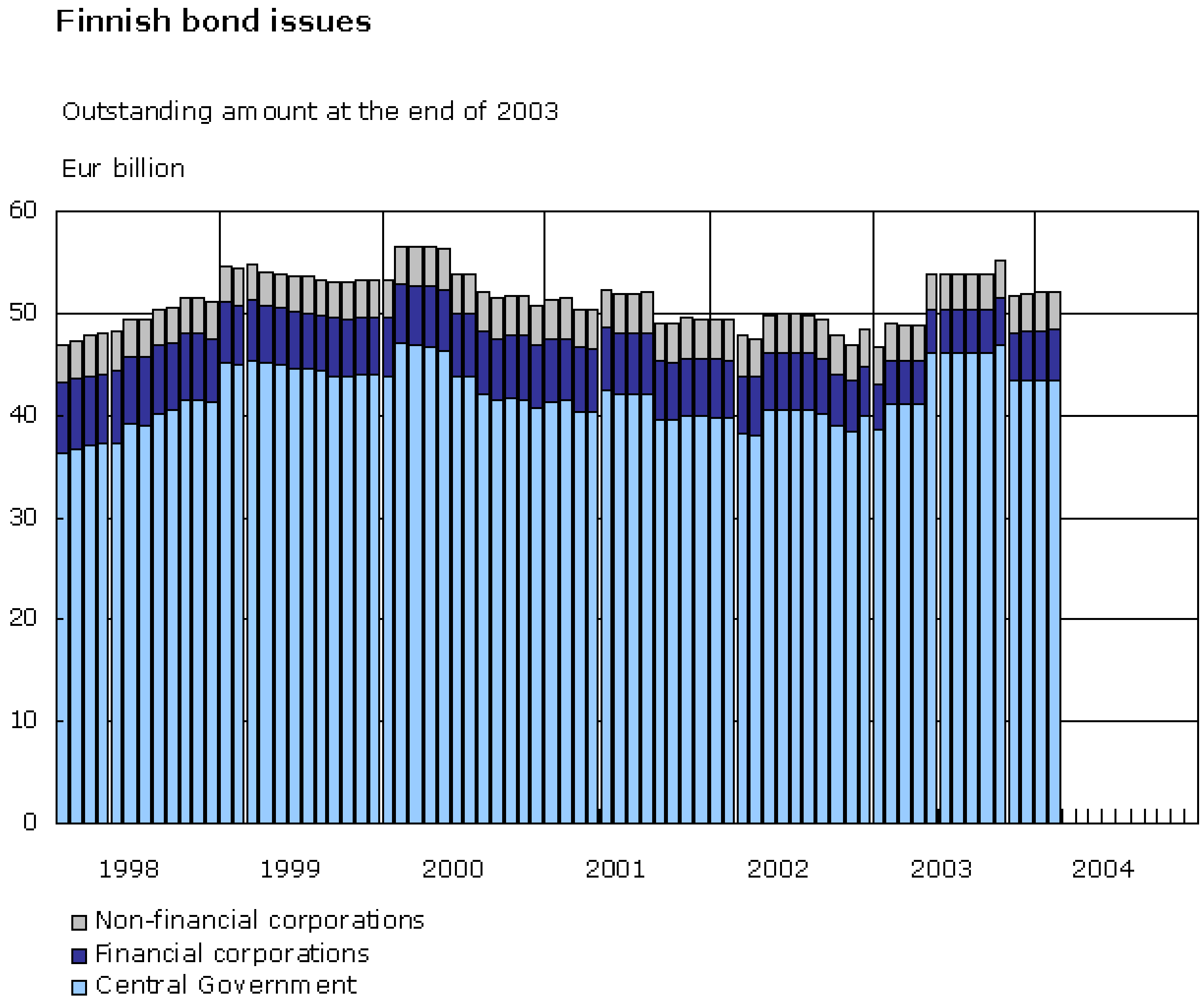
The narrowing of bond spreads and the convergence of the spreads of bonds of different credit ratings that took place in the bond markets in 2003 is probably coming to a halt, since the risk/return ratio of corporate bonds is considered as being record low in relation to the risk/return ratio of government bonds. Expectations of recovery and enhanced business performance have boosted the demand for corporate bonds. The widening of bond spreads can also be attributed to investors' anticipation of higher return on investment under conditions of low inflation and interest rates. The increase in demand for corporate bonds have pushed up prices and reduced effective yield on corporate bonds.

Interest rates of corporate bonds in the euro area



Sources: European Central Bank, Reuters and Merrill Lynch

Owing to the low interest rate level and bond financing renewals, the European bond markets were lively in 2003, although Finnish issuance was more subdued. Despite Central government being the dominant issuer, it also accounted for abundant redemptions, which meant that by the end of 2003, the stock of government bonds totalled EUR 43 billion, ie EUR 4 billion less than in the autumn. Issuance by non-financial corporations did not increase in 2003 with corporate stock, amounting to just under EUR 4 billion, at the same magnitude as it had been for years. Financial corporations were the only sector whose net financing in the bond markets started to increased in late 2003 and continued to increase in the early parts of 2004. At the end of 2003, the financial corporations' stock of bonds amounted to EUR 5 billion. The total outstanding amount of bonds was EUR 52 billion.



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Lending by monetary financial institutions (MFIs) continues to grow briskly

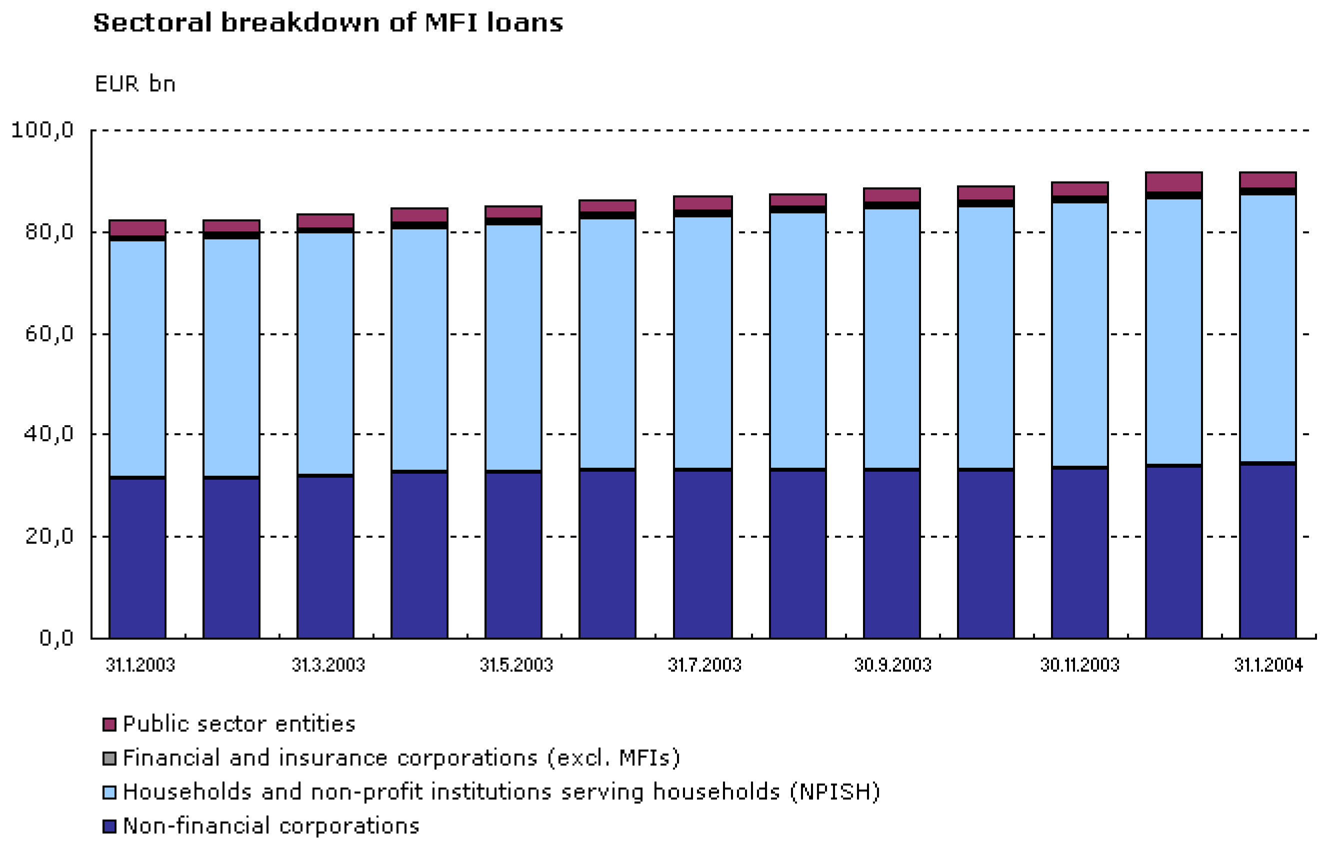
The vast majority of MFI loans are granted by deposit banks and other credit institutions. At the end of January 2004, resident MFIs' combined euro-denominated stock of loans to the public stood at EUR 91.8 billion. This translates into an annual growth rate of 12.0%, which is clearly faster than a year ago, when the corresponding rate was 9.1%. The growth of loans to households has been particularly fast.[1]

1) The data, which is based on the Bank of Finland's statistical review Financial Markets, cover resident MFIs' euro-denominated loans to euro area residents. Resident MFIs refer to the Bank of Finland, deposit banks, other credit institutions and money market funds.

MFI lending focuses on loans to non-financial corporations and households

Resident MFIs' stock of loans consists mainly of household and corporate credit. At the end of January, loans to households accounted for nearly 58% and loans to non-financial corporations (including housing corporations) for just over 37% of resident MFIs' combined stock of loans. Loans to financial corporations, insurance corporations and public sector entities (excluding the central government) represented barely 5% of the combined amount of outstanding loans.

Debt financing by households continued to be supported by the low level of interest rates and the robust financial position of households. At the end of January, the stock of outstanding MFI loans to household totalled EUR 53.2 billion. This translates into an annual growth rate of 13.6%. Outstanding MFI loans to non-financial corporations amounted to EUR 34.3 billion, which represents an annual growth rate of 9.8%.



Source: Bank of Finland.

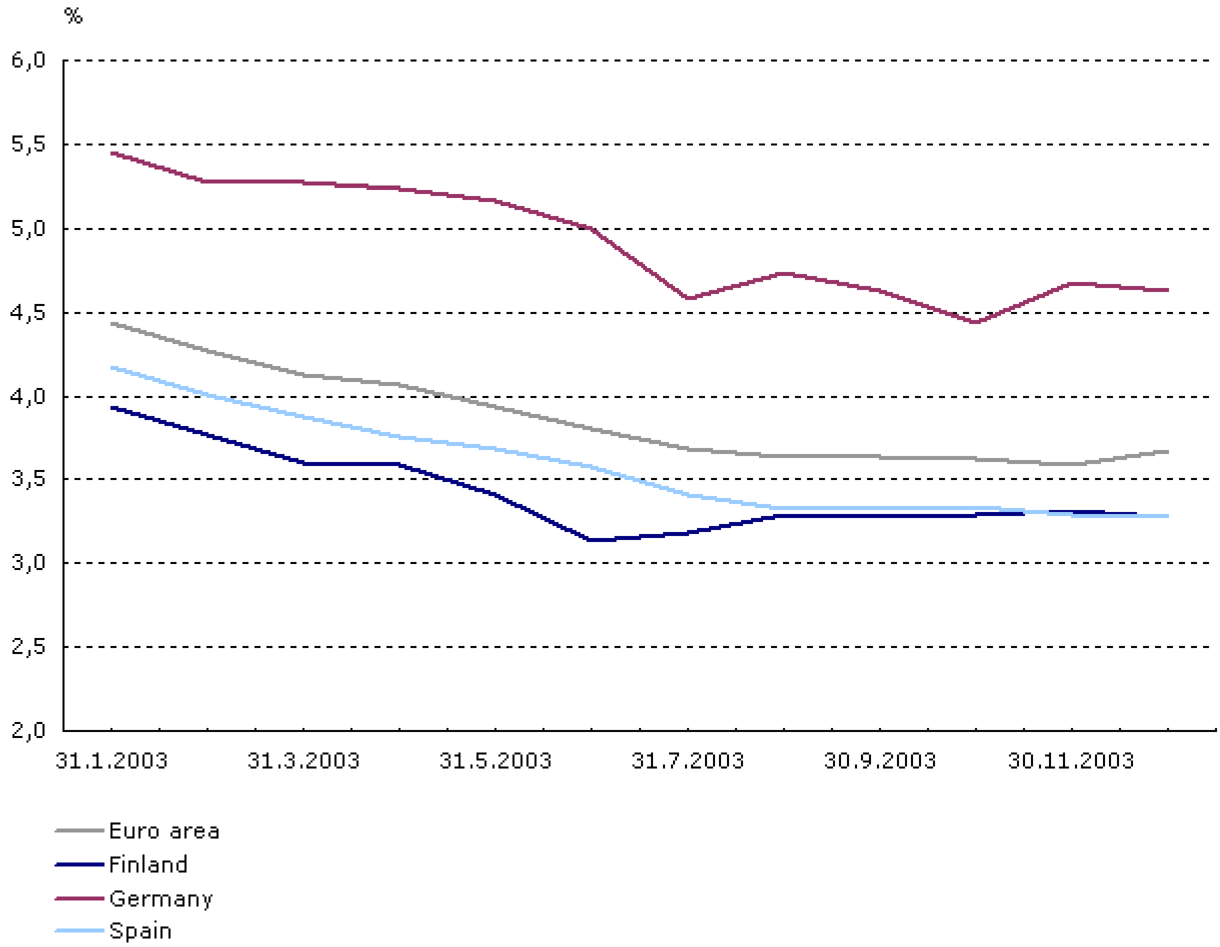
Strongest growth in housing loans

Housing loans accounted for more than two thirds of MFI lending to households. The vitality of the housing markets in 2003 showed no signs of abatement in early 2004. At the end of January, resident MFIs' combined stock of housing loans amounted to EUR 36.4 billion. The increase in housing loans in Finland stands out as particularly sharp in the light of the corresponding figures for the euro area as a whole. In 2003, the stock of loans granted in Finland grew by 15.6% compared with 8.3% in the entire euro area (see the ECB Monthly Bulletin 3/2004).

The dynamic housing markets continue to support the rising trend in house prices, albeit at a slower pace than last year. According to Statistics Finland, prices of old flats in Finland rose by 6.8% on average in 2003, compared with 10.1% in 2002. However, there are large regional differences in house price developments. A recent forecast by the Bank of Finland suggests that house prices will rise by approximately 6% in 2004.

Interest rates of housing loans are exceptionally low. This is mainly a result of the low level of market rates, but competition in the housing loan markets has also narrowed banks' interest rate margins on lending. At the end of January, the average rate of interest on the whole stock of housing loans was 3.51% and that on new housing loans 3.21%. The average rate of interest on new housing loans in Finland has for long been the lowest in the euro area.

Average rate of interest on new housing loans, interest-linked up to one year, 2003



Sources: Bank of Finland, ECB and NCBs.

Finnish households are exposed to interest rate risk

In Finland, households bear the interest rate risk attached to housing loans themselves. The interest rates of most housing loans are linked to up-to-one year market rates. Hence, market rate changes swiftly affect the debt financing costs of households. Hence, the primary criterion for the granting of a housing loan must be whether the customer would be able to service his debt if, for example, a significant increase in interest rates occurs. In addition, MFIs are advised to pay even closer attention to the adequacy of collateral than before, bearing in mind the high house price levels already reached.

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Bank profitability nearly on a par with the 2002 level

Restructuring and financial results of insurance operations rocked the profits of financial groups in 2003. Appreciation of investments strengthened the financial results of insurance operations, whereas the profits of banking operations remained more or less on a par with the 2002 level.

The total profits of Finnish banks (excluding Nordea Bank Finland)[1] rose by 5% from the previous year. Profits improved although new banks entering the banking sector reported a loss for their first business year. Starting expenses and other investments burdened the initial operations of the newcomers, whereas the corresponding income is accrued gradually. The profitability indicators for 2003 were nearly on a par with the 2002 level. Banks' total return on equity (ROE %) slightly deteriorated from 11.5% in 2002 to 10.3%. By contrast, the total return on assets (ROA %) remained at the 2002 level of 0.9%. Nevertheless, the equity growth was stronger than the growth of the balance sheet total.

1) For figures of Nordea Bank Finland, see the enclosed table.

Banks' net income from financial operations decreased

Banks' net income from financial operations decreased in 2003 due to narrower interest rate margins. However, the impact of narrowing margins was dampened by the continuous strong growth in lending and funding and the use of derivatives for hedging purposes. In 2003, lending continued its robust growth at 12%, while deposits grew at the clearly more modest rate of 6%.

The interest rate margin between credit institutions' lending and deposits narrowed throughout the year, although short-term market rates edged upwards in June 2003. However, the rise in market rates and price competition only affect the situation with a time lag, as the pricing of most loans granted is not revised until months or even years later.

Increase in other income compared to the previous year

Other income, such as fee income increased. In particular, fee income from payment transactions and lending increased with the volume growth. Fee income from portfolio management also increased compared to 2002. On the other hand, as a proportion of total fees, the securities-related fee income was still small in most banks. An exception came from small banks mainly involved in investment services and securities intermediating, for whom securities-related fee income continued to be a significant source of revenue.

The significance of other business income increased. Such income is mainly income from real estate, such as rental income, sales profits and income from shares and participations in real estate corporations. Non-recurring capital gains from the sale of shares in real estate corporations were also reported for the financial year.

Banks succeeded in cutting their costs

Total bank costs decreased in 2003, despite new banks entering the banking sector. Banks have succeeded in cutting their costs by increasing their cost discipline and laying-off staff. However, in the course of the financial year staff expenses increased by more than 2%, but savings from layoffs are not expected to show in full until 2004.

Other administrative expenses, such as office, IT and market expenses decreased by more than 5%, although the new operators also caused a raise in these expenses. The cost efficiency for the whole sector, the cost income ratio, weakened due to the decreased net income from financial operations, although expenses were kept low.

Profit impact of loan and guarantee losses nearly non-existent

The profit impact of loan and guarantee losses was still small at EUR 13 million (EUR 7 million in 2002). In gross terms, the loan and guarantee losses reported for the financial year were smaller than the previous year, at EUR 62 million (EUR 79 million). Nonperforming assets were also small[2].

2) See article Low level of non-performing assets and loan losses.

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Banking sector capital adequacy strengthened

The banking sector capital adequacy ratios strengthened clearly in 2003. At the turn of the year 2003/2004, the total capital adequacy of the banking sector was 18.9% (11.7% one year earlier) and the Tier 1 capital adequacy calculated on the basis of original own funds 16.8% (8.6%).

Nordea restructuring behind the improved capital adequacy

In June 2003, a legal restructuring of Nordea was commenced with the objective of transforming the group's Swedish parent company, Nordea Bank AB (publ), into a European banking company operating in the local markets through branches. As part of the restructuring, Nordea Bank Finland (NBF) Group has sold its Nordic branches to Nordea Group's parent company. The sale of the branches has decreased NBF Group's risk-weighted assets and exposures by 60%. Because no corresponding reduction in own funds occurred, NBF Group's capital adequacy clearly strengthened.

Despite Nordea's restructuring, NBF Group's market share in the Finnish banking sector is still considerable. Thus the group's improved capital adequacy ratios show as a considerable growth of the banking sector capital adequacy.

Other Banking groups

The total profits of Finnish banks (excluding Nordea Bank Finland) rose compared to the previous year. Banks can include their profit after dividends in their original own funds. In fact, some of the banks will pay larger dividends than usually in 2004, because a partial double taxation of dividends will be introduced at the beginning of 2005. The generous dividends have dampened the growth in banks' own funds.

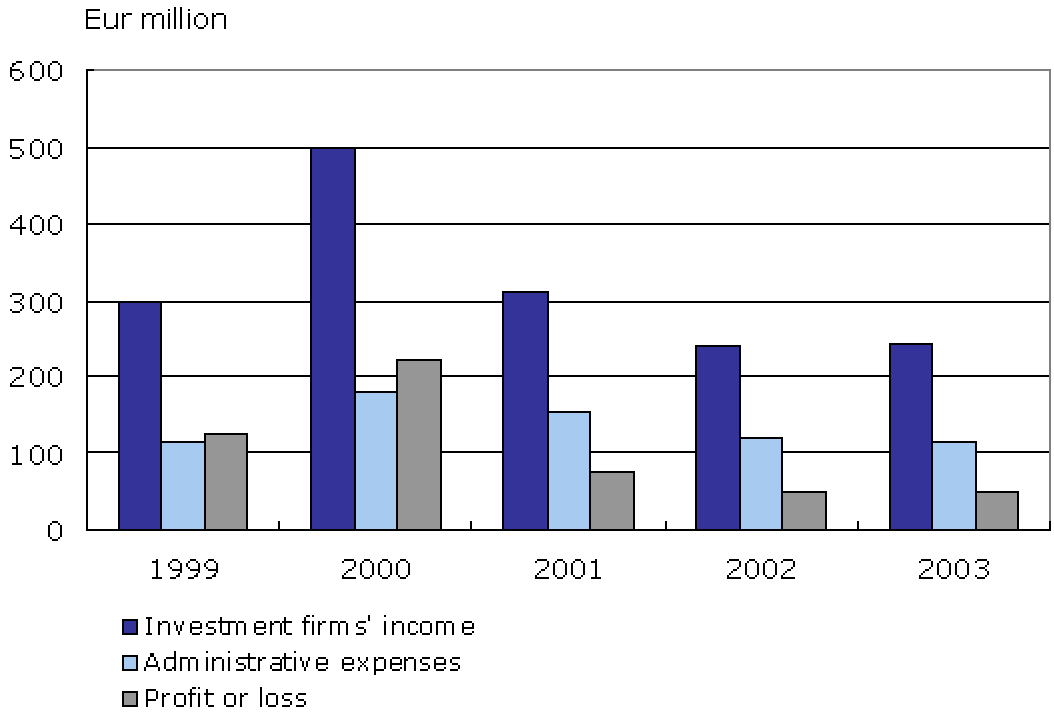
The brisk lending has continued and clearly raised banks' risk-weighted assets and exposures, and as a result the banking sector's capital adequacy would have deteriorated without the Nordea restructuring affecting capital adequacy ratios. Nonetheless banks' capital adequacy ratios are strong, and in international terms the capital adequacy of the Finnish banking sector is quite appropriate.

Decrease in investment firms' income stopped

Investment firms' income[1] for 2003 matched the one of the previous year. Compared to the record year 2000, income has decreased by half and turnover to one quarter. In this recession, investment firms had to lay off staff to maintain business profitability. Administrative expenses were cut to two thirds of the expenses of record years. Investment firms have most likely passed the bottom mark of profitability. In terms of income, the last quarter of 2003 was clearly better than the three preceding quarters.

1) Here income refers to income from investment services composed of fee income (securities brokerage, market making, arrangement and underwriting of issues, asset management, lending and funding, safekeeping of securities, and investment and financial advice) and net income from securities trading and foreign exchange trading.

Development of investment firms' income, expenses and turnover in 1999–2003



Source: Financial Supervision Authority.

Asset management companies' income up

The securities market recession most adversely affected investment firms providing securities brokerage and corporate finance services. The income of companies with the core business of providing corporate finance services shrank by 40% on average in 2003. By contrast, the income of companies with asset management as their core business rose by 25% on average during the same period.

In relative terms, income after deduction of expenses is larger in investment firms providing asset management than in investment firms, on average. The profit/income of all investment firms was 21%, whereas it was 28% in investment firms with asset management as their core business. At the end of 2003, the assets managed were EUR 46 billion.[2] The income of the five most significant investment groups[3] comprised two thirds of the income of all investment firms.

2) Assets managed with full power of attorney.
3) Alfred Berg Finland Oyj Abp, Alfred Berg Asset Management Ltd, FIM Group Ltd (FIM Asset Management Ltd, FIM Securities Ltd, FIM Corporate Finance Ltd), Mandatum Asset Management Ltd, Mandatum Stockbrokers Ltd., Mandatum & Co Ltd, Nordea Securities Holding Oy (Nordea Securities Oyj, Nordea Corporate Finance Ltd), Nordea Investment Management Finland Ltd and Opstock Ltd.

Capital adequacy broadly unchanged

Investment firms' capital adequacy ratios vary significantly from one firm to another. In 2003, the average capital adequacy ratio, at 73%, was a little better than the previous year. The capital adequacy ratio, which is calculated on the same grounds as the corresponding ratio in credit institutions, does not provide a very good description of investment firms' capital adequacy. Capital requirements are based on credit and market risks, which do not necessarily arise in the supply of investment services on customers' behalf.

The aggregate surplus of investment firms' own funds deteriorated slightly in 2003, which decreased the loss buffers of these firms. The own funds surplus[4] of EUR 107 million was 7% smaller than in 2002. In particular, the surplus was decreased by the raise of the absolute minimum capital requirement to EUR 5 million for investment firms acting as clearing parties.

4) Surplus according to the strictest requirement (absolute minimum capital requirement, capital required for covering credit and market risk or capital requirement for fixed charges).

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Low level of non-performing assets and loan losses

Finnish banking groups report very small amounts of non-performing assets. In December 2003, non-performing assets amounted to EUR 416 million, which is 19.4% less than in the previous year. They continued to account for a minor proportion of lending stock. In December 2003, non-performing assets accounted for about 0.4% of lending stock, compared with 0.6% one year earlier.

Amount of non-performing assets declined in all sectors

The sectoral breakdown reveals that the amount of non-performing assets declined in all sectors compared with December 2002. Non-performing assets decreased by approximately EUR 40 million in the corporate and the non-resident sector and by EUR 29 million in the household sector as from December 2003.

Loan losses account for a small proportion of lending stock

Finnish banking groups' loan losses did not erode profits since previous loan loss recoveries and compensations, as well as reversals of loan loss provisions, exceeded recorded loan losses and loan loss provisions by EUR 30 million. Banking groups' gross loan losses, excluding reversals and recoveries, stood at EUR 142 million in December 2003. They accounted for as little as 0.15% of lending stock. Compared with December 2002, their amount has declined by almost 25%.

Gross loan losses declined somewhat in all sectors as from December 2002. Gross loan losses declined by EUR 27 million in the non-resident sector, by EUR 12 million in the corporate sector and by EUR 3 million in the household sector.

Banking groups' non-performing assets and loan losses continue to be at a low level. Even though no growth has been observed, credit risk figures are nevertheless at such a low level that the amount of non-performing assets and loan losses will probably increase in future. The strong growth in lending has been concentrated on consumer loans and housing loans in particular. Housing loans are usually covered by real collateral and it can be said that, historically, housing loans account only for a small proportion of Finnish banking groups' loan losses. Long maturities of housing loans and interest rate fluctuations, households' unpredicted and unexpected expenses, possible uncertainty related to employment and strong growth of house prices are threats that, if they materialise, affect the amount of banks' non-performing assets and loan losses. There is particular cause for concern when the amount of a housing loan borders on the debtor's ability to service the loan. In addition, the risk of company loan losses increases in individual sectors when companies' willingness to invest becomes greater as a result of favourable economic developments.

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Banks' liquidity improved

The combined balance sheet of Finnish banks[1] grew in 2003. Lending grew mainly due to strong demand for housing loans. Deposits also increased, albeit not as rapidly as lending.

Most of the lending was financed through deposits. At the end of 2003, 87% of banks' lending was financed through deposits. Financing for the remainder came, for example, from certificates of deposits and bonds issued by banks. At the same time, banks reduced their claims on other credit institutions. Funds freed from claims were channelled to lending. Banks have usually managed to finance the growth of lending without difficulties through deposits and other available sources of funding. Deposits have however been the cheapest way to obtain financing.

1) The banking sector covers Finnish deposit banks (parent banks) with their branches (eQ Pankki Ltd, Evli Bank Plc, Gyllenberg Private Bank Ltd, Nordea Bank Finland Plc, Sampo Bank Plc, The mortgage society of Finland, Tapiola Bank Ltd, Bank of Åland Plc, the OKO Bank Group, local cooperative banks, savings banks, Aktia Savings Bank Plc, Nooa Savings Bank Ltd and Skärgårdssparbanken Ab).

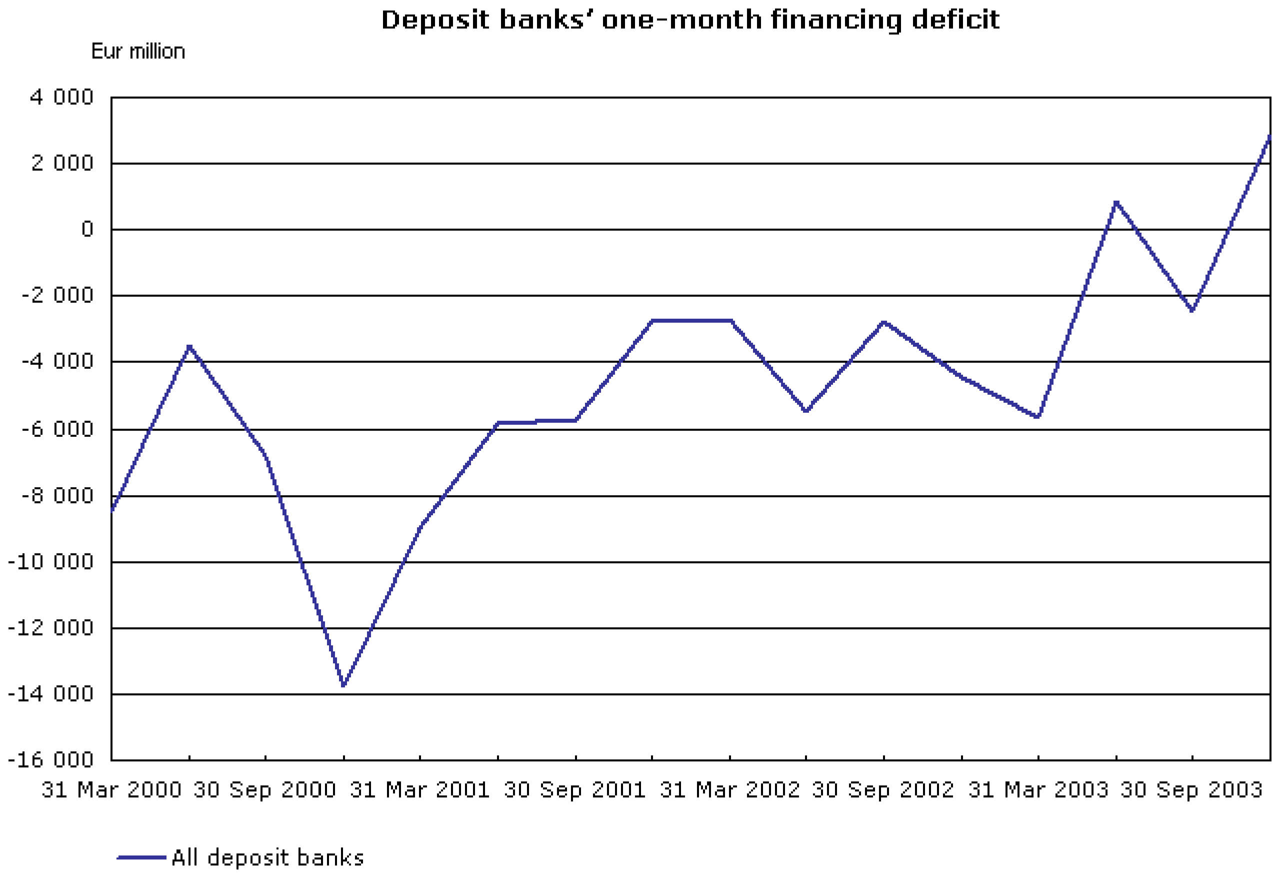
Small decreases in funding maturities

Banks' funding maturities shortened somewhat compared with 2002. Since there were similar movements in the maturities of banks' claims, the shortening of the maturities of liabilities had no significant impact on the imbalance between the maturities of claims and liabilities. Excluding deposits made by the public and repayable on demand, 47% of deposit banks' liabilities will fall due within one month, about 66% within six months and 72% within one year. Commercial banks' liabilities fall due somewhat more rapidly than those of local banks. The amount of euro-denominated liabilities has remained unchanged at about 75% of deposit banks' total liabilities.

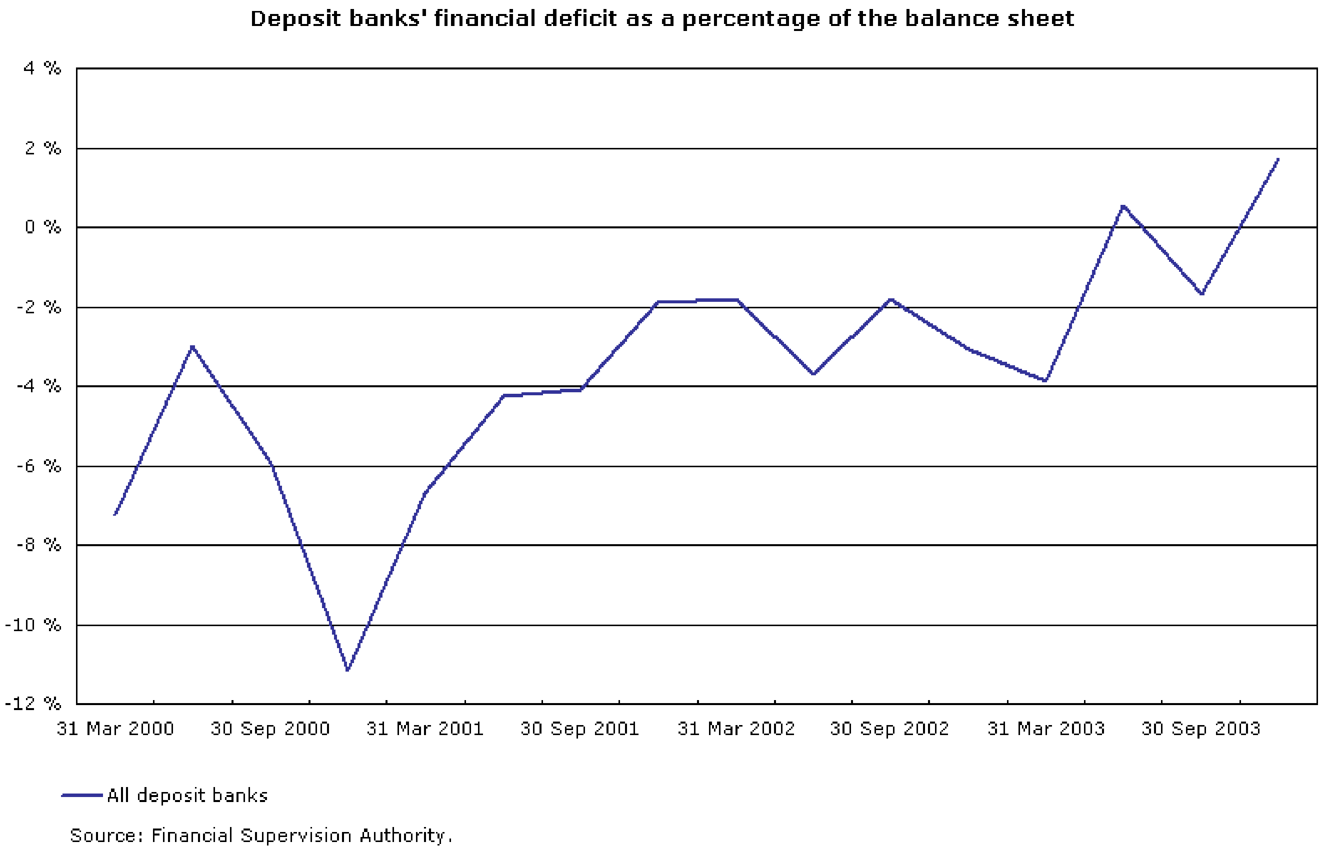
Deposit banks' total liquidity position improved

Deposit banking sector's liquidity position improved during 2003, although developments differed across various banks. At its highest, banks' combined short-term one-month funding deficit amounted to EUR 5.7 billion during the year, ie to about 4% of the balance sheet totals. During 2003 the funding deficit turned into a surplus of EUR 2.9 billion. The liquidity positions of local bank groups were in surplus throughout the year, reflecting the high proportion of deposits in these banks' acquisition of funding. Commercial banks run funding deficits as, in addition to public deposits, they tap money and capital markets for their business funding. All in all, the Finnish banking sector's liquidity position is stable.

Banks' liquidity maintenance is primarily based on customer deposits and funding obtained through money and capital markets. They can also acquire funding by selling their holdings of debt securities and shares. Banks can obtain central bank financing against adequate collateral.



Source: Financial Supervision Authority.



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Banks' income risk increased in relation to net income from financial operations

Deposit banks' income risk, stemming from the effects of a 0.5 percentage point change in interest rates, has increased since the end of 2003. A 0.5 percentage point rise in interest rates would cause an increase of EUR 162 million or about 7.3% in net income from financial operations. At the same time, a rise in interest rates would diminish the values of banks' on-balance sheet bonds (investment risk); thereby slightly weakening the positive earnings effects of the rising level of interest rates. Developments in the banking sector's interest rate risk have been divergent, and some banks have even witnessed lower interest rate risk in their balance sheets since the end of 2002. The banking sector's combined interest rate risk is not alarmingly high compared to the sector's risk-bearing capacity.

The above described income risk only measures the effects of market rate changes on net income from financial operations. However, a factor that has the strongest impact on both net income from financial operations and the interest rate margin between bank funding and lending is the margin that is charged by the banks themselves. The size of this margin is determined by competition in the banking sector, overall economic conditions, borrowers' repayment capacity and collateral assets. Interest rate margins contracted in the first half of 2003 and are now exceptionally narrow. Currently, deposit rates are very low, which indicates that these rates are quite unresponsive to downward movements in interest rates. Falling interest rates would therefore have an impact on lending rates, in particular, which would increasingly put a strain banks' net income from financial operations.

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