



Financial Market Report

3 • 2010

- Increasing rates on fixed-term deposits
- Brighter prospects for domestic banks
- Irish banks getting more capital support
- Identity theft from internet accounts for increasing share of means-of-payment fraud



Bank of Finland

Financial Stability and Statistics

8.11.2010

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Project team

Jarmo Pesola
Eeva Alho
Nina Björklund
Jonna Elonen-Kulmala
Timo Iivarinen
Ilkka Kaukoranta
Kimmo Koskinen
Harri Kuussaari
Jyrki Lehtinen
Hanna Putkuri
Pertti Pylkkönen
Maria Ritola
Maija Salmela
Elina Salminen
Eero Savolainen
Hermann Teräväinen
Jukka Vauhkonen
Hanna Westman

Coordination

Kimmo Virolainen
Päivi Heikkinen
Jouni Timonen

Postal address
PO Box 160
FI-00101 HELSINKI, FINLAND

Street address Snellmanin aukio
Phone +358 10 8311
Fax +358 9 174 872

Email
firstname.surname@bof.fi
www.bof.fi

Swift SPFB FI HH
Business ID 0202248-1
Domicile Helsinki

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1 Financial intermediation

1.1 Interest rates rising on fixed-term deposits

Elina Salminen, Kimmo Koskinen

Fixed-term deposits are again attracting households. The interest rate paid by banks on long-term deposits is higher than market interest rates.

Non-MFI¹ deposits are the most important source of financing for deposit banks operating in Finland. The majority of non-MFI deposits are household deposits. Non-MFI deposits account for ca 75% of deposit banks' non-MFI lending. The stock of non-MFI deposits amounted to EUR 110 billion at end-August, ca 70% of which was accounted for by households.

The financial market crisis further emphasised the importance of deposits, as banks' funding directly from the markets dried up. At the same time, growth in deposits increased sharply. Household deposits are a very stable source of funding for banks, as they are generally subject to only minor cyclical fluctuations.

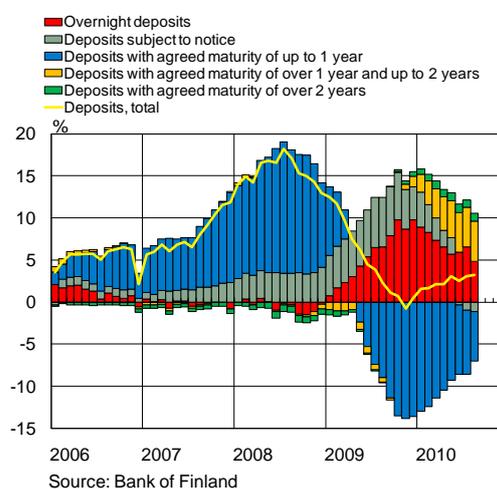
During the financial market crisis, households shifted funds from eg higher-risk instruments, such as equities and investment funds, to safe bank deposits. Attractive interest rates on fixed-term deposits also provided an incentive for depositors.

¹ Non-MFIs are households, non-profit institutions serving households, non-financial corporations, housing corporations, general government, insurance corporations and other financial corporations.

Following the acute phase of the crisis, the stock of household deposits started to shrink in 2009. The popularity of fixed-term deposits weakened considerably with the decline in market interest rates, and funds were shifted to liquid transaction accounts. Households also started to invest in eg investment funds; their net subscriptions increased considerably in 2009. The annual growth rate of total deposits declined sharply towards the end of 2009, and at the end of the year it actually turned negative.

Since the start of 2010, the annual growth rate of household deposits has slowly picked up, reaching 3.9% at end-August (Chart 1). Fixed-term deposits are also again attracting households.

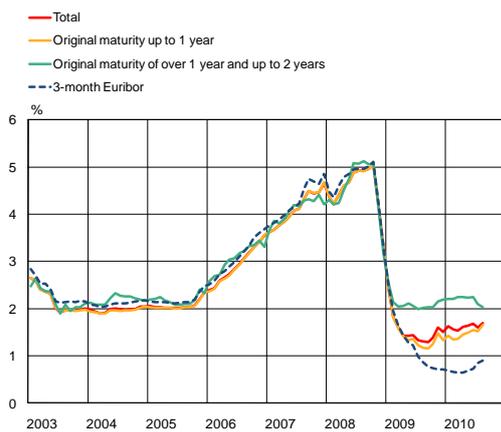
Chart 1. Annual growth of households' deposits, by type



Deposit rates generally move closely in line with short-term market rates, but now there is clear evidence of differentiation (Chart 2). The chart shows the average interest rate on new business on households' fixed-term deposits, and for comparison, the 3-month Euribor. The chart shows that deposit

rates have not fallen as much as market rates. In the past two years, interest rates on new business on fixed-term deposits have risen considerably higher than short-term market rates.

Chart 2. Average interest rates on new business on households' fixed-term deposits



Source: Bank of Finland.

The interest rate on new business on deposits with agreed maturity of over 1 year, in particular, has since the early 2009 been considerably higher than that on short-term deposits and market rates. The interest rate on new business on deposits with agreed maturity of over 1 year and up to 2 years has since the start of 2010 been over 2%.

The average interest rate on deposits with agreed maturity of over 2 years is however lower, at slightly below 2%. This is due to the fact that ca a third of the stock is structured deposits with a relatively low average interest rate. A structured product is a deposit with a low interest rate combined with a tailored derivative for extra yield. The statistics however only reveal the low interest rates on such deposits. Excluding structured products, the average interest rate on new business on deposits with agreed maturity of over 2 years rose in August to 2.34%.

Banks' interest rate spreads on deposits have indeed shrunk rapidly with the decline in market interest rates and competition in deposits. By acquiring

longer-term stable funding, banks are also preparing for new banking regulations² that will increase the role of long-term deposits in banks' funding.

The interest rate on fixed-term deposits has risen not only in Finland but also in other euro area countries, where interest rates on new business on deposits with agreed maturity have started to rise. In the euro area, the pace of rise has even been faster on average than in Finland.

Market interest rates have fallen to exceptionally low levels as a result of the financial market crisis, as the European Central Bank has lowered its key interest rate to 1% and the Eurosystem has lent the banks as much liquidity as they required. Consequently, the shortest Euribor rates have fallen even below the ECB key interest rate. The decline in Euribor rates has a direct impact on banks' net interest income because the spread between deposit rates and market rates is shrinking. The majority of household deposits are in transaction accounts with very low interest rates, leaving little room for interest rate cuts. Banks benefited from these low-interest-rate deposits when market interest rates were higher. The current decline in market rates has eroded some of the benefits.

At the start of the summer, market interest rates were on a slow upward trend, with the liquidity position of the Eurosystem returning to normal. This has reduced the pressure on banks' interest rate spread on deposits³. The spread indeed turned positive in the summer.

² Basel III reform, see Section 5: Key regulatory and supervisory initiatives.

³ 3-month Euribor minus the average interest rate on the stock of household deposits.

1.2 Finland is still a country of short-term reference rates and low interest rates on housing loans

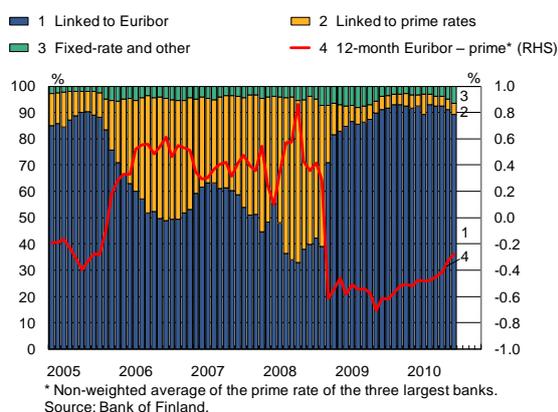
Hanna Putkuri

In Finland, the use of Euribor rates as reference rates for new housing loans has been widespread since the start of 2009. Compared to the rest of the euro area, the portion of floating-rate housing loans is high and the average interest rate on housing loans is low.

New business on housing loans

The majority – ca 90% – of new housing loans granted by Finnish MFIs to households since January 2009 are linked to Euribor rates. The remaining 10% are divided equally between loans linked to banks' own reference rates (prime rates) and fixed-term loans (Chart 3).

Chart 3. Finnish MFIs' new business on housing loans by reference rate



The portion of fixed-rate loans of new business on housing loans has remained virtually unchanged in

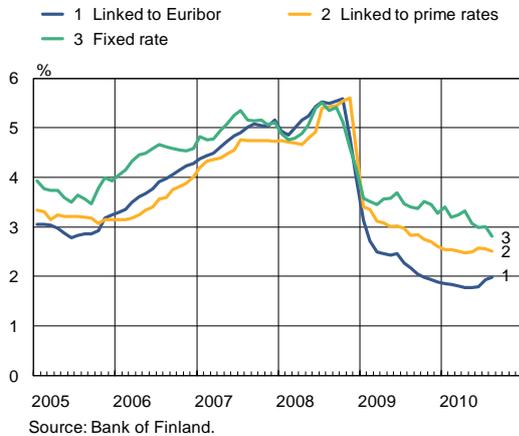
recent years, whereas the popularity of Euribor and prime rates has varied greatly depending on developments in interest rates. The use of prime rates as reference rates in housing loans plummeted in late 2008 when Euribor rates started to decline rapidly. At the same time, the spread between the 12-month Euribor and the average prime rate of the three largest banks operating in Finland turned within one month from positive to clearly negative (Chart 3). Earlier historical developments also show that households react quickly to changes in interest rates and usually favour the lowest rate at the time of signing the agreement.

The popularity of different Euribor rates has also varied over time, but there are no long-term statistical data available. In June–August 2010, of the new business on Euribor-linked housing loans, the majority, over 60%, were linked to the 6- or 12-month Euribor, less than a fourth to the 3-month Euribor, and slightly over 10% to the 1-month Euribor.⁴

In terms of reference rate, the interest rate on new business on housing loans was in August 2.0–2.8%. Fixed-rate loans were the most expensive, but at the same time cheaper than ever in the period under review, ie since 2005 (Chart 4).

⁴ Statistics on reference rates have been more detailed since June 2010 when the Bank of Finland revised the statistical reporting of MFIs.

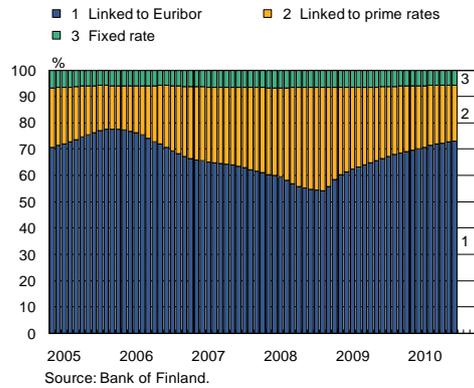
Chart 4. Interest rate on Finnish MFIs' new business on housing loans by reference rate



Stock of housing loans

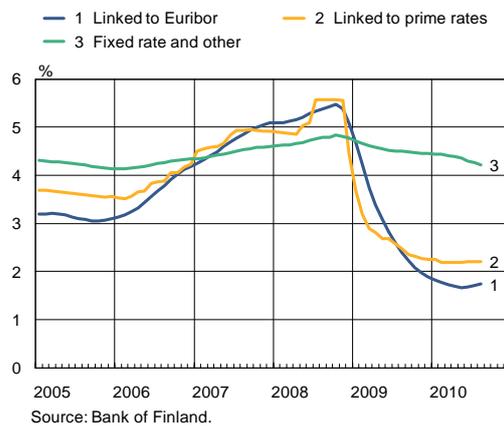
Changes in reference rates and the demand for and supply of loans linked to different reference rates eventually affect also the structure of the stock of housing loans and the average interest rate on different types of loans. The portion of Euribor-linked housing loans in the stock of housing loans has increased steadily since the start of 2009, to ca 73% at-end August 2010. Loans tied to prime rates still account for over one-fifth of the stock of housing loans. The portion of fixed-rate loans and loans tied to other rates has remained virtually unchanged over the years, at ca 6% (Chart 5).

Chart 5. Finnish MFIs' stock of housing loans by reference rate



An examination of the stock of housing loans shows that the average interest rate is lowest on housing loans tied to Euribor rates and highest on fixed-rate loans. At the time of higher market interest rates in 2007–2008, the situation was the reverse: those with fixed-rate housing loans paid the lowest interest rates on average (Chart 6).

Chart 6. Interest rate on Finnish MFIs' stock of housing loans by reference rate

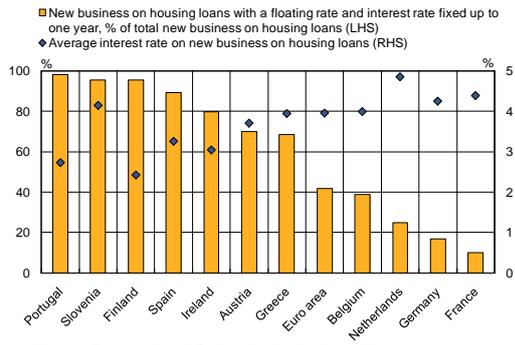


Comparison with other euro area countries

Compared to the other euro area countries, interest rates on Finnish households' new housing loans are among the lowest. This is at least partly due to the use of short-term reference rates. In countries where long-

term reference rates or fixed rates are favoured, the average interest rate on new business on housing loans is higher (Chart 7). In addition, competition between banks, funding costs and banks' risks affect the interest rates on loans, via the loan-specific margins set by banks.

Chart 7. New business on housing loans in euro area and selected euro area countries, 2009



Sources: European Central Bank and national banks' websites.

2 Banks and insurance corporations

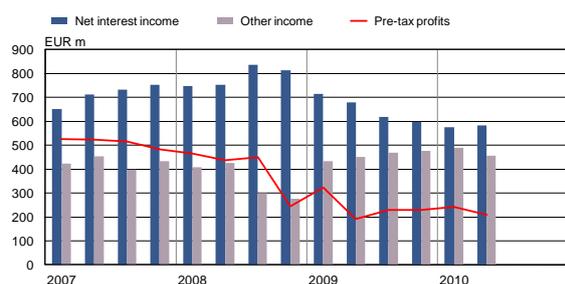
2.1 Domestic banks' near-term outlook is brighter

Eero Savolainen

The financial results of Finnish banking for January–June declined on the previous year, due to sluggish developments in net interest income. The outlook has however improved: net interest income seems to have bottomed out and loan losses have decreased.

The pre-tax profits of Finnish banking for January–June 2010 were 15% lower than in the year-earlier period (Table 1). The low market interest rates were passed on fully to retail rates, and tight competition for deposits and loans squeezed net interest income (Chart 8).

Chart 8. Pre-tax income and profits of Finnish banking



* Nordea's banking operations in Finland, Danske Bank's banking operations in Finland, OP-Pohjola Group's banking and investment services, Aktia's banking business, savings banks, local cooperative banks, Bank of Åland and Evli Bank.
Sources: Banks' interim reports and financial statements, and Bank of Finland.

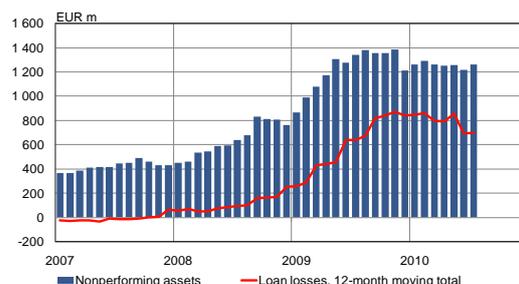
Recent developments indicate that the decrease in net interest income has come to a halt. Interest rate expectations for the next few years, based on interest rate futures are higher than current market interest rates. When market interest rates rise, lending rates

usually rise more than deposit rates, which boosts net interest income.

Other income, particularly net fee income, increased in the first half of 2010, but total income was lower than a year earlier. Growth in expenses was moderate.

Loan losses were in January–June more than a third lower than in the year-earlier period. Annually adjusted they amounted to 0.3% of the lending stock. The quality of loans outstanding is no longer deteriorating: the amount of nonperforming assets has remained at just over EUR 1.2 billion since the end of 2009. The growth in loan losses also came to a halt at the end of 2009. In July, the 12-month moving total of loan losses was EUR 698 million, compared to EUR 841 million for the whole of 2009 (Chart 9).

Chart 9. Deposit banks' nonperforming assets and impairment losses



The figures include Nordea Bank Finland Plc, OP-Pohjola Group central Cooperative, Sampo Bank Plc, Aktia Bank Plc, eQ Bank Ltd, Evli Bank Plc, FIM Bank Ltd, SEB Gyllenberg Private Bank Ab, S-Bank Ltd, Tapiola Bank Ltd, Bank of Åland Plc, local cooperative banks, savings banks, and foreign credit institutions that have branches with deposit bank operations in Finland and that are subject to the reporting obligation.

Source: Financial Supervisory Authority.

Increased corporate funding raised the required amount of regulatory capital in the second quarter. This weakened the capital adequacy of the sector slightly, but the average capital adequacy ratio (14.1 at end-June) was still high. Banks have sufficient regulatory capital, and the quality is good. Tier 1

capital excluding principal loans (*core tier 1* capital), which is the most suitable for covering losses, accounts for over 90% of the banking sector's regulatory capital.

MFIs' volumes have returned to an upward path. The lending stock has been boosted by the pickup in lending to non-financial corporations and housing corporations. In July 2010, the stock of euro-denominated loans grew by 5.0% year-on-year. The rate of growth was even higher for deposits: their annual growth rate in July was 5.4%, compared with 0.6% in January.

Banks' overall margin remained at 1.6% in the first half of the year, but the weight of its components have changed: what banks have lost as a result of narrowing lending margins was offset by wider margins on deposits. The margin for housing loans has narrowed since the start of 2009, which is reflected in the margin for the lending stock, as is the narrow deposit margin.

The majority of the banking groups and financial conglomerates expect results for 2010 to be at least as good as in 2009; some have revised their assessments upwards. Loan losses are expected to decline.

Table 1. Items from income statements of banks operating in Finland, January–June 2010, and changes on the previous year

	Net interest income		Other income, net		Total expenses		Loan losses, net		Profit before tax	
	EUR m	Change	EUR m	Change	EUR m	Change	EUR m	Change	EUR m	Change
Nordea Group	2 484	-7 %	1 980	0 %	2 350	7 %	506	..	1 608	-3 %
Nordic banking	1 887	-5 %	1 273	24 %	1 736	12 %	409	..	1 015	20 %
Banking in Finland	379	-10 %	336	13 %	425	8 %	110	..	180	-22 %
*Nordea Bank Finland Group	578	-9 %	686	-23 %	521	-1 %	167	..	576	-31 %
Danske Bank Group	1 604	-15 %	1 641	-33 %	1 782	-14 %	1 042	..	421	32 %
Banking	1 574	-16 %	749	8 %	1 504	-13 %	1 162	..	-343	..
Banking in Finland	155	-32 %	107	6 %	223	-5 %	25	..	14	..
*Sampo Bank Group	158	-41 %	161	46 %	214	-4 %	13	..	92	..
OP-Pohjola Group	452	-20 %	615	21 %	723	0 %	77	..	266	-5 %
Banking and investment services	418	-21 %	367	4 %	544	-1 %	77	..	163	-40 %
*Pohjola Bank	127	7 %	326	7 %	253	2 %	62	..	139	13 %
Savings banks	67.9	-10 %	36.4	23 %	71.2	5 %	2.5	..	30.6	-10 %
Aktia Group	77.5	8 %	50.7	30 %	78.8	4 %	8.4	..	41.0	137 %
Banking	75.4	9 %	19.7	10 %	49.1	-2 %	8.0	..	38.0	99 %
Local cooperative banks	42.2	-7 %	19.0	19 %	40.7	3 %	2.8	..	17.8	-14 %
Bank of Åland Group	19.9	4 %	29.0	24 %	44.7	27 %	0.1	..	4.2	-85 %
Evi Bank Group	0.8	-64 %	29.4	25 %	27.7	21 %	0.0	..	2.5	-22 %
1. Finnish banking	1 158	-17 %	943	9 %	1 425	3 %	226	..	450	-15 %
2. Finnish financial groups	1 397	-17 %	1 626	-1 %	1 721	1 %	271	..	1 030	-15 %
3. Financial groups operating in Finland	4 748	-11 %	4 400	-13 %	5 118	-2 %	1 638	..	2 391	2 %

Other income includes eg net fee income, capital gains/losses from sales of tangible and intangible assets, capital gains from sales of wound-up operations, and shares in profit/losses of associated companies. Expenses include depreciations and write-downs on tangible and intangible assets, refunds to shareholders and profit distributions to staff.

.. = change not meaningful.

1. Savings banks, Aktia Group's banking, local cooperative banks, Bank of Åland Group, Evi Bank Group, OP-Pohjola Group's banking and investment services, Nordea Group's banking operations in Finland, and Danske Bank Group's banking operations in Finland.
2. Savings banks, Aktia Group, local cooperative banks, Bank of Åland Group, Evi Bank Group, OP-Pohjola Group's banking and investment services, Nordea Bank Finland Group, and Sampo Bank.
3. Nordea Group, Danske Bank Group and the Finnish banking groups listed in this table (excl. Nordea Bank Finland and Sampo Bank).

Sources: Banks' interim reports and Bank of Finland.

2.2 EU-wide stress tests screened banks' sovereign exposures

Eeva Alho

The stress test conducted in the summer revealed that European banks' capital adequacy is good on average and that their direct exposures to European sovereign debt are smaller than feared. The banking system however still has weak parts, and the aim is to strengthen them via restructuring. Government support measures have been set up. The governments have not yet completely exited from earlier support measures.

The resilience of the largest European banks was tested in the summer in a Europe-wide stress testing exercise. The objective of the exercise was to assess the resilience of banks' capital adequacy to larger loan losses and lower asset prices due to a severe global recession. In the adverse scenario, GDP would in 2010–2011 deviate by three percentage points from the EU Commission forecast, interest rates would rise and banks' funding costs would increase. The test imitated possible impacts on the banking system of an escalation of the sovereign debt crisis and a recurrence of the financial market stress seen in 2008 in the course of a fragile recovery. The exercise included 91 banks, representing 65% of the EU banking sector's total assets.

The results were published on an aggregate and bank-by-bank basis for the first time. The average Tier 1 capital ratio would decrease to 8.6% by the end of 2011, from 10.2% at the end of 2009. Seven banks'

Tier 1 capital ratio fell below the minimum target ratio of 6%, with an overall shortfall of EUR 3.5 bn of Tier 1 own funds. The markets were calmed by the fact that European banks' capital adequacy is sufficient on average and that governments are prepared to provide capital support, if necessary. The stress test succeeded in identifying individual banks' exposures and in reducing the loss of confidence in the European banking system as a whole.

The test was failed by one bank in Greece and one in Germany, and five Spanish *caja* savings banks. Several banks just barely passed the threshold, and in many cases, capital adequacy declined rapidly from the level at end-2009. As a result of the macroeconomic shock assumed in the exercise, the Tier 1 ratio of five banks fell below the threshold. The assumed sovereign shock eroded the capital adequacy of those banks that had the largest exposures to Greek, Portuguese, Irish and Spanish sovereign debt.

Spanish, Greek and German banks' Tier 1 ratios declined in the stress exercise more rapidly than that for the EU as a whole. Greek banks' capital adequacy weakened particularly as a result of the assumed upward shocks to Greek government bond yields, resulting in higher loss rates on corporate and retail exposures. The Greek government has announced that it will participate in strengthening banks' capital base by the end of 2010. Restructuring is aimed at resolving the problems of the banking sector, which is suffering from the weakness of the Greek economy and the drying up of funding.

In Spain, nearly the entire savings bank sector has been subject to restructuring. Excess capacity has been reduced and legislative amendments enable savings banks to raise equity capital from the markets. Total assets in the amount EUR 1.2 trillion are subject to mergers, one-third of which have been undertaken

without the support of the public Fund for Orderly Bank Restructuring (FROB).

The resilience of the Spanish savings banks was suspected prior to the stress testing exercise, but markets were also particularly interested in the exposures of the German banking system. The persistent weakness of the regional banks (*Landesbank*) operating as central banks of local savings banks was reflected in the test results. Of the German banks, Hypo Real Estate Holding failed the test. It has announced that it will need EUR 10 billion of additional capital from the Financial Market Stabilization Fund, and the bank's toxic assets will be transferred to an asset management company. Two German banks just barely passed the test. The test results indicate that the regional banks are less resilient to the weakening of macroeconomy than other German banks are. In contrast with the Spanish savings bank sector, the restructuring of the German regional bank system has not been advanced as vigorously.

Sovereign debt exposures

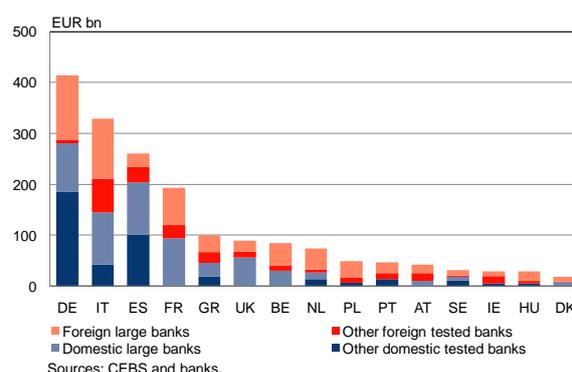
Prior to the stress testing exercise, the markets were fearful of the investment exposures from European government bonds that would be brewing in the banks' balance sheets if a government failed to repay its loan. In terms of limiting market disruptions, the biggest problem is the contagion risks between national banking systems.

Banks' exposures from investments in the government sector turned out to be smaller than expected. On average, European banks' biggest exposures are to the home country sovereign, followed by investments in government bonds of neighbouring countries. Spanish banks, in particular, were subject of

market suspicion, but with the exception of large commercial banks, the exposures are mainly due to lending to the domestic property sector, rather than direct exposures from sovereign debt.

The stress test was conducted at a time when governments had provided major capital support to the banks. The biggest capital injections have taken place in the United Kingdom and Germany. In addition to the direct capital support shown in Chart 1, banks' funding has been supported by loan guarantees and liquidity support.

Chart 10. Distribution of sovereign exposures, gross claims, 31 March 2010



The portion of foreign large banks in the reported total sovereign exposures to eg Greece and Spain is relatively small, and the local banks usually carry the biggest risks. The biggest exposures to Greek, Portuguese and Irish sovereign debt are usually held by banks that have been given the most capital support in Europe. French banks also hold relatively large sovereign exposure positions in investments in government bonds other than the home state. Despite their large sovereign exposure position in absolute terms, a larger portion of Italian and German banks' claims are on their own government.

Table 2. The largest state capital support in the financial crisis in Europe and stress test results

Country	Bank	State capital injections		Tier 1 capital EUR m 2009	Tier 1 ratio, actual 2009	Adverse scenario Tier 1 ratio 2011	Sovereign risk EUR m, claims, gross 3/2010	
		9/2008-6/2010	Repaid				Total	Home sovereign
United Kingdom	RBS	47 400		62 898	14.4	11.2	90 449	19 964
	Lloyds	30 200		47 530	9.6	9.2	8 276	5 143
Germany	Commerzbank	18 200		29 521	10.5	9.1	73 300*	42 800*
	Bayerische Landesbank	10 000		14 788	10.9	8.8	37 426*	32 607*
	Hypo Real	7 870		7 613	9.4	4.7	150 426	33 702
	WestLB	3 000		5 148	14.4	7.1	19 242*	10 028*
France	BNP Paribas	5 100	X	62 910	10.1	9.6	95 950	18 087
	Credit Agricole	3 000	X	52 405	9.7	9.0	52 592	25 407
	Société Générale	3 400	X	34 693	10.7	10.0	42 487	15 105
Italy	Unicredit	4 000	X	39 034	8.6	7.8	81 765	38 832
	Intesa Sanpaolo	4 000	X	30 205	8.3	8.2	71 400	63 681
	Monte dei Paschi di Siena	1 900		9 093	7.5	6.2	28 220	27 756
	Banco Popolare	1 450		7 125	7.7	7.0	8 524	8 284
Netherlands	ING	10 000	½	34 015	10.2	8.8	46 658	4 199
	ABN Amro/Fortis	23 700 **		15 481	13.0	9.9	21 666	9 825
Belgium	Dexia	6 400		17 573	12.3	10.9	58 170	7 903
	KBC	7 000		13 440	10.9	9.4	50 711	21 839
Ireland	Bank of Ireland	3 500		9 575	9.2	7.1	1 314	1 186
	Allied Irish	3 500		8 542	7.0	6.5	9 564	4 136
Austria	Erste Bank	1 900		11 486	9.2	8.0	26 130	5 795
Denmark	Danske Bank	3 500		15 847	11.7	10.0	27 660	7 326

Sources: CEBS, banks, EU Commission.

* 5/2010 situation.

** EUR 6.9 bn from the government to ABN Amro-Fortis Bank Nederland and EUR 16.8 bn from the government in the purchase of Fortis' operations in the Netherlands.

2.3 Irish banks to receive additional capital support from the state

Eeva Alho

The cost of the banking crisis will reach a record high in Ireland. The concentration of lending made the Irish banking system particularly vulnerable, and losses caused by the collapse of the property market are now being removed from banks' balance sheets. The state has guaranteed all the deposits to prevent widespread withdrawal of deposits.

The rapid growth of lending to the property and construction sector that preceded the sharp downturn of the Irish economy was one of the causes of Irish banks' distress, which has escalated into a global banking crisis, with asset prices plummeting and funding from the interbank money market becoming increasingly difficult to obtain. The downturn has increased banks' loan losses and weakened capital adequacy, which has forced banks to resort to Irish state support and central bank financing. The government has supported banks' funding with guarantees, capital support and organised the transfer of nonperforming loans to an asset management agency.

The Irish government has established a National Asset Management Agency (NAMA) into which banks' nonperforming loans resulting from property lending are transferred. In exchange, banks receive government-guaranteed securities issued by NAMA. The transfer of loans to NAMA is estimated to total EUR 81 billion, which is one-tenth of the total assets

of the Irish banking system. Five financial institutions are participating in the scheme: the three largest banks (Anglo Irish Bank, Allied Irish Banks and Bank of Ireland) and the building societies EBS and Irish Nationwide Building Society.

The banks benefit from the NAMA arrangement because it takes property assets that have lost their value off the balance sheet, reduces large exposures and improves liquidity, as the removal of balance sheet items reduces the need for funding. In addition, the government guaranteed securities issued by NAMA are eligible as collateral for ECB monetary policy operations. The ECB's liquidity operations have recently been a significant source of funding for Irish banks. The financial position of Irish banks is sensitive to changes in deposit funding, and the stock of deposits has declined slightly in recent months. Irish banks have for months been unable to obtain debt financing from the markets.

Thus far, two tranches of loan transfers have been completed, covering toxic assets with a total book value of EUR 27 billion. An average discount of 52% was applied to the loans, which reflects the collapse of property values. A higher discount in the second tranche of transfers raised concerns about the condition of banks' balance sheets and larger discounts on the remaining loans, and thus about the need for additional capital support.

At the end of September, the Irish central bank and government estimated the total cost of the banking crisis at ca EUR 45 billion. They revealed the amount of additional capital support that is required by the end of 2010, and noted that no additional state borrowing will be necessary this year as a result of the capital support. The cost of restructuring the banking sector is estimated to total 20% of GDP, over half of which is accounted for by Anglo Irish Bank, the third largest

bank in Ireland. The rapid growth of Anglo Irish during the economic boom was largely based on massive lending to the property sector. In 2009, the bank posted a loss of EUR 12 billion and in January–June its losses totalled over 8 billion. The Irish government has decided to split Anglo Irish into a deposit bank and an asset recovery bank that manages the remaining toxic assets before its gradual resolution. The deposits in the deposit bank have full government guarantee, but the bank will not be allowed to increase its lending.

The state has provided Anglo Irish Bank capital 23 billion in capital support, and an additional EUR 6.4 billion in capital will be needed. If Anglo's property loans result in higher-than-expected losses, the need for additional capital could potentially be 5 billion higher. The total cost for the state of restructuring Anglo Irish could be as high as EUR 34 billion. According to an announcement by the Irish government and central bank, the rights of holders of senior debt will be respected, but the Department of Finance has launched an examination of the restructuring of Anglo, and it expects the results to show that the subordinated debt holders will have to share some of the costs that have arisen.

Allied Irish Banks (AIB) has received EUR 3.5 billion in capital support from the National Pension Reserve Fund. AIB's losses in January–June totalled nearly EUR 2 billion. According to a recent estimate, AIB is required to raise an additional EUR 3 billion in capital by placing an open offer to shareholders of AIB shares. The transaction will be fully underwritten by the National Pension Reserve Fund. In contrast, the Bank of Ireland, the largest bank in Ireland, has succeeded in strengthening its capital position, and it does not need state capital support to fulfil the capital requirements at the end of 2010.

The calculation of required additional capital is based on capital adequacy criteria according to which banks have to achieve the minimum *core tier 1* capital ratio of 8% and the minimum equity capital ratio of 7% by the end of 2010. The central bank wants to prepare for the tighter capital adequacy requirements included in Basel 3 and ensure that banks meet the capital requirements, despite the long transition period for the requirements. The calculations take into account the losses expected on NAMA loans and estimates on losses on other loans, applying a high loan loss rate. In the Europe-wide stress test exercise in the summer, the *Tier 1* target capital ratio was 6%. Bank of Ireland and AIB were included in the test, but not Anglo Irish Bank because the two others were large enough to achieve the required coverage of the national banking sector.

The Europe-wide stress test exercise was carried out on the basis of the consolidated year-end 2009 figures, and the developments in financial results and capital adequacy were assessed in a stress scenario covering 2010 and 2011. Irish GDP was assumed to decrease by 2.1% in 2010, but to increase again in 2011.

The results of the exercise show the weak condition of Irish banks. AIB's stressed Tier 1 capital ratio declined to 6.5% and that of Bank of Ireland to 7.1% at the end of 2011. In the stress testing, the Irish Central Bank and Financial Regulator assumed higher loan losses on NAMA loans and other investment and property loans than those required by CEBS. Recent development of the Irish economy and the increase in banks' losses have however been unforeseen. The estimates of NAMA losses and the need for additional capital have been adjusted upwards in the course of the year, as data on the discount on the first tranche of loan transfers have been published.

Table 3. Capital support provided to Irish banks

Bank	Balance sheet, EUR bn	State capital support	Additional capital required by the end of 2010	State capital support total EUR 42.7–51.2 bn
Bank of Ireland	180	3.5 bn from the Irish Pension Reserve Fund	-	3.5
Allied Irish Banks	169	3.5 bn from the Irish Pension Reserve Fund	3.0 bn via open offer of 5.4 bn underwritten by the Irish Pension Reserve Fund, of which 3.7 bn as cash investment, with option to convert additional 1.8 bn into preferred	3.5–7.2
Anglo Irish Bank	87	18.6 bn in government promissory notes, 4 bn in cash	6.4 bn, additional capital support a maximum of 5 bn if losses larger than expected	29.3–34.3
EBS Building Society	22	0.8 bn	-	0.8
Irish Nationwide Building Society	13	2.7 bn in government promissory notes	2.7 bn in government promissory notes	5.4

Source: Banks' interim reports, 2009 financial statements.

2.4 Chinese banking system serves as government policy instrument

Maria Ritola

China's huge financial sector is heavily banking-oriented. The size of the banking business is illustrated by the lending stock of Chinese banks: in 2009 it exceeded the country's GDP by ca 20%. The Chinese banking sector is especially large compared to countries of the same level of economic development whose lending stocks relative to GDP are on average less than half of that of China. The special nature of the Chinese banking sector is emphasized by its key role as the government's economic policy instrument, exemplified by the stimulus package introduced during the global economic crisis and implemented primarily by increasing lending by the largest banks.

Extensive state-ownership in the banking system

Approximately 70% of the Chinese banking sector is state-owned. The four largest banks – Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), Bank of China (BoC), and Agricultural Bank of China (ABC) – together constitute an important policy instrument for the government. When necessary, these banks provide strong support for the country's economic growth via their lending activities. The Chinese central bank regulates tightly benchmark deposit and lending rates and minimum interest rate margins, which prevents the

banks from competing on interest rates. Consequently, Chinese banking-sector profits are based on increasing the volume of lending. Risk taking and lending are controlled through reserve requirements and annual quotas on lending.

The combined balance sheet of the four largest banks amounts to ca half of the entire Chinese banking sector. The other half is accounted for by commercial banks in the cities and regions, banks operating in the countryside, increasingly market-driven policy banks, and banks that are either partly or wholly in foreign ownership. Due to strict regulation by the authorities, the operations of banks in total foreign ownership are still minor in the Chinese market. This is illustrated by the combined balance sheet of the foreign banks, which in 2009 accounted for less than 2% of the entire Chinese banking sector. China also has an unofficial banking sector whose lending stock is estimated to correspond to as much as 20% of that of the official banking sector. The unofficial sector is a key source of financing for small and medium-sized enterprises that have difficulties in acquiring financing from the official banking sector.

At the end of 2009, Chinese banks' stock of deposits was ca 80% and their stock of lending ca 20% larger than the country's GDP. The large size of the banking system is due to the high savings ratio of households and non-financial corporations, and government regulation which hampers the development of the financial market. For example, equity and bond markets still play a minor role in the financing of Chinese corporations, compared to bank loans.

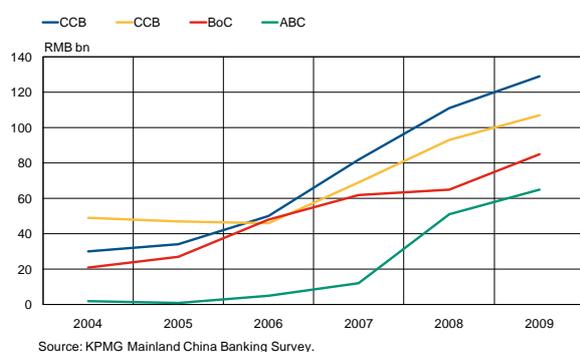
Chinese banks' profits growing rapidly

Chinese banks survived the economic and financial crisis with only minor losses, because their holdings of foreign companies' securities have been quite modest,

due to restrictions on capital flows imposed by the authorities. In the wake of the financial market turmoil, among the country's four largest banks, ICBC became the world's largest bank and CCB the second largest, in terms of market capitalization. BoC and ABC rank 7th and 8th.

Even though Chinese authorities narrowed banks' interest rate margin to 2.5 percentage points in 2009, the profits of the four large commercial banks rose by 15% to 30% on the previous year, to nearly RMB 390 billion (EUR 43 bn). There are only few studies on the efficiency of Chinese banks, and several indicate that the four largest banks are less efficient than eg commercial banks operating in cities or banks with foreign ownership. The results also show that the banks' profits are not dependent on the efficiency of operations. The studies cover the years 2000–2007, and so do not necessarily reflect the current situation.

Chart 11. Profits of the four largest banks in China, RMB bn (their combined balance sheet accounts for ca 50% of the entire sector)



Approximately 80% of the profits posted by Chinese banks is still interest income from core banking business. The share of other sources of income, eg service charges, has however been rising in recent years (in 2009 by ca 30% on the previous year) with the diversification of banking services. Increased wealth growth has boosted the demand for eg asset management, consumer credit, leasing, private

banking, and insurance services. The rapid development of services is also reflected in the growing number of debit and credit cards; at end-2009, their number reached over two billion, ie two cards per capita.

Chinese banks' foreign acquisitions have been minor especially in the aftermath of the economic and financial crisis. Instead, the banks have focused on increasing organic growth by opening up branches around the world.

Government stimulus package implemented through banks

Even though the Chinese banking sector was not directly affected by the financial crisis, it has had an indirect effect on the Chinese economy. Playing a key role in the economic stimulus, Chinese banks increased their lending considerably in 2009, encouraged by the government: lending grew by ca 31% on the previous year. This was also partly reflected in banks' profits. The rapid growth of lending has its downside, as it has probably distorted the allocation of capital and it will in future lead to further nonperforming assets. According to official statistics, these problems are not yet weighing on banks' results because in 2009 the share of nonperforming assets in the stock of lending decreased to less than 2%. This year, the Chinese authorities announced that they aim to keep growth in lending at less than 20%, due to the risk of overheating and inflationary pressures.

As a result of structural changes already implemented by authorities, the condition of the banking system has improved significantly. Banks have removed nonperforming assets from their balance sheets, and there has been considerable build-up of banks' capital via direct state aid. The stimulus package has however raised doubts, particularly about the strength of loans granted by local governments to

off-budget projects; these loans are estimated to account for as much as one-third of the growth in the lending stock in 2009. The China Banking Regulatory Commission (CBRC), the authority that supervises the Chinese banking sector, has in 2010 addressed the irregularities by restricting lending to such corporations whose stock of loans grew by over 70 % in 2009. Moreover, the CBRC has prohibited the granting of new loans to several projects planned by the local governments.

3 Securities markets

3.1 Huge increase in turnover on the global foreign exchange market, according to the BIS survey of foreign exchange and derivatives market activity

Harri Kuussaari

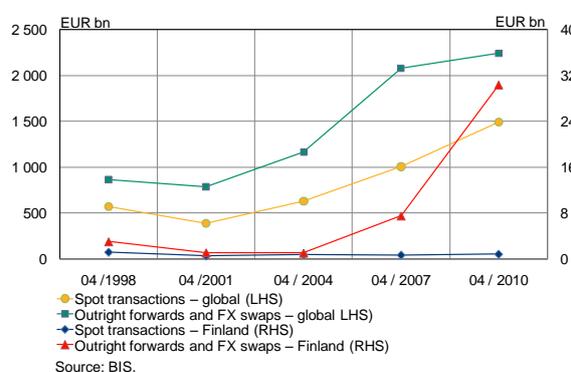
The average daily turnover in the global foreign exchange market in April 2010 was nearly USD 4.0 trillion. In Finland, the average daily FX turnover was ca USD 31 billion. Global daily turnover was 20% higher than in April 2007. In Finland, growth has been considerably more robust, with a nearly fourfold increase in average daily turnover on April 2007. Activity in the global OTC derivatives markets continue to increase, whereas in Finland turnover has declined since 2007.

The Bank of International Settlements (BIS) conducts a triennial survey of national foreign exchange and derivatives markets in order to determine the size and structure of foreign exchange and derivatives markets globally. Financial institutions were asked to provide data on their transactions in FX and OTC derivative contracts in April 2010. Data on derivatives concern the over the counter (OTC) markets.

Foreign exchange market

The average daily turnover on the global foreign exchange markets increased to USD 3,981 bn in April 2010, from USD 3,324 in 2007. This was mainly due to growth in turnover of spot transactions, the increase in turnover of other foreign exchange instruments being more modest. The daily FX turnover of financial institutions operating in Finland increased to USD 31.2 bn, from USD 8.3 bn in 2007. The large increase was due, in particular, to the expansion of foreign exchange swaps in intra-banking group liquidity management. The share of FX swaps in total FX trades in Finland increased to 97%. Spot transactions in Finland increased only slightly.

Chart 12. Average daily turnover of FX trades, 1998 – 2010

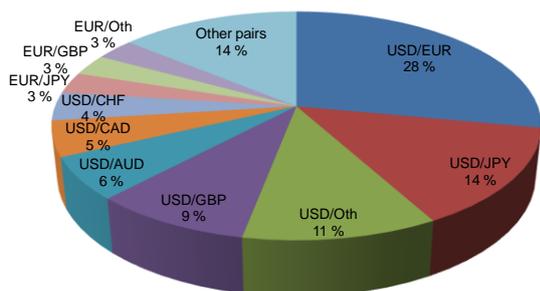


Global results show that the FX trading activity of financial institutions other than large banks has increased. In addition to non-reporting banks, this group includes mutual funds, hedge funds, insurance companies, pension funds, and central banks. Foreign exchange market activity is steadily becoming more global, with cross-border transactions accounting for 65% of trading activity in April 2010 (1998: 54%;

2007: 62%). In Finland, the share of cross-border transactions was 96%.

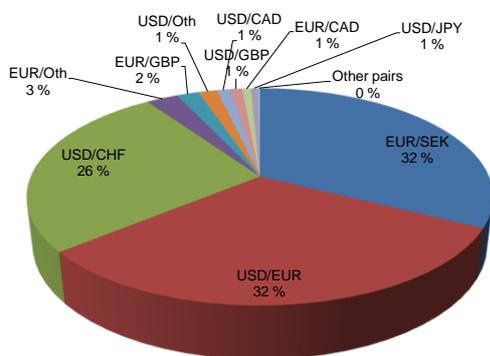
The percentage share of the US dollar continues to decline slowly, but it is clearly still the most actively traded currency. The euro and Japanese yen gained slightly relative to 2007. USD/EUR, USD/JPY and USD/GBP were the most transacted currency pairs. In Finland, the range of FX trades is considerably smaller, and the most transacted currency pairs in April being EUR/SEK, USD/EUR and USD/CHF.

Chart 13. Global FX turnover, by currency pairs, April 2010



Source: BIS.

Chart 14. FX turnover in Finland, by currency pairs, April 2010



Source: BIS.

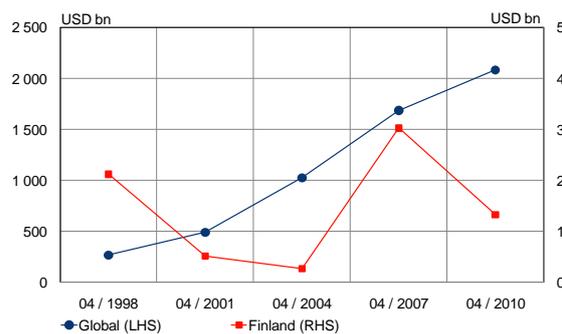
The United Kingdom has the highest turnover in FX trades; it accounted for nearly 37% of global foreign

exchange market turnover in April 2010, followed by financial institutions in the United States (18%) and Japan (6%).

Activity in OTC interest rate derivatives

Activity in the OTC interest rate derivatives market grew by 24% compared to 2007. The average daily turnover in April was USD 2,083 bn. The increase was mainly due to growth in forward rate agreements. In Finland, the daily turnover of interest rate derivatives dropped from USD 3 bn to slightly over USD 1 bn, due to a decrease in turnover of interest rate swaps and OTC interest rate options.

Chart 15. Average daily turnover of OTC interest rate derivatives, 1998-2010



Lähde: BIS.

3.2 Majority of domestic investment funds' claims are on Europe

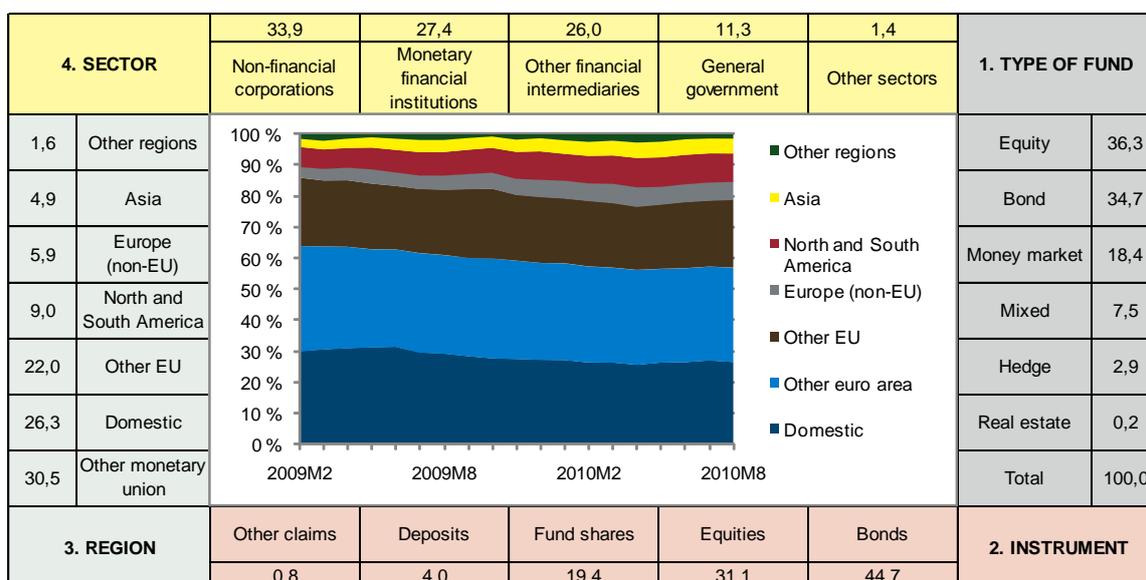
Hermann Teräväinen, Jyrki Lehtinen

The consolidated balance sheet of investment funds registered in Finland shrank in the financial market turmoil, to EUR 41.0 bn at end-February 2009. This was followed by 18 months of fairly stable developments in assets, due to positive net subscriptions and balance sheet valuation changes. At the end-August 2010, the consolidated balance sheet of domestic investment funds totalled EUR 59.6 bn. This article examines the breakdown of

claims in the balance sheet, by type of fund, instrument, region, and sector.

At the end of August 2010, the number of investment funds registered in Finland was 500. Over half (259) of the funds were equity funds, which were also the largest type of fund in balance-sheet terms (36.3%) (Chart 16). The number of investment funds classified as bond funds was considerably lower (97), but they however accounted for 34.7% of the consolidated balance sheet. The share of money market funds was 18.4% (31 funds). In the past 18 months, the share of equity funds has increased, at the expense of money market funds. At the end of August 2010, the above-mentioned three types of funds accounted for nearly 90% of the consolidated balance sheet of Finnish investment funds (EUR 59.6 bn).

Chart 16. Breakdown of claims in domestic investment funds' balance sheet (31 Aug 2010: total EUR 59.6 bn), % by type of fund, instrument, region, and sector, (outer circle) and developments in claims, by region on 28 Feb 2009 – 31 Aug 2010 (inner chart)



Source: Bank of Finland.

By type of instrument, the majority of claims were at end August 2010 in bonds (44.7%) and equities (31.1

%). The allocation of portfolios has changed significantly in the past 18 months: in February 2009,

57.4% of investment funds' total investment portfolio was in bonds and only 20.4% in equities. The values of both equity and bond investments have increased in the balance sheet, boosted by positive net subscriptions and valuation changes. A considerably larger portion of new investments was in equities, which have posted higher yields than bonds; hence the shift in allocation.

One-fifth (19.4%) of the claims was in fund shares of other investment funds (incl. ETF investments⁵). A significant portion (47.4%) of this was domestic funds' (funds of funds) investments in other domestic funds. These investments totalled EUR 5.5 billion at end-August 2010.⁶ Of fund investments, 40.1% were in the euro area – particularly Luxembourg (27.1%) where the majority of euro area investment funds are located.

Investment funds' portfolio is focused on Europe. As much as 84.6% of total investment was in Europe and over half (56.8%) in the euro area (the majority of investments being euro-denominated). Of non-euro area countries, a particularly high portion of the investment is in Sweden, United States and the United Kingdom – exactly one-fourth (25.0%). At end-August 2010, the portfolio was allocated among 102 countries.

By sector, one-third (33.9%) of the claims were on non-financial corporations. Domestic investment funds also had significant investments in MFIs (27.4%) and other financial institutions (26.0 %). In the past 18 months, the portion in general government has shrunk from 19.0% to 11.3%. Resources have been withdrawn from the bonds of nearly all of the ten

most-heavily weighted governments in the consolidated balance sheet. These countries include the large euro area countries and Sweden. In 2010, there have been positive net subscriptions only in German and Spanish government bonds.

Table 4 presents four dimensions; type of fund, instrument, region and sector. At end-August 2010, investment funds' investments were in 306 different combinations, taking all the above-mentioned dimensions into consideration simultaneously⁷. The table illustrates the hard core of domestic investment funds' investments, ie largest investments in terms of value, considering the four dimensions. The results shown account for as much as 50.0% of investment funds' consolidated balance sheet total (EUR 59.6 billion).

The most significant combination was long-term funds' investments in bonds issued by general governments of other euro area countries. At end-August 2010, their weight was 6.1%, ie EUR 3.7 billion. The same portion was accounted for by equity funds' investments in domestic non-financial corporations' equities. The third biggest combination category was money market funds' investments in bonds issued by MFIs located in the EU (excl. euro area); the majority of these investments were short-term, ie in bonds with maturities of less than one year. Interestingly, long-term funds have significant investments (EUR 2.5 bn) in other domestic investment funds. The other results were largely as expected and give a clear picture of the key channels of investment.

⁵ Exchange Traded Fund = an index fund that trades like a stock on a stock exchange.

⁶ See Financial Statistics – Annual Review 2009, pp. 34–35.
http://www.bof.fi/en/julkaisut/tilastojulkaisut/raha_ja_pankkitilastot_vuosikatsaus.htm

⁷ The theoretical number of combinations is $1050 = \text{number of fund types (6)} * \text{number of instruments (5)} * \text{number of regions (7)} * \text{number of sectors (5)}$

Table 4. Claims in domestic investment funds' balance sheet, hard core (50.0% of total claims), 31 August 2010 (four dimension: type of fund, sector, region and instrument)

	Type of fund	Sector	Region	Instrument	EUR m	%
1	Bond	General government	Other euro area	Bonds	3 666	6,1
2	Equity	Non-financial corporations	Domestic	Equities	3 651	6,1
3	Money market	Monetary financial institutions	Other EU	Bonds	3 305	5,5
4	Equity	Non-financial corporations	North and South America	Equities	2 694	4,5
5	Bond	Other financial intermediaries	Domestic	Fund shares	2 460	4,1
6	Equity	Non-financial corporations	Europe (non-EU)	Equities	2 199	3,7
7	Equity	Non-financial corporations	Other EU	Equities	2 140	3,6
8	Money market	Monetary financial institutions	Other euro area	Bonds	2 044	3,4
9	Equity	Other financial intermediaries	Other euro area	Fund shares	2 041	3,4
10	Bond	Other financial intermediaries	Other euro area	Fund shares	1 918	3,2
11	Equity	Non-financial corporations	Other euro area	Equities	1 905	3,2
12	Equity	Non-financial corporations	Asia	Equities	1 813	3,0
					29 837	50,0

Source: Bank of Finland.

4 Infrastructure

4.1 Criminals have shifted focus from copying payment cards to wallet and identity theft

Maija Salmela

As payment cards with a chip have become increasingly widespread, card misuse has become more difficult. Criminals have thus shifted their focus from copying cards to stealing payment card PINs and wallets. Crime is also increasingly committed via the internet, eg identity hijacking.

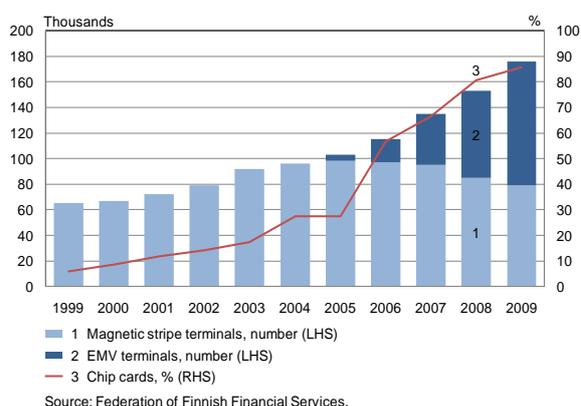
Criminals try to gain benefits in the easiest possible way, which is why the copying of payment cards has decreased and will continue to decrease as the use of chip cards is rapidly gaining ground in Finland (Chart 17). It is much more difficult to misuse a chip card than a traditional payment card equipped with a magnetic stripe.

In late September, newspapers reported on a 'wallet league' that had managed to obtain over EUR 60,000 in southern Finland.⁸ These criminals, targeting the elderly, operated in small groups. Often the victim or bystanders did not even notice that a wallet had been stolen. An intoxicated person may also fall victim because he or she could be an easy victim.

⁸ For example:

<http://www.hs.fi/kotimaa/artikkeli/Lompakkoliiga+rosvonnut+60+000+euron+saaliin+etel%C3%A4isess%C3%A4+Suomessa/1135260384011> (in Finnish only).

Chart 17. EFTPOS terminals and chip cards in Finland



If a pickpocket obtains a person's payment card PIN he can access that person's account data with the help of the payment card in the stolen wallet. Often criminals steal the PIN before stealing the wallet, eg at a checkout counter or an ATM.

Means-of-payment fraud is however increasingly internet crime, eg the high jacking of personal data using malicious software. This personal data, eg credit card information, online banking codes or personal details, can then be turned into money, with only a minor risk of getting caught. The risk of getting caught is small because the internet and mobile equipment enable criminals to cooperate globally and anonymously.

In Finland, criminals targeted Nordea in early 2010 and withdraw money from Nordea's online banking customers using malicious software.⁹ The malicious software fooled the customers into revealing their online banking codes. Nordea compensated its

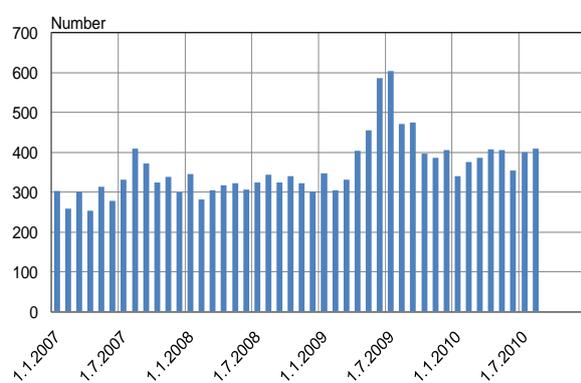
⁹

<http://www.nordea.fi/Tietoa+Nordeasta/Nordea+varoitaa+asiakkaitaan+haittaohjelmasta/1285712.html> (in Finnish only).

customers for losses, and has since tightened the monitoring of payment transactions and introduced additional means of confirming private customers' online banking payment transactions, ie by SMS or phone. Additional confirmation is required for large credit transfers or when the payee is previously unknown.

Early 2010 saw the biggest theft of payment card data ever in Finland when data from over 100,000 cards were stolen from a poorly protected payment system of a store in Helsinki. The police started investigating the matter when Luottokunta, a payment card service provider, reported its suspicions immediately after the theft. All the data stolen were on magnetic stripe payment cards, and the criminals were able to access it via the internet. The store has since updated its payment system.

Chart 18. Means-of-payment fraud reported to the police per month in 2007–2010



Source: National Bureau of Investigation.

Means-of-payment frauds reported to the police (Chart 18) include minor fraud and aggravated fraud and the planning of means-of-payment fraud. As a result of preventive work by the Finnish police, criminals have often been caught before large numbers of citizens have fallen victim. The peak in the number of reported means-of-payment frauds in summer 2009 was due to the fact that two active groups of criminals entered Finland, and citizens reported a large number of frauds

before the police caught some of the members of the groups and stopped their actions. In 2010, there has not been such a peak in means-of-payment frauds, even though summer is often the season for foreign crime.

Finland has been more successful in preventing fraud than the large EU countries because in a small country authorities and the corporate sector are better able to work in close and effective cooperation. Thus the risk of getting caught is significantly higher in Finland than in the other European countries. Criminals may however be attracted to Finland by the milder punishment for means-of-payment fraud.¹⁰

¹⁰

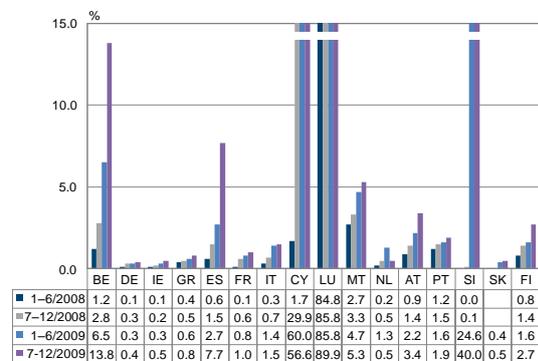
<http://www.mtv3.fi/uutiset/rikos.shtml/arkistot/rikos/2010/09/1193847> (in Finnish only).

4.2 Slow progress on SEPA¹¹

Timo Iivarinen

The Single Euro Payments Area (SEPA) complements the benefits of the single currency and is a logical continuation of the integration process. If the objective is to achieve a true single economic area and the benefits it will generate, payments must be a part of the process. SEPA migration has progressed slowly even though the common principles are close to being finalized. In Finland, SEPA migration will be completed nearly on original schedule. Most countries will not achieve this target.

Chart 19. Share of SEPA credit transfers in total credit transfers in the euro area



Source: European Central Bank.

Common standards, faster settlement of payments and less complicated payment procedures are beneficial for the entire EU economy. The most significant benefit is the increased overall efficiency of payments.

Competition will become tighter and it will be easier for customers to bid for payment services, as all payments in SEPA will be executed in accordance with uniform standards and commonly agreed rules.

¹¹ Single Euro Payments Area.

In future, the adoption of payments-related product innovations will be increasingly likely and easier because the playing field is one large market area, instead of a large number of small areas applying different standards.

Despite the undisputed benefits to the entire society, migration to SEPA has been fairly slow. In 2008, SEPA credit transfer was launched. In 2009 we saw the introduction of SEPA direct debit, and in 2010 all providers of traditional direct debit services must deliver SEPA direct debit services as payer services. SEPA cards have also been launched. SEPA for cards will be completed in 2011 when all ATMs and POS are EMV-compliant¹².

As of the above-mentioned dates it has been or will be possible to make SEPA-compliant payments. A completely different matter is how quickly Europe fully migrates to the use of SEPA payment instruments. At the end of 2009, SEPA credit transfers accounted for 2.7% of total credit transfers in Finland (see Chart 1). In summer 2010, the corresponding figure was 3.3%. Large European countries have been even slower to migrate to SEPA credit transfers. In a few small countries, the percentage of SEPA credit transfers is already fairly large. Finland too, is expected to migrate quite extensively to SEPA credit transfer, as large invoicers – eg government agencies and many large companies – start using SEPA credit transfers.

The use of SEPA direct debit is still modest (0.05% of total direct debits in the euro area), but payment by SEPA direct debit will be possible across the entire euro area in 2010 at the latest. Finnish banks probably will not provide direct debit services to their invoicer

¹² See

http://www.rata.bof.fi/fi/Saastajalle/Tuotteet_ja_palvelut/Maksukortit/Pages/EMV-kortit.aspx (in Finnish only).

customers but will provide services based on e-invoicing. Customers who do not like to use a computer will be provided a service for confirming e-invoices for payment. As for card payments, over half of the POS transactions in Europe are EMV transactions. This applies also to Finland; nearly all cards in Finland are already EMV-compliant.

Due to the slowness of migration to SEPA, authorities have tried to find ways to speed up the process. The European Commission published in summer a Working Paper¹³ on the setting of a SEPA migration end-date that would be binding on all Member States. The Working Paper proposes a 12-month transitional period for credit transfers and a 24-month transitional period for direct debit (after entry into force of a regulation), after which only SEPA-compliant products could be used. For small national systems, an even longer transitional period (36 months) is envisaged. Thus far it is unclear when the Commission will finalise the regulation on SEPA migration end-dates, but a regulation is expected to be adopted.

Finland's migration to SEPA has progressed fairly well, and the original target of completing migration by the end of 2010 will be nearly achieved. The use of SEPA credit transfer is spreading rapidly; direct debit will be replaced by e-invoicing; and as regards card payments, the portion of SEPA-compliant POS will increase.

If a regulation is adopted, the transitional period for credit transfer and direct debit would be 4 to 5 years following the start of services provision. This should be sufficient for complete migration. Finland at least will complete migration by the end-date laid down in the possible regulation.

¹³ See http://ec.europa.eu/internal_market/payments/docs/sepa/end-date_migration_en.pdf

5 Key regulatory and supervisory initiatives

5.1 Basel Committee on Banking Supervision tightens banks' capital adequacy requirements considerably

Jukka Vauhkonen

Banks are required to have significantly more equity capital and other higher-quality regulatory capital in future. An additional capital requirement may be imposed on systemically important banks.

The Basel Committee on Banking Supervision is finalising its comprehensive reform of banking regulation. Basel III will reform banks' current capital adequacy framework (Basel II) and establish many new regulatory instruments. This article examines the latest amendments to Basel III, published in summer and early autumn 2010.¹⁴

The reform is a response to the deficiencies in international financial regulations exposed by the financial crisis. The reform has two key aims: 1) to strengthen banks' resilience 2) to reduce systemic risk.

Strengthening the resilience of the banking sector

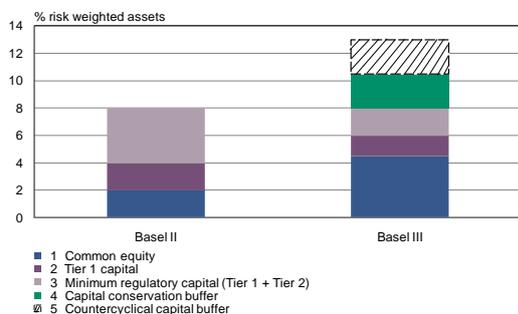
The financial crisis exposed serious deficiencies in the capital adequacy and liquidity regulations for banks. Banks should have sufficient capital to cover possible losses. The financial crisis revealed that the minimum requirement for banks' regulatory capital was too low and in particular the quality requirements too easy.

The Group of Central Bank Governors and Heads of Supervision, the oversight body of the Basel Committee on Banking Supervision, on 12 September published the new minimum capital standards for banks. The minimum requirement for the highest-quality capital, which consists of eg retained profits and equity capital (and similar-quality regulatory capital in non joint stock companies), is currently only 2% relative to risk-weighted assets. In future, the requirement for common equity will be 7% relative to the bank's risk-weighted assets; 4.5% for the minimum requirement and 2.5% for the capital conservation buffer (see Chart).

At the same time, a smaller portion of weaker-quality statutory capital (other Tier 1 capital and Tier 2 capital) is accepted in the calculation of capital adequacy. The Basel Committee had already agreed on tightening the quality criteria for regulatory capital, which in effect tightens banks' capital adequacy requirements by several percentage points.

¹⁴ The reform package is examined in more detail in an article by Haajanen and Vauhkonen, Financial Market Report 1/2010.

Chart 20. Minimum regulatory capital requirement in Basel II and Basel III (relative to risk-weighted assets)



The Basel Committee in July 2009 also published amendments to the capital adequacy requirements for financial instruments held for trading, securitised assets and certain off-balance sheet items, which will increase the capital requirements.

The resilience of banks will be further strengthened by introducing a new non-risk-based leverage ratio and two quantitative liquidity standards.¹⁵ Based on the quantitative impact studies it had conducted, the Basel Committee decided to postpone implementation of these new requirements to 2015 (liquidity coverage ratio) and 2018 (net stable funding ratio and leverage ratio).

Reducing systemic risk

The reforms included in Basel III are also aimed at reducing systemic risks caused by the procyclicality of lending, links between financial companies, and systemically important banks.

Excessive growth of total lending to the private sector has often led to a banking crisis and collapse of banks' lending capacity. National authorities have the discretion to impose a national countercyclical capital buffer (maximum 2.5%) to protect the national banking system from the consequences of excessive lending.

¹⁵ For more details, see Financial Market Report 1/2010.

The countercyclical capital requirement will take effect when the total lending-to-GDP ratio is exceptionally high relative to its trend level. The Basel Committee has developed an indicator that authorities are expected to use as a basis for their countercyclical buffer requirement. Authorities can also use macroeconomic indicators, supervisory information, market information and discretion as basis for their decisions.

The countercyclical capital buffer should be used only rarely, eg once every 10 to 20 years. Otherwise the buffer requirement is 0%. If a bank does not fulfil the buffer requirement, authorities will restrict its profit distribution and remuneration.

Many details on countercyclical capital buffers are still open. For example, each country can independently decide which authority or authorities set the buffer requirements.

Probably the most important of the Basel Committee's ongoing initiatives is to determine jointly with the Financial Stability Board¹⁶ whether an additional capital requirement or other additional requirements should be imposed on systemically important banks. More information on these additional requirements will be released by the end of the year when the entire reform package is finalised.

¹⁶ Financial Stability Board's (former Financial Stability Forum) task is to coordinate the cooperation of national authorities and international organisations in the development of financial regulation and supervision.

5.2 Comprehensive financial market reform in the US

Ilkka Kaukoranta, Hanna Westman

New financial market legislation was adopted in July in the United States. The aim of the comprehensive legislative package is to reform the operation of the financial sector to prevent a financial crisis like the one in 2008. This is the most significant financial market reform since the 1930s recession.

The new financial market act affects particularly macro-prudential supervision, the supervision and crisis management of systemically important companies, the structure of banking and insurance supervision, as well as the supervision of shadow banking operations and credit rating agencies. The Act also eg improves consumer protection, enhances shareholders' influence on remuneration schemes, and improves the transparency of the Federal Reserve (Fed).

Macro-prudential supervision will fall under the mandate of the new Financial Stability Oversight Council (FSOC). FSOC encompasses representatives of all the authorities involved in financial market regulation and supervision¹⁷. FSOC will be assisted by the Office of Financial Research which will be a part

¹⁷ Treasury Secretary will be Chairperson, a member of the Board of Governors of the Fed will be appointed Vice Chairman with responsibility for Supervision, and voting members will be the Securities and Exchange Commission (SEC), Commodity Futures Trading Commission (CFTC), Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), Federal Housing Finance Agency (FHFA), National Credit Union Administration (NCUA), and the new Bureau of Consumer Financial Protection.

of the Treasury and will be given extensive powers to collect information from financial corporations and other authorities. The main duty of the FSOC is to eliminate the assumption that the government will bail-out systemically important companies¹⁸ if there is a threat of bankruptcy. FSOC can recommend to the Fed tighter capital, leverage, liquidity and risk management standards for systemically important companies. Most importantly, the FSOC has the power to put under Fed supervision any non-banks it finds to be systemically important. The FSOC has the right, together with the Fed, to unwind a company that poses an acute threat to financial stability.

The act clarifies authorities' actions in a crisis situation similar to the collapse of Lehman Brothers. Systemically important financial companies must prepare a credible plan for unwinding a company in a crisis situation and inform the authorities of this 'living will'. The act enables a special procedure in which the FDIC can, if necessary, take over and unwind a systemically important financial company. Earlier this procedure applied only to banks.

The supervision of banks and insurance companies is streamlined. With the reform, all financial companies that own a deposit institution that is covered by deposit protection will be subject to the Bank Holding Act. Regulatory arbitrage is hampered by prohibiting banks from transferring from one supervisor to another by amending the charter, unless both banking supervisors approve the amendment. The ineffective Office of Thrift Supervision is abolished, and the majority of its banking supervision functions

¹⁸ The impact of a company's collapse on the financial system and the economy, the size of the company, its leverage and dependency on short-term finance, and the company's importance as a source of finance and liquidity for households, non-financial corporations and municipalities in the entire financial system is taken into account in designating a company as systemically important.

are transferred to the OCC. Regarding insurance supervision, the Act establishes a new Federal Insurance Office (FIO), which will gather information on the insurance sector and monitor any potential systemic risks.

The regulation and supervision of shadow banking operations is tightened. The Act includes an abridged version of the Volcker Rule that prohibits proprietary trading by banks. A bank's investments in hedge funds may not exceed 3% of its Tier 1 capital. The restrictions apply also to non-banks supervised by the Fed. Large hedge funds will be supervised by the SEC, and OTC derivatives will fall under the mandate of the SEC and CFTC. At the same time, the Act requires mandatory clearing of derivatives transactions through regulated central clearing organizations and mandatory trading through regulated exchanges or swap execution facilities. This enables more efficient supervision of derivatives trading. In addition, capital requirements and margin requirements will be imposed for major counterparties in derivatives trading. The Act changes the securitisation of credit so that issuers of asset-backed securities are required to retain 5% of the underlying credit portfolio. The Act also requires securitisers to disclose more information on the underlying credit portfolio and other shareholdings.

The Act significantly increases the supervision of credit rating agencies. An Office of Credit Ratings will be established as part of the SEC. It will monitor credit rating agencies procedures, dependency of third parties, and the accuracy of ratings. To enhance supervision, the SEC is mandated to revoke a credit rating agency's right to issue a credit rating if the ratings are consistently unreliable. The new Act enables investors to sue the credit rating agency if the rating is intentionally misleading or misleading due to negligence. The SEC must also develop a mechanism

to prevent a securities issuer from playing credit rating agencies against each other to get the best possible rating for its security. References to credit ratings in legislation are also reduced, and authorities are required to study the possibilities of further reducing the dependency of legislation on credit ratings.

Consumer protection issues were previously divided among seven regulatory bodies, whereas now consumer protection is consolidated under a new, independent agency, the Bureau of Consumer Financial Protection (BCFP). The Bureau will have rulemaking powers over banks and other market participants that offer or provide consumer financial products or services. The Act also introduces concrete changes to the position of consumers. For example, consumers are entitled, under certain circumstances, to check their credit score free of charge. In the mortgage sector, lenders must assess more diligently whether borrowers can repay their loans.

The Act seeks to improve investor protection by granting the SEC the right to stipulate that the position of dealers providing investment advice would be equated with that of an independent fiduciary investment advisor. Dealers must in future be more transparent and seek to ensure that their financial products are aligned with customer's interests. Supervision by the SEC is enhanced by establishing a system where the whistleblower of a securities law violation can be rewarded a significant percentage of the fine imposed.

Shareholders are granted the right to cast non-binding votes on executive compensation. In addition, the independence of compensation committees from company management is increased. Listed companies must also design clawback policies that ensure the recovery of incentive-based compensation from current or former executives following a revision of

financial statements, upon which the compensation was based.

To counterbalance the increasing power of the Fed, its transparency and political control is enhanced. The Government Accountability Office (GAO) will by December 2010 examine the Fed's lending and open market operations during the financial crisis. GAO is granted the right to inspect, in particular, lending and open market operations also in future. In addition, GAO is ordered to investigate the Fed's governance rules and potential conflicts of interest.

6 Key corporate arrangements and events in the financial sector

<i>Date</i>	<i>Event and description</i>
January 2010	<p><i>Moody's confirms Aktia Bank's ratings: short P-1 and long A1.</i></p> <p><i>Standard & Poor's affirms M-Real's credit ratings C and CCC+. Rating outlook stable.</i></p> <p><i>SAV-Rahoitus Oyj announces it will apply for authorisation as a credit institution.</i></p>
February 2010	<p><i>Standard & Poor's downgrades UPM-Kymmene's long-term rating from BB+ to BB.</i></p> <p><i>Fitch affirms UPM-Kymmene's ratings B and BB-. Rating outlook stable.</i></p> <p><i>Algoengineering Europe Limited commences trading in CCP cleared securities at NASDAQ OMX Helsinki. Algoengineering Europe Limited trades from London.</i></p>
March 2010	<p><i>Tikkurila Oyj's share is listed on the NASDAQ OMX Helsinki stock exchange and the shares of Julius Tallberg Real Estate Corporation are delisted from NASDAQ OMX Helsinki.</i></p> <p><i>Eufex announces that it will apply for a banking licence.</i></p> <p><i>Moody's revises Iceland's ratings outlook from negative to stable.</i></p> <p><i>Parex Banka ends its membership in NASDAQ OMX Helsinki.</i></p> <p><i>Financial Supervisory Authority (FIN-FSA) revokes Sofia Bank's authorisation. The bank's own funds fell below the minimum level for a credit institution.</i></p> <p><i>Standard & Poor's affirms the United Kingdom's long-term sovereign credit rating AAA, but the outlook is negative.</i></p> <p><i>Fitch downgrades Portugal's long-term foreign and local currency issuer default ratings from AA to AA-. Rating outlook negative. Short-term foreign currency rating is affirmed at F1+.</i></p>

<i>Date</i>	<i>Event and description</i>
April 2010	<p><i>S&P affirms Portugal's ratings A-1 and A+, outlook negative.</i></p> <p><i>Marketing of long-term pension savings accounts commences.</i></p> <p><i>Fitch downgrades Greece's Short-term foreign currency Issuer Default Rating from F1 to F2, and the long-term foreign and local currency IDR from BBB+ to BBB-.</i></p> <p><i>Moody's lowers Greece's ratings from P-1 to P-2 and from A2 to A3. Outlook negative.</i></p> <p><i>S&P lowers Greece's sovereign ratings from A-2 to B and from BBB+ to BB+.</i></p> <p><i>S&P lowers the long-term rating on the Kingdom of Spain from AA+ to AA.</i></p> <p><i>Moody's changes Stora Enso Oyj's ratings outlook from negative to stable. The company's ratings are NP / Ba2.</i></p> <p><i>LCM Sweden AB commences trading in CCP cleared securities at NASDAQ OMX Helsinki. LCM Sweden trades from Stockholm.</i></p> <p><i>Straumur-Burdaras Investment Bank hf ends its membership in NASDAQ OMX Helsinki.</i></p> <p><i>NASDAQ OMX Helsinki exchange starts calculating the new OMX Helsinki 15 Index. The OMX Helsinki 15 Index has a base value of 500 at the base date 18 December 2009. The index consists of the 15 most traded shares on the NASDAQ OMX Helsinki exchange.</i></p>
May 2010	<p><i>Fitch downgrades Spain's Long-term foreign and local currency Issuer Default Ratings from AAA to AA+. Rating outlooks stable.</i></p> <p><i>Burgundy applies for authorization to operate a regulated market as an exchange for listing and trading warrants, certificates, exchange traded funds (ETFs) and structured products.</i></p> <p><i>Germany bans naked short selling of shares of 10 financial institutions and credit default swaps on Eurozone government debt.</i></p> <p><i>Spain's central bank takes over savings bank CajaSur.</i></p> <p><i>Finlandia Fund Management Company Ltd is granted authorisation.</i></p>
June 2010	<p><i>S&P raises Estonia's short-term foreign and local currency sovereign credit ratings from A-2 to A- and the long-term rating from A- to A. Rating outlooks stable.</i></p>

Date	Event and description
June 2010	<p><i>The period of validity of the temporary act on investment activities and solvency provisions of private sector pension insurers was extended until the end of 2012. The provisions were amended at the end of 2008, and initially they were to remain in force until the end of 2010. The extended period of validity of the temporary act took effect on 1 June 2010.</i></p> <p><i>Sampo Life Insurance Baltic changes name to Mandatum Life Insurance Baltic.</i></p> <p><i>Spanish savings banks Caja Madrid and Bancaja plan a merger. They are also planning to link up with five smaller savings banks. The liquidity and capital adequacy of the alliance would be assessed as an entity.</i></p> <p><i>Moody's downgrades Greece's government bond ratings: short-term from P-1 to NP and long-term from A3 to Ba1. Outlook stable.</i></p> <p><i>Larox Corporation delisted from NASDAQ OMX Helsinki.</i></p> <p><i>Fitch upgrades UPM-Kymmene Oyj's long-term IDR from BB- to BB. Outlook stable.</i></p> <p><i>Fitch revises Stora Enso's rating outlook from negative to stable. Long-term IDR affirmed at BB.</i></p> <p><i>S&P revises its outlook for Nokia from stable to negative. Ratings: A-1 and A.</i></p> <p><i>Moody's revises Spain's rating outlook from stable to negative. The long-term foreign currency government bond rating is Aaa.</i></p> <p><i>The Supervisory Board of OP-Pohjola Group Central Cooperative takes a decision in principle on the reorganization of the Central Cooperative acting as the group's central institution, as of 1 January 2011.</i></p>
July 2010	<p><i>SEB announces it will sell its German retail business to Banco Santander for slightly over EUR 500 billion.</i></p> <p><i>Moody's downgrades Portugal's long-term sovereign debt rating from Aa2 to A1. Rating outlook stable.</i></p> <p><i>Moody's downgrades Ireland's government bond ratings from Aa1 to Aa2. Rating outlook stable.</i></p> <p><i>Moody's revises Iceland's rating outlook from stable to negative. The ratings are P-3 and Baa3.</i></p>
August 2010	<p><i>The Act on Mortgage Banking enters into force in Finland.</i></p>

<i>Date</i>	<i>Event and description</i>
August 2010	<p><i>Fitch downgrades Fingrid's ratings by a notch. Short-term IDR from F1+ to F1, and long-term IDR from AA- to A+. Rating outlook negative.</i></p> <p><i>S&P raises Metso's short-term rating from A-3 to A-2. Long-term rating (BBB) is unchanged. Rating outlook stable.</i></p> <p><i>S&P lowers Ireland's long-term credit rating from AA to AA-. Rating outlook negative.</i></p> <p><i>The licence of the Swedish investment bank HQ Bank is revoked for trading operations and other deficiencies.</i></p> <p><i>The central cooperative banks Etelä-Savon Osuuspankki, Juuan Osuuspankki, Pieksamäen Osuuspankki, and Savonlinnan Osuuspankki announce plans to merge to form Suur-Savon Osuuspankki.</i></p> <p><i>The savings banks Lammin Säästöpankki and Tuuloksen Säästöpankki announce plans to merge in March 2011.</i></p>
September 2010	<p><i>S&P places UPM-Kymmene's rating (BB) on watch for possible downgrading. UPM and Myllykoski have been discussing a possible reorganisation.</i></p> <p><i>Moody's upgrades M-Real's long-term rating from Caa1 to B3. Rating outlook positive.</i></p> <p><i>Moody's downgrades Spain's long-term credit rating from Aaa to Aa1. Rating outlook stable.</i></p> <p><i>Moody's changes the outlook on Metso's Baa2 long-term issuer rating to stable from negative.</i></p> <p><i>Pohjola Insurance Ltd and Pohjantähti Mutual Insurance Company announce that they are planning to merge in spring 2011.</i></p> <p><i>BayernLB and WestLB announce that they are assessing the possibilities of a merger.</i></p>
October 2010	<p><i>Moody's places Ireland's Aa2 local currency and foreign currency government bond ratings on review for possible downgrade.</i></p> <p><i>Fitch downgrades Ireland's ratings: short-term foreign currency IDR to F1 from F1+ and long-term foreign and local currency IDR from AA- to A+. Rating outlook negative.</i></p>