Financial Market Report

2 • 2007

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- Banks' profitability and cost efficiency continued to improve in the first quarter
- Listed exchanges prove to be attractive to investors – is OMX joining the Nasdaq fold?
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EUROJÄRJESTELMÄ
EUROSYSTEMET

Bank of Finland

Financial Markets and Statistics

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1 Financial intermediation

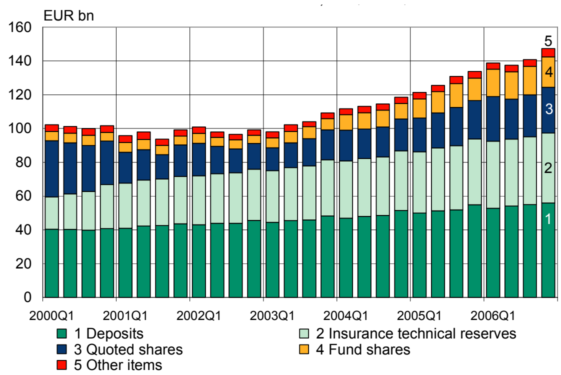
1.1 Households' net financial assets increased in 2006 despite growing indebtedness

Eero Savolainen

Domestic sectors' financial assets and liabilities did not change dramatically in 2006. While households' indebtedness continued to increase the rapid growth in financial assets led to an increase in the sector's net financial assets. Non-financial corporations had little need to acquire new debt financing because of the high level of internal finance generated by good profitability. Assets managed by mutual funds continued to increase robustly, for the fourth consecutive year.

Households'[1] net financial assets, ie financial assets minus liabilities, continued to expand in 2006. According to quarterly financial accounts compiled by the Bank of Finland, net financial assets totalled EUR 69 billion at the end of the year, up by over 7%, year-on-year. Although liabilities increased relatively faster than receivables, the larger amount of financial assets enabled an increase in net financial assets in terms of euro. The value of households' financial assets[2] increased to EUR 147 billion at the end of 2006, up by EUR 14 billion on the year-earlier period (Chart 1).

Chart 1. Households' financial assets, 2000Q1–2006Q4



Source: Bank of Finland.

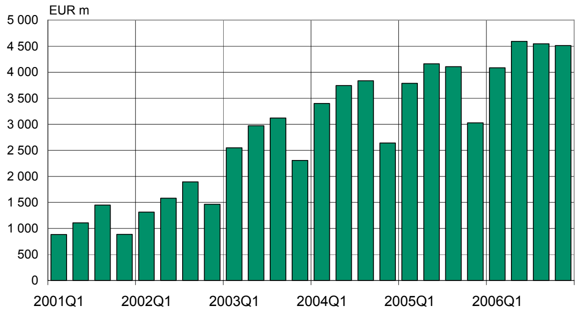
Households accumulated a diversity of financial assets. Deposits continued as the largest item, despite a 3 percentage point decline, to 38%, as a proportion of total financial assets. This was partly due to the abolition of wealth tax. In previous years, wealthy households sold some of their money market fund shares just before the end of the year and temporarily invested the income mainly in short-term deposits to avoid the wealth tax. With the removal of the tax, this tactic became unnecessary, which contributed to an

[1] Does not include non-profit institutions serving households (NPISH).

[2] Quarterly data published by the Bank of Finland do not include unquoted shares and other equity or other accounts receivable due to a lack of data sources.

increase in fund investments and a decrease in deposits compared to year-end 2005 (Chart 2).

Chart 2. Households' holdings of money market fund shares



Source: Bank of Finland.

Households' holdings of quoted shares increased by EUR 4 billion, due entirely to favourable share price developments, as households' net equity investments were virtually nil. Households thus invested 'new money' in the securities markets indirectly via mutual funds and unit-linked insurance, instead of direct equity investments.[3]

Growth in household indebtedness declined slightly on the previous year. Robust demand for housing loans however boosted the annual rate of growth of household loans to 12.7%. Of total household credit (EUR 78 bn), 98% – virtually all of it – is granted by MFIs.

Statistics on instant loans (a subject of public debate) are not available. They are estimated to account for only a minor share of households' total debt. Instant loans may nevertheless have a major impact on the financial situation of an individual household.

Non-financial corporations' debt financing (loans and debt securities) grew moderately in 2006, by 4.4%, year-on-year, which partly reflects non-financial corporations' good profitability and robust internal financing. Financial accounts show that non-financial corporations' liabilities grew mainly due to rising share prices.[4]

Finnish mutual funds (incl. money market funds) continue to be extremely popular. Fund assets grew by 37% in 2006, at nearly the same rate as in the three previous years. As in previous years, ca two-thirds of the growth was accounted for by net subscriptions and one-third by changes in value. Mixed funds and fixed-income funds gained in popularity, at the expense of equity funds. Although equity funds just barely maintained their position as the most popular fund type, they accounted for only 6% of net subscriptions in 2006.[5]

Insurance saving remained highly popular. Its growth slowed slightly on the previous year, to just over 7% in 2006. Unit-link insurance accounted for an increasing proportion of insurance savings: at year-end 2006, they accounted for 28% of total insurance savings, which is nearly double the amount of three years earlier.[6]

[3] See Financial Markets Report 1/2007, p. 4–5.

[4] In financial accounts, quoted shares are entered under liabilities even though, unlike liability items, they do not carry repayment obligations.

[5] Source: Statistics Finland's statistics on mutual funds.

[6] Source: Federation of Finnish Financial Services' statistics on insurance savings.

1.2 Narrowing of euro area banks' margin on loans came to a halt in 2006

Laura Vajanne

The narrowing of margins of euro area MFIs new business on loans seems to have come to a halt and they have remained at the level of early 2006. The persistent squeezing of margins ended around the time that Eurosystem key interest rates and market interest rates went on the rise. With the introduction of Basel II, the margins on loans for house purchase narrowed while margins on small loans to non-financial corporations widened.

In the euro area, the narrowest margins are on loans for house purchase and large loans to non-financial corporations.[7] The average margin on new business on loans for house purchase with floating rates is 0.6 percentage point.[8] In Finland, France and Ireland, for example, the margin on loans for house purchase is narrower than the average.

The narrow margins on loans for house purchase indicate that competition among lenders is tight in the countries of the monetary union. This competition is mainly between domestic banks rather than on a cross-border level. It appears that in many euro area countries loans for house purchase have become a means for attracting new customers for banks. The narrow margin on loans for house purchase is partly explained by the other banking services linked to the loan agreements, which are priced to compensate for possibly narrow margins on loans. The small margins also reflect favourable risk ratings on loans for house purchase under the Basel II capital adequacy requirements.

Another heavily-competed lending area for euro area banks (in terms of interest rate margin) is large loans to non-financial corporations (exceeding EUR 1 million). The margin on these loans is ca 0.75 percentage point.[9] The margin on new business loans to non-financial corporations has shrunk only slightly in recent years. This suggests that banks have been competing on large loans to non-financial corporations for quite some time and have already pushed the margins to a low level. In Finland, the margin on these loans is at the average level for the euro area. The margins are most favourable in Italy, Belgium, and Austria.

The margin on smaller loans to non-financial corporations is significantly higher than on larger ones. In most countries the margin is 1 to 1.5 percentage points (euro area average: 1.4 percentage points). Basel II may have caused some pressure to expand margins on loans to non-financial corporations, due to increased capital requirements on risk-weighted corporate loans.

The margin on households' consumer credit has most clearly narrowed.[10] The margin on consumer credit has also had the most room for downsizing. In 2003, the average margin on such loans was 4.5

[7] A national breakdown of MFI interest rates on key loan and deposit items are issued on the website of the ECB and the euro area central banks. The monthly series is available up to 2003.

[8] The margin on a loan for house purchase with variable interest rate is the difference between the interest rate on the loan and the 12-month Euribor.

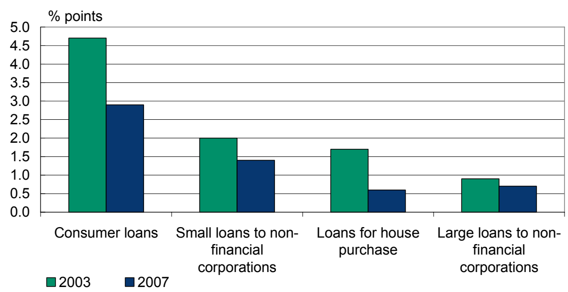
[9] Versus the 3-month Euribor.

[10] Examination of consumer credit covers loans that have interest rates fixed up for 1–5 years, and the margin is calculated relative to the interest rate on the 2-year Eurobond. A country-specific breakdown of interest rates on other consumer credit is not available.

percentage points, while in early 2007 it was ca 3 percentage points. In addition to Finland, smaller-than-average margins are found in Germany, Austria, and Luxembourg.

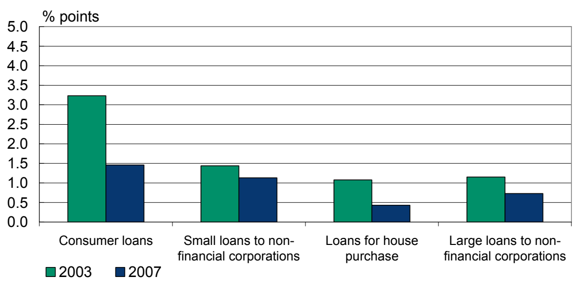
Profitability of the euro area banking sectors has been good in recent years, and the downward trend in margins has not weakened it. The 'favourable pricing' of bank loans has supported growth in loan volumes in several countries. In many euro area countries, growth has been rapid in loans for house purchase. Growth in bank loans to non-financial corporations has also picked up significantly in recent years. The growth rate of loans has been particularly rapid in euro area countries that have seen a definite pick-up in economic activity.

Chart 3. Average margin on euro area MFIs' new business on floating-rate loans



Source: European Central Bank.

Chart 4. Margin on Finnish MFIs' new business on floating-rate loans*



* Margin on loans for house purchase is calculated using the weighted average of the 12-month Euribor and prime rates.

Source: Bank of Finland.

1.3 Proportion of indebted households highest at the high income levels

Hanna Putkuri

The bulk of household debt is held by households with high levels of income. Debtors with the highest income also have greater wealth than other debtors.

The Finnish household sector's debt ratio – debt relative to annual disposable income – stood at a record 97% at the end of 2006. The ratio is a measure of average household indebtedness and it is used to indicate the financial burden of indebtedness. The debt ratio for the entire sector is, however, a very rough indicator because only one in two households has debt.[11] Income and assets are also distributed very unevenly among households. It is therefore important to examine indebtedness also based on household-specific data. The following examination is based on data from the latest wealth survey by Statistics Finland in 2004.[12]

Disposable income is a key factor affecting a household's borrowing and repayment capacity. In the following, households are divided into five equal-size groups so that quintile I comprises households with the lowest disposable incomes and quintile V households with the highest disposable incomes. In the two highest income quintiles about two-thirds of the

[11] The proportion of indebted households was in February 2007 the same as in spring 2003 (Federation of Finnish Financial Services, survey on saving and the use of credit, spring 2007).

[12] The data covers 3,455 households. The results are generalised by a household-specific weighting coefficients to represent all Finnish households.

households have housing, consumer or study debt, but very few consider themselves overindebted (Table 1). In the lowest income quintiles, the proportion of indebted is clearly lower, but a larger proportion of indebted suffer from overindebtedness. The highest median debt ratio is found in households in income quintile IV.

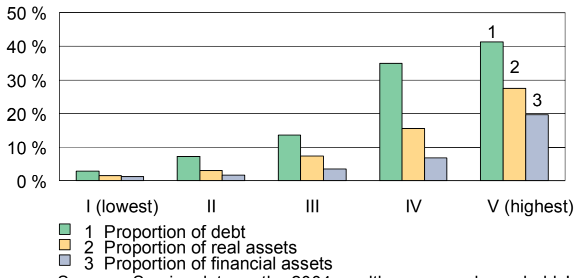
Table 1. Proportion of indebted and overindebted households and typical debt ratio by income category in 2004

Income quintile	*Proportion of indebted households*	*Proportion of overindebted of indebted**	*Debt ratio of indebted ***
I (lowest)	*27 %*	*23 %*	*61 %*
II	*38 %*	*15 %*	*34 %*
III	*52 %*	*8 %*	*42 %*
IV	*70 %*	*6 %*	*89 %*
V (highest)	*67 %*	*2 %*	*81 %*
I–V	*51 %*	*8 %*	*64 %*

** Debt exceeds capacity to service debt, household's estimate.*
*** Debt, % of disposable annual income, median.*
Sources: Service data from the 2004 wealth survey on households' assets by Statistics Finland and Bank of Finland calculations.

Over 40% households' total debt is in the highest income quintile. The indebted in the highest income quintile also hold 27% of real assets[13] and 20% of financial assets (Chart 5).[14]

Chart 5. Indebted households' share of total household debt and assets by income category in 2004



Sources: Service data on the 2004 wealth survey on households' assets by Statistics Finland and Bank of Finland calculations.

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[13] Dwellings, transport vehicles, durable goods, and forest.

[14] As the examination only covers indebted households, the proportions of wealth do not sum to 100% over all income categories.

2 Banks and insurance corporations

2.1 Rapid growth in net interest income

Hanna Putkuri

Rising interest rates and continued strong demand for credit boosted banks' results for the first quarter of 2007, compared to the year-earlier period. Both profitability and cost efficiency improved. The majority of banks believe that they will post better results in 2007 than in 2006.

In the first quarter of 2007 a major structural change took place as Sampo Bank Group became a subsidiary of the Danske Bank Group on 1 February. In addition, Aktia Group commenced insurance operations on 17 January 2007 when Veritas Life Insurance Company Ltd became its subsidiary.

Banks' pre-tax results for the first quarter of 2007 improved on the corresponding period of 2006. The total operating profit of the Finnish banking business (see Table 2) grew by 16%, to EUR 499 million. The improved performance was based mainly on the rapid growth of net interest income.

Growth of net interest income was supported by rising market interest rates and continued strong demand for credit. Bank of Finland statistics[15] show that deposit banks' stock of euro-denominated loans to non-MFIs was in the first quarter of 2007 on average 10% higher than in January–March 2006. The volume of deposits also increased rapidly, and the improved deposit margin had a positive impact on growth in net interest income.

Developments in other income were mixed. Net fee income increased as a result of continued robust demand for loans and various types of saving and investment products. In contrast, net investment income and net trading income declined at many banks. Comparisons are however hampered by non-recurring items.

Expenses increased at a moderate and clearly slower rate than income. As in 2006, growth in expenses was mainly due to increased business operations and rising wages and performance-linked bonuses.

Net loan losses and other impairment losses remained moderate. For many banks, recoveries exceeded new loan losses.

Banks' capital adequacy remained good on average. Many banks for the first time published capital adequacy ratios based on the Basel II framework.

[15] Financial Markets – Statistical Review 5/2007.

The total operating profit of financial conglomerates operating in Finland grew in the first quarter of 2007 by 9%, to EUR 1,927 million. Insurance business was the key factor behind the improved results for two conglomerates. For the OP Bank Group, total operating profit for life and non-life insurance was EUR 25 million higher than in the first quarter of 2006. Insurance business boosted Aktia Group's net operating profit by EUR 10.4 million.

Table 2. Key items from banks' income statements in January–March 2007

	Net interest income		Other income, net		Total expenses		Operating profit	
	EUR m	Change	EUR m	Change	EUR m	Change	EUR m	Change
Nordea Group	1 004	8 %	870	5 %	992	6 %	895	5 %
Retail banking	817	7 %	470	1 %	686	4 %	636	3 %
Retail banking in Finland	237	14 %	130	6 %	165	2 %	224	26 %
Life insurance	-	-	70	0 %	39	0 %	31	0 %
Danske Bank Group	768	14 %	706	3 %	787	8 %	710	10 %
Banking	663	14 %	375	1 %	615	4 %	446	20 %
Banking in Finland*	72	7 %	38	14 %	79	32 %	32	-21 %
OP Bank Group	244	21 %	313	4 %	289	4 %	246	16 %
Banking and investment services	244	18 %	161	-4 %	197	0 %	184	11 %
Non-life insurance	-	-	101	9 %	70	0 %	31	33 %
Life insurance	-	-	52	33 %	16	-20 %	36	92 %
OKO Bank Group	26	0 %	152	3 %	114	10 %	65	-6 %
Savings banks (excl. Aktia)	38	27 %	12	-9 %	29	4 %	22	38 %
Aktia Savings Bank plc (Group)	21	-1 %	52	352 %	50	146 %	22	78 %
Retail banking	15	-5 %	8	19 %	17	12 %	6	-20 %
Life insurance	-	-	44	-	39	-	4	-
Local cooperative banks	26	26 %	7	-16 %	18	0 %	15	36 %
Bank of Åland plc (Group)	9	13 %	9	27 %	10	12 %	8	28 %
Evli Bank Group	0	-67 %	17	27 %	12	-2 %	3	191 %
eQ Group	2	73 %	11	4 %	8	17 %	5	-1 %
1. Finnish banking business	643	15 %	393	2 %	535	5 %	499	16 %
2. Financial conglomerates operating in Finland	2 112	12 %	1 997	6 %	2 195	8 %	1 926	9 %

Other income includes eg net fee income, capital gains/losses from sale of tangible and intangible assets, ans shares in profits/losses of associated companies.

Expenses include depreciation and write-downs on tangible and intangible assets.

The various items do not equal operating profit, as some profit and loss account items are not included in the table.

The percentage change was calculated on corresponding figures for 2006.

* Includes the Group's branch office in Helsinki, and Sampo Bank Group's banking business in Finland in February–March. The percentage change was calculated on comparable (pro forma) figures for the first quarter of 2006.

1. Includes savings banks, Aktia Group's retail banking business, local cooperative banks, Bank of Åland Group, Evli Bank Group, eQ Group, OP Bank Group's banking and investment services, Danske Bank Group's banking business in Finland, and Nordea Group's retail banking in Finland.
2. Includes Finnish banking and financial groups, Danske Bank Group and Nordea Group.

Source: Banks' interim reports.

2.2 Will the period of small loan losses continue?

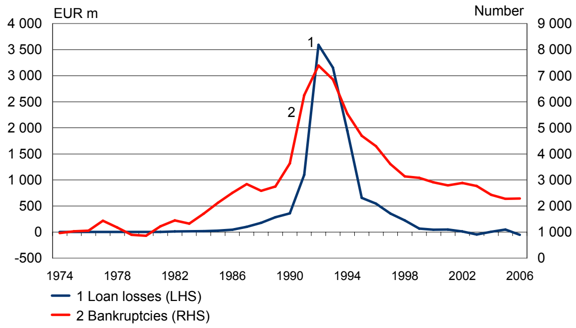
Jarmo Pesola

The amount of banks' loan losses has been extremely small throughout the current decade. This clearly contrasts with the situation in the early 1990s recession and banking crisis when loan losses at worst amounted to nearly 5% of banks' stock of lending. The low level of loan losses is not only a Finnish phenomenon. Instead it has become almost global in recent years.[16] The situation does not seem to be changing in the short term.

Loan losses or impairment losses on loans and other receivables arise when there is objective evidence that the value of the receivables item or group of items has decreased. Several kinds of events can result in loan losses, the most significant being debtor bankruptcy. The bank may however, later, eg as the result of liquidation of the enterprise in bankruptcy, recover some of its assets previously recorded as loan losses. These recoveries reduce the final net loan losses. The Finnish banking sector thus recorded in 2003 and 2006 negative net loan losses because recoveries exceeded gross loan losses.

Loan losses are a manifestation of realised credit risk. Loan losses can be predicted by monitoring developments in banks' nonperforming assets as well as the number of bankruptcies filed and new payment defaults (Annex Chart 77 and 76). Useful anticipatory indicators also include credit risk measures based on market information such as yield spreads (Chart 73), volatility in asset values and distance-to-default indicators.

Chart 6. Banks' net loan losses (EUR m) and number of corporate bankruptcy proceedings instituted in Finland, 1974–2006



Source: Statistics Finland.

The history of loan losses in Finland can be divided into three periods (Chart 6). The first period, which ran up to the late 1980s, was a period of low loan losses. In an environment of strictly regulated financial markets it was relatively easy to avoid large loan losses. The deregulation of financial markets progressed step by step in the 1980s. Bank lending was liberalised and borrowers adapted to the new situation by rapidly incurring debt. As a result, corporate bankruptcies and loan losses started to increase.

Indebtedness increased debtors' fragility and thus credit risks. Unfortunately, a series of external macroeconomic shocks hit Finland in the early 1990s. The combined effect of fragility and macroeconomic shocks pushed the Finnish economy into a recessionary spiral. This resulted in explosive growth of corporate bankruptcies and loan losses, and a banking crisis. The banking crisis brought notable changes eg in the structure of the banking sector. The share of households in banks' loan losses remained below 10% in the crisis years.

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[16] International Monetary Fund: Global Financial Stability Report, April 2007; and European Central Bank: Financial Stability Review, December 2006.

As the recession slowly began to draw to an end, bankruptcies and loan losses began to recede and banks' capital adequacy improved. At the turn of the century, banks' reached the current low level of loan losses.

Will banks be able to maintain this minimal level of loan losses or are they sowing the seeds of trouble, as often happens in good times?

Anticipatory indicators do not point to any deterioration in the situation in the short term. Moreover, eg stress tests show that banks' risk-bearing ability is good.[17] In addition, the new Basel II capital adequacy framework enhances banks' pricing of credit risks and strengthens risk buffers. On the other hand, banks have shifted risks away from the banking sector, and there is no certainty that these risks will not eventually hurt the banks also.

Nowadays financial markets also efficiently absorb small disturbances, as a result of improved diversification of risks. However, one cannot rule out the possibility that an exceptionally large and widespread shock could alter the situation so that spreading of disturbances through contagion channels would suddenly strengthen.

[17] Bank of Finland: Financial Stability Report, 2006.

3 Securities markets

3.1 Listed exchanges have been good investment objects

Pertti Pylkkönen

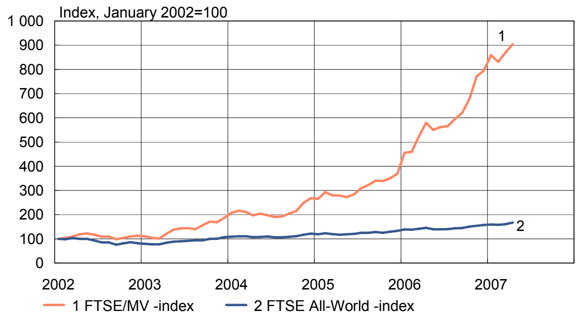
Listed exchanges' have posted good results in recent years and their share prices have risen significantly more than share prices on average.

The listing of exchanges began in spring 1987 when the Stockholm Stock Exchange became a listed company. The next significant listing took place in autumn 1998, when the Australian Stock Exchange went public. A more extensive wave or listings began at the start of the current decade when increasing numbers of stock and derivatives exchanges in Asia, Europe and the United States demutualized or otherwise converted to listed companies[18]. The number of publicly listed securities exchanges is already close to 20.

Another important sign of developments in exchanges, in addition to public listing, is the mergers and planned mergers of marketplaces. In Europe, the most significant developments have been the launch of Euronext in 2000 and the merging of Nordic exchanges under the OMX brand. Euronext merged in spring 2007 with the New York Stock Exchange. In May the boards of directors of Nasdaq Stock Market Inc. and OMX AB announced their plans to combine the two companies. If the merger materialises, the new Nasdaq OMX Group will list nearly 4,000 companies, with market capitalisation of more than USD 5 trillion.

Six listed exchanges currently operate in Europe.[19] European exchanges that have listed are characterised by increased efficiency and clear improvements in profitability. This is reflected also in the strong performance of share prices quoted on the exchanges. In the past five years, these prices have risen considerably faster than the average rate.

Chart 7. Index of listed exchanges and the global index



Source: Bloomberg.

The operating strategies of listed exchanges differ considerably and the main source of income varies.

[18] IOSCO: Regulatory Issues Arising From Exchange Evolution. Final Report, November 2006.

[19] BME (Bolsas y Mercados Espanoles), Deutsche Börse, NYSE Euronext, Hellenic Exchange (Athens), London Stock Exchange, and OMX .

Some of the exchange operators also own a central counterparty (CCP) or a central securities depository, in which case these operations may account for a notable share of the exchange's total income, as is the case with Deutsche Börse (owner of the Frankfurt Stock Exchange).

For example, a considerably larger proportion of the London Stock Exchange's (LSE) income comes from the money flow generated by new listings. The number of new listings is considerably larger on the LSE (incl. AIM, a marketplace for smaller companies) than in continental Europe. Equity trading and selling market information are other key sources of income for the LSE. The LSE does not own a central securities depository or central counterparty.

For some exchanges, eg the Swedish OMX, IT functions and services related to exchange business account for a considerable proportion of total income. The Deutsche Börse Group and Euronext Group are other key providers of IT services.

The stock markets' long-standing strong undertone has contributed to the continued improvement in profitability of the exchanges. Stock market turnover has increased rapidly everywhere as a result of large numbers of new and active operators, such as hedge funds. New trading technologies have also improved market liquidity and boosted the exchanges' income.

In addition to growth in income, the exchanges have succeeded in curbing costs. For example, the cost-to-income ratio improved for all European listed marketplaces.

Table 3. Cost/income ratio (%) of selected exchanges

	2005	**2006**
Athens	*45*	..
BME	*38*	*34*
Deutsche Börse	*66*	*55*
Nasdaq	*47*	*27*
NYSE Euronext	*67*	*63*
London Stock Exchange	*71*	*50*
OMX	*71*	*68*

Sources: Exchanges' annual reports.

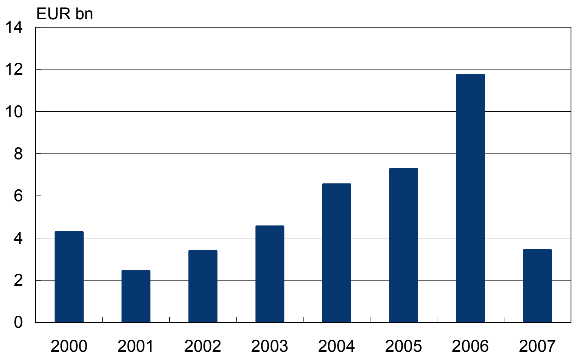
3.2 Growth of equity funds comes to a halt

Pertti Pylkkönen

The growth of Finnish mutual funds in 2006 was among the fastest in the EU – even as equity funds have stopped growing.

Finnish mutual funds continue to grow robustly. At year-end 2006, assets of Finnish mutual funds totalled about EUR 61 billion, after growing by over a third on 2005. Net subscriptions accounted for a major share in the asset growth (EUR 16 bn): new investments totalled over EUR 12 billion.

Chart 8. Domestic mutual funds' net subscriptions, 2000–4/2007



Sources: Helsinki Stock Exchange and Finnish Association of Mutual Funds.

Growth of Finnish funds' assets was among the fastest in the EU. Only in Poland was the growth faster.

In January–April, Finnish funds' assets continued to grow at a rapid pace. Fund assets have grown by EUR 5 billion, to over EUR 66 billion, in 2007. Net subscriptions account for nearly EUR 3 billion of the growth. About half of the net subscriptions were in money market funds. In the first quarter of 2007, net withdrawals from equity funds totalled over EUR 40 million.

There were no major changes in holdings of fund units in 2006. Households still hold about a fourth, ie EUR 15 billion, of domestic fund units. Life and non-life insurance corporations accounted for a fifth of fund investments at year-end 2006. Other key domestic fund investors include non-financial corporations and various types of financial institutions. These investor groups hold over 11% of fund assets. Foreign investors' holdings of Finnish funds' assets continues to increase moderately, and accounts for over 13% of the total. The majority of investments come from outside the euro area, mainly from Sweden.

At year-end 2006, about 70%, ie over EUR 40 billion, of domestic funds' investments were in the international financial markets. Half of the investments were in the euro area and half elsewhere.

Currently, 27 fund management companies operate in Finland, managing about 500 different funds. Half of the funds are equity funds. Finnish equity funds are small by international standards; their assets amount to less than EUR 100 million on average.

Of Finnish households' financial assets (EUR 147 bn), 13% is invested in fund units. In 2000, fund investments accounted for only 5% of households' financial assets.

Amendments to the Mutual Funds Act took effect on 1 May 2007. The Act was supplemented with provisions on special mutual funds investing mainly in real-estate and real-estate securities. The act on real-estate funds was supplemented with provisions on limited partnerships.

3.3 Can Project Turquoise challenge the securities exchanges?

Emilia Koivuniemi

The Markets in Financial Instruments Directive (MiFID) will take effect in November 2007. But its impacts are already evident. One of them is Project Turquoise which, if realised, could create competitive pressures among securities exchanges.

Project Turquoise has progressed unnoticed and has met with more scepticism than support. The project was initiated by seven large investment banks: Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, Merril Lynch, Morgan Stanley, and UBS. The aim is to create a multi-lateral trading facility (MTF) that would compete with the London Stock Exchange and other national exchanges in the euro area. The plan is to launch the trading facility in November 2007, when the MiFID comes into effect.

The MiFID enables the creation of cross-border multi-lateral trading facilities among member states adopting the directive as domestic trades no longer have to be reported in the local stock exchanges. Project Turquoise provides banks, fund managers and other investors a trading platform that is independent of national stock exchanges.

Investment banks' silent approach to Turquoise has not assured market participants, many of which doubt the feasibility of the project[20]. The general opinion is that the project's timetable is overly ambitious. Stock exchanges have dismissed the project as mere threats, due to the fact that in the past nine years, seven similar projects have been launched in Europe, none of which has threatened the position of national stock exchanges.[21]

This spring, however, the investment banks behind Project Turquoise took a significant step towards implementing the project, after having selected EuroCCP[22] as provider of the clearing and settlement solution for the project[23]. EuroCCP will partner with Citigroup's Global Transaction Services as its settlement agent[24]. Finding the right service solution was expected to be the most difficult part of the project[25].

EuroCCP will provide the project with a pan-European clearing and settlement solution based on a single platform. This decision supports the aim of Turquoise to considerably cut the clearing and settlement costs of equities trading.

A technology provider was sought that would guarantee a reliable infrastructure, entry to the European clearing and settlement network, and reasonable prices. The plan is that the clearing and settlement solution would operate at cost price, ie all income exceeding operating costs will be refunded to

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[20] Cohen, Norma, 'Turquoise reality being fleshed out', Financial Times, 19 April 2007, www.ft.com

[21] Pfeifer, Sylvia and Roberts, Dan, 'We're on our way to global exchanges', Sunday Telegraph, 18 November 2006, www.telegraph.co.uk

[22] European Central Counterparty Ltd is a subsidiary of the Depository Trust & Clearing Corporation (DTCC). It is located in London, and it is supervised by the Financial Services Authority (FSA) of the United Kingdom. Like Project Turquoise, the DTCC and its subsidiaries are owned and managed by its users.

[23] 'Project Turquoise banks select EuroCCP for clearing and settlement', Finextra, 18 April 2007, www.finextra.com

[24] 'Project Turquoise appoints EuroCCP and Citigroup as its clearing and settlement agents', The Trade News, 18 April 2007, www.thetradenews.com

[25] See footnote 19.

the members. EuroCCP also intends to sign the European Code of Conduct on Clearing and Settlement of European securities exchanges and central securities depositories, which was prepared by the European Commission and infrastructure operators in November 2006.

A multi-lateral trading facility will exert some leverage over stock exchanges currently holding a monopoly position. It is expected to affect particularly the position of the London Stock Exchange. According to some sources, the aim of Turquoise is to pressure securities exchanges into lowering fees and adjusting their cost structure either directly or indirectly by merging with other exchanges[26]. Providing scant information about the progress of the project was probably a strategic choice.

The aims of the project are similar to those of the Code of Conduct, which took effect in December 2006 because it also is designed to increase transparency and comparability of prices and services and thus reduce prices and promote competition.

It terms of competition, it is essential that Project Turquoise not lead to a new monopoly but rather to increased efficiency. The total trading volume of the banks that launched Turquoise accounts for 50% of the equities trading volume in Europe[27]. If the banks behind Turquoise succeed in attracting all that volume to the new trading platform, it will become a major new competitor in the field

[26] McDowall, Bob, 'The technology challenges in building new exchanges', IE4C, 22 November 2006.

[27] See footnote 19.

3.4 Eurosystem launches consultation on collateral management – will CCBM2 be implemented in parallel with T2S?

Kristina Rantalainen

Integration of the euro area's financial market infrastructure is moving ahead. The collateral management procedures for Eurosystem credit operations will be reviewed, on the basis of the TARGET2 payment system and TARGET2-Securities (T2S) initiative. The changes in collateral management arrangements will be made in parallel with implementation of the T2S project. The reform will enhance central banks' liquidity management.

In April 2007, the Governing Council of the European Central Bank decided to review the collateral management procedures for Eurosystem credit operations.[28] The focus of the review is the current system for handling cross-border collateral, in particular the Correspondent Central Banking Model (CCBM)[29]. The aim is to develop a single platform for managing both domestic and cross-border collateral in the form of securities and bank loans.

The CCBM was originally designed as an interim solution prior to links between central securities depositories. The purpose of the system is to ensure

[28] Http://www.ecb.int/ecb/cons/html/t2securities.en.html

[29] The new arrangement will be called Collateral Central Bank Management (CCBM2).

smooth implementation of the single monetary policy and the soundness and efficiency of payment systems.

Use of the CCBM has increased steadily since 1999. The biggest problem is that the system has been implemented by national central banks through highly-differing internal arrangements. The process of handling collateral varies from manual to highly-automated[30], and procedures are not standardised. All this affects the speed of executing transactions and raises costs.

The purpose of CCBM2 is to increase the efficiency of collateral management, to remove shortcomings caused by lack of standardisation, and to enhance liquidity management for market participants and payment system users.

Harmonisation of procedures and communication tools will remove the barriers to financial market integration identified by the Giovannini Group[31].

The CCBM2 will provide a wider range of collateral management services than the current CCBM. It is intended that CCMB2 will enable management of all types of securities eligible as collateral:

- domestic and cross-border collateral
- collateral managed by pool pledge or repo technique.

The management of customers' liquidity is enhanced by the real-time processing of collateral and the highest possible level of STP[32].

The ECB is inviting market participants to contribute on the definition of the user requirements for this new arrangement by 27 June 2007. The new system will be based on existing systems such as that of the Nationale Bank van België/Banque Nationale de Belgique and De Nederlandsche Bank[33]. The new system will be developed in parallel with the TARGET2-Securities project, to exploit synergies and avoid overlaps.

[30] The Bank of Finland's collateral management system was among the most advanced when Finland joined the economic and monetary union in 1999.

[31] The group established in 1996 and headed by A. Giovannini focuses on identifying barriers hampering the development of financial markets and finding ways to remove the barriers. In its report published in 2003 the group presented 15 barriers to the integration of clearing and settlement.

[32] Straight-Through Processing; the automated processing of transactions, with as few manual stages as possible.

[33] Http://www.ecb.int/ecb/cons/html/t2securities.en.html

4 Infrastructure

4.1 National SEPA migration plan

Timo Iivarinen

The Finnish banking community on 16 May 2007 published a new version of the national SEPA migration plan. The SEPA project will mostly impact banks' own operating methods.

The European Payments Council (EPC), the European Central Bank and national central banks in the euro area have agreed that national banking communities should prepare a national SEPA implementation and migration plan to facilitate the realisation of a Single Euro Payments Area (SEPA). Version 2 of the national implementation and migration plan in Finland was published on 16 May 2007 by the Federation of Finnish Financial Services. The Bank of Finland participated in drafting the plan, as part of its financial market oversight duties.[34]

The first version of the plan was published over a year ago (on 15 March 2006). The second version of the plan provides a better overview of banks' plans. The national plan covers the basic payment services: credit transfer, direct debit, and payment cards.

SEPA credit transfers will be provided as of 1 January 2008. New payment cards have to be issued; banks are obliged as from 1 January 2008 to distribute to their customers payment cards that are accepted throughout the euro area. Domestic debit cards will not be accepted after 2010.

The European direct debit scheme will be introduced only after the recently adopted Payment Services Directive has been incorporated into national legislation, probably in late 2009. Finnish banks consider the European direct debit scheme to entail many risks. Thus the Finnish banks anticipate that the Finnish direct debit scheme will be gradually replaced by the e-invoice, so that the European direct debit would not be used for invoicing in Finland. Paying via direct debit invoice will however be possible.

To ensure European-wide transmission of payments, Finnish banks will join the Euro Banking Association's (EBA) STEP2 system, which reaches all European accounts. In addition, in the SEEBACH project, banks are examining clearing and settlement services available for credit transfers. In this project, Finnish banks' objective is to ensure that the level of current domestic payment services is maintained with the introduction of SEPA. Services will still not be fully harmonised throughout the euro area. For example, the reference standard used in Finland is a uniquely Finnish solution. Finnish banks are nonetheless actively promoting the creation of a pan-European reference standard.

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[34] Matti Louekoski 'SEPA on euron veli' http://www.suomenpankki.fi/fi/suomen_pankki/ajankohtaista/puheet/2007/mlpuhe_16052007.htm (speech in Finnish only).

In interbank payment transfers, a common UNIFI (ISO 20022) standard will be used. The banks also recommend that new data transmission and security procedures be used in communication between banks and corporate customers.

Companies have traditionally transmitted payments via electronic banking software provided by software houses. Banks will thus actively inform software houses about the SEPA-related changes, to speed up the process of making the required changes to their software.

For private customers the changes will be minor, as banks will make the changes to their online banking solutions. In practice, the only SEPA-related change is that customer and bank are identified by the International Bank Account Number (IBAN) and Bank Identifier Code (BIC). This information is in fact already shown on customers' account statements. As regards card payments, banks will provide their customers with new payment cards.

The Finnish banking community has been among the first to prepare a national migration plan. Thus far only about a fourth of the countries have drawn up a plan. The national SEPA Implementation and Migration Plan is available on the Federation of Finnish Financial Services' website (www.fkl.fi).

4.2 Popularity of card payments continues to grow

Kati Salminen

Finns increasingly pay for purchases by various types of payment cards[35]. Banks and Luottokunta, a Finnish credit card service provider, will in the next few years introduce new types of payment cards. Payment flows in the EU continue to grow. The number of outgoing TARGET payments from Finland grew robustly in late-2006, due to new customers.

The number and usage of payment cards have expanded rapidly in Finland in recent years. The number of credit and online debit cards has increased by 15% on average in the past few years, whereas the growth in number of debit cards has almost stopped. With the introduction of a Single Euro Payments Area (SEPA), banks will replace the current debit card with new debit cards in the next few years. These types of account-linked Visa Debit cards are already being used on a trial basis in Finland.[36] The new cards are equipped with a chip, and the payment transactions are authorised via an EMV payment terminal.[37] The aim is to harmonise payment methods in SEPA and improve the safety of payment card usage. At the end of 2006, only 17% of payment terminals in Finland were

[35] Federation of Finnish Financial Services: Statistical data on the banks' payment systems in Finland 1997-2006. http://www.fkl.fi/asp/system/empty.asp?P=2786&VID=default&SID=912667300137797&S=1&C=20779

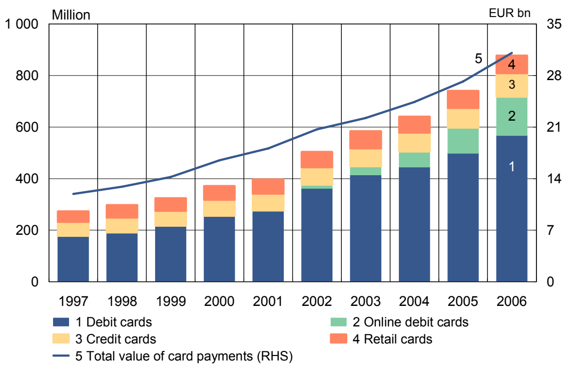
[36] Luottokunta Info 1/2007 (in Finnish only).

[37] EMV is a payment card standard developed by the international credit card companies MasterCard and Visa.

equipped with this new technology. By contrast, an increasing number of cards distributed by banks and Luottokunta are chip cards (with the exception of debit cards).

The use of payment cards increased in 2006 by 19% in numbers, and by 14% in value. Strongest growth was witnessed in the use of Visa Electron. The number of Visa Electron transactions increased by 51% and the value by 45% on 2005. By far the most popular payment card is still the domestic debit card; purchases by debit card account for 65% (in numbers) and for 63% (in value) of total card transactions (Chart 9).

Chart 9. Number of card payments by type of card and total value of payments



Source: Federation of Finnish Financial Services.

The number of customer payments transferred by banks continued to grow steadily. In 2006, the number of transferred transactions was nearly 1.4 billion, of which 96% went from customer to bank electronically. The number of online banking agreements reached 3.9 million, whereas growth in the number of online banking transactions levelled off slightly, to just 2.7%, year-on-year. The use of ATMs continued to decline in terms of all the functions.

The number of credit transfers made by giro ATMs was 35 million in 2006, whereas the number of online banking transactions was over 290 million.

The number of cash withdrawals declined by 6% on the previous year, and the average value of a withdrawal was some EUR 84.

The volume of transactions transferred in the PMJ interbank payment system grew slightly. The daily number of debit transactions (card payment settlements) was 1.3 million, and the daily number of credit transactions (credit transfers) was 0.9 million. In terms of value, credit transactions account for as much as 94% of total transactions transferred via the PMJ.

The daily volume of payments transferred in the Finnish POPS system for interbank online express transfers and cheques has remained broadly unchanged in recent years. The number of transactions nevertheless declined in 2000–2006 by over 35%. Currently, the average daily number of transactions in the POPS system is 2,300 with a daily value of EUR 1.8 billion.

Payment flows in the EU increased steadily in 2006. The volume of payments transferred in the TARGET payment system maintained by the Eurosystem grew by 9% on the previous year in terms of both number and value. Currently, 17 EU countries are connected to TARGET, either directly or indirectly via the TARGET component of another member state. The number of transactions transferred in the BoF-RTGS, the Finnish TARGET component, has grown robustly, particularly the number of cross-border payments since the end of 2006, when a number of new Swedish account holders joined the system. This was due to a decision by the central bank of Sweden to disconnect its TARGET component (Euro RIX-RTGS) at the end of 2006, which led some of its customers shift to the BoF-RTGS system.

The number of payments transferred in BoF-RTGS increased in January–April 2007 by nearly 30% compared to the year-earlier period. The value of payments increased by more than 50%. The daily average number of payments in BoF-RTGS amounted to 2,570 in January–April 2007, with a total value of EUR 41 billion. In 2006, the daily average number of payments was 2,050, with a total value of EUR 22 billion.

Payment flows in STEP2, the retail payment system operated by the Euro Banking Association (EBA) continued to increase rapidly. The number and value of payments transferred in the system grew by nearly 50% in January–April 2007, year-on-year. The system, established in 2003, currently has 107 direct participants and over 1,600 indirect participants globally.[38] The daily number of payments transferred in the system in April 2007 reached almost 375,000, with a daily value of EUR 1.5 billion.

Securities trading grew on 2006: the number of share trades settled in APK's HEXClear system grew by 46% and the value by 36%. In 2006, the number of share trades settled was 9.6 million and the value was EUR 600 billion. Growth in trading volumes has remained strong in 2007. In January–April, the number of trades settled increased by 59% and the value by 20%, year-on-year.

The number of money market transactions continued to decline slowly. The volume of settled money market instrument trades decreased on 2005, by 17% in numbers and 8% in value. In 2006, the number of trades settled was about 14,900, with a value of EUR 135 billion.

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[38] http://www.abe.org/home/page.aspx?ID={DB4ACC57-625E-4C0D-9F33-411F5BB67365}

5 Key corporate arrangements and events in the financial sector

Date	*Event and description*
November 2006	*Sampo Group announces it will sell all the companies that are part of Sampo Bank Group to Danske Bank, for EUR 4.05 billion.*
	Aktia annouces it will acquire Veritas Life Insurance Company Ltd and an 80% stake in Oy Fondex AB (Rahastotori Oy).
	Bank of America announces agreement to acquire U.S Trust Corporation from The Charles Schwab Corporation for USD 3.3 billion.
	Fitch and S&P confirm ratings for Finnish government bonds: Fitch: F1+ and AAA; S&P: A-1+/AAA.
	Moody's downgrades Stora Enso's ratings: short-term from P2 to P3 and long-term from Baa2 to Baa3.
December 2006	*NYSE Group and Euronext shareholders approve merger agreement.*
	Iceland's alternative marketplace ISEC to merge with First North in April 2007.
	eQ Corporation and owners of investment firm Fides agree on a transaction in which eQ Bank purchases Fides' share capital for EUR 6.4 million.
	If P&C Insurance Holdings Ltd is granted a licence to start non-life insurance operations in Russia. If has had a representative office in St Petersburg since 1995.
	Confederation of Finnish Industries, Helsinki Stock Exchange and the Central Chamber of Commerce of Finland establish the Securities Market Association.

Date	*Event and description*
	Pohjola Group Ltd merges with its parent company OKO Bank plc at the end of the year. Pohjola Non-Life Insurance Company Ltd, A-Insurance Ltd, Eurooppalainen Insurance Company Ltd, and the Sesam non-life insurance companies operating in the Baltic states continue operations as subsidiaries of OKO Bank.
January 2007	*Pohjola Non-Life Insurance Company Ltd merges with OP Life Assurance Company Ltd at the start of 2007.*
	Sampo Life merged its subsidiaries operating in the Baltic states into one company, SE Sampo Life Insurance Baltic. The company's domicile is Estonia.
February 2007	*The Swedish bank Swedbank announces it will acquire the Ukrainian bank TAS-Kommerzbank for slightly over USD 700 million.*
	FIM Group Corporation's main shareholders announce they will sell their 68.1% holding of share capital to Icelandic bank Glitnir banki hf. The transaction was finalised in March. At the end of the public tender offer period in May, Glitnir held over 98% of the share capital.
	Acquisition of Sampo Bank by Danske Bank Group was completed at the beginning of the month. S&P raises the bank's short-term issuer rating from A-1 to A-1+, and long-term issuer rating from A to *AA-. Moody's raises the bank's long-term issuer rating from A1* to *Aa2.*
	Moody's revises its bank rating methodology. As a result, Moody's upgrades OKO Bank's and Sampo Bank's long-term credit rating from Aa2 to Aaa. Nordea's (incl. Nordea Bank Finland) long-term credit rating is raised from Aa3 to Aaa. Aktia's short-term credit rating is upgraded from P-2 to P-1 and long-term rating from A3 to Aa2.
March 2007	*Nordea acquires a 75.01% stake in the Russian bank JSB Orgresbank.*
	Policyholder's of Kansa life insurance corporation to receive full compensation plus interest for their insurance premiums in 2007.
	Moody's downgrades M-Real's long-term credit rating from B2 to B3. Rating outlook stable. Also S&P lowered M-Real's long-term credit rating, from B+ to *B; rating outlook remains negative.*
April 2007	*The (25) companies listed on the Icelandic stock exchange become part of the Nordic List.*
	ABN AMRO and Barclays announce their agreement on a possible merger. A consortium formed by Fortis, Royal Bank of Scotland and Santander make a competing offer for the shares in ABN AMRO. In their offer updated in May, the consortium offers EUR 38.40 per ABN AMRO share, while Barclays offers EUR 34.87 per share.

Date	*Event and description*
	Moody's revises bank ratings issued in February. The rating of Nordea Bank Finland's, OKO's and Sampo Bank's long-term senior bonds is lowered from Aaa to Aa1. Aktia is downgraded to A1.
	The New York Stock Exchange and Euronext merge. The name of the new company is NYSE Euronext.
	Life insurance company Duo commences operations. The company was established by the Savings Banks' Group and the insurance group Lähivakuutus.
	The savings banks with a majority shareholding in Nooa Savings Bank redeem OKO Bank's shares in Nooa Savings Bank. Savings banks' holding in Nooa increases to 95%.
	Skandia Life's insurance business, together with all the policies are devolved to Fennia Life Insurance Company Ltd.
	Eurex and International Securities Exchange (ISE) announce they have signed a letter of intent on a merger. Eurex will acquire ISE for ca USD 2.8 billion.
	OMX plans to acquire the Armenian Stock Exchange and the Central Depository of Armenia. OMX, the Central Bank of Armenia and the government of Armenia sign a letter of intent on the acquisition.
May 2007	*The Icelandic bank Straumur-Burdaras Investment Bank hf acquires a majority stake in eQ Corporation, for EUR 260 million.*
	UniCredit SpA acquires Capitalia SpA for EUR 21.8 billion. The new bank will be the largest in Italy and the second largest in Europe.
	Banca Popolare di Milano acquires Banca Popolare dell'Emilia Romagna for EUR 5.7 billion.
	Securities listed on the Luxembourg Stock Exchange migrate to the NSC trading platform provided by Euronext.
	The Oslo Stock Exchange and the central securities depository VPS agree on a merger.
	S&P raises Metso Corporation's short- and long-term credit rating by a grade. Short-term from A-3 to A-2 and long-term from BBB- to BBB.
	Royal Sun & Alliance Insurance Group offers DKK 6.4 billion for the remainder of shares in Codan A/S.
	The boards of directors of Nasdaq Stock Market Inc and OMX AB jointly announce that they have entered into an agreement to combine the two companies.

Date	***Event and description***
	E. Öhman J:or Securities Finland Ltd acquires Quorum Fund Management Company from its parent company Quorum Ltd. The new name of the fund management company is E. Öhman J:or Fund Management Finland Ltd.