Financial Market Report

4 • 2005

- Changes in structure of non-financial corporations' assets and liabilities
- Banks' operating profits good – thanks mainly to robust growth in lending stock and other income
- EU banks differ little in terms of income structure but greatly in terms of funding sources
- Securitisation of housing loans has increased significantly in the USA and in some European countries
- New payment services directive promotes Europe-wide single payment area

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Bank of Finland

Financial Markets and Statistics

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1 Financial intermediation

1.1 Non-financial corporations' financial assets and liabilities

Pertti Pylkkönen

Non-financial corporations' financial assets have increased steadily due to growth in loans receivable. The growth rate of corporate borrowing (excl. shares) has increased. New loans are obtained primarily from banks.

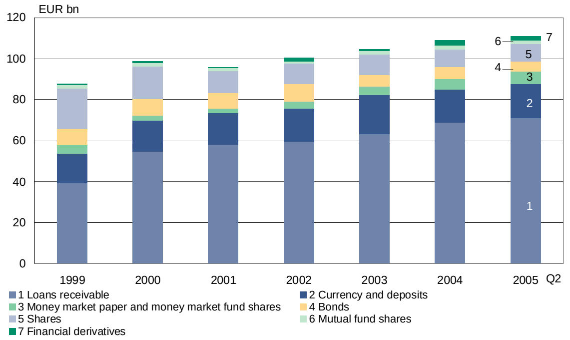
Non-financial corporations' financial assets

Financial accounts show that Finnish non-financial corporations' financial assets have increased slowly in the current decade. Financial accounts[1] compiled by the Bank of Finland show that non-financial corporations' financial assets totalled nearly EUR 88 billion in 1999 and had increased to EUR 111 billion in June 2005.

Of total financial assets, a large proportion (over 60%) is in loans receivable. The growth in loans receivable has been fairly rapid. At the end of 1999, loans receivable totalled EUR 39 billion, and in June 2005, they already amounted to more than EUR 71 billion. Of total loans receivable, a small proportion is in claims on financial corporations, and the rest is mainly in intra-corporate sector claims (eg trade credits).

Financial assets excluding loans receivable have, by contrast, decreased by almost EUR 10 billion since the turn of the century. This is mainly due to a decline in non-financial corporations' holdings of quoted shares.

Chart 1. Non-financial corporations' financial assets



Source: Bank of Finland.

The value of quoted shares held by non-financial corporations has decreased considerably since the turn of the century. In 1999, the value of foreign and domestic quoted shares held by non-financial corporations was nearly EUR 20 billion. Owing to a fall in share prices and to a decrease in cross-ownership of companies, the value of quoted shares held by the corporate sector had dropped to EUR 8.5 billion in June 2005. Foreign quoted shares accounted

[1] Statistical Review, November 2005. Financial Markets. Table 11.2. Bank of Finland.

for only a small part (less than EUR 0.3 billion) of the total value.

The structure of financial assets has changed in terms of debt instruments receivable, with a rapid increase in investments in the short-term money market, ie in money market paper and money market funds. As a result, their share of the narrowly defined financial assets has increased from about 5% at the turn of the century to 15% in June 2005. The use of money market funds in liquidity management has increased due to the higher returns compared to deposits. Of total fixed income investments, the share of bonds has decreased. In 1999, bonds accounted for approximately a sixth of non-financial corporations' financial assets. In June 2005, the figure had dropped to just over 10% (EUR 5 billion).

The volume of cash and deposits has remained stable for several years, at EUR 15 to 16 billion. The increased use of money market funds has halted the growth of non-financial corporations' deposits. Of total deposits, a significant proportion (approximately 70%) is in sight deposits. The average interest rate on sight deposits is currently about 0.8%, ie clearly lower than money market rates.

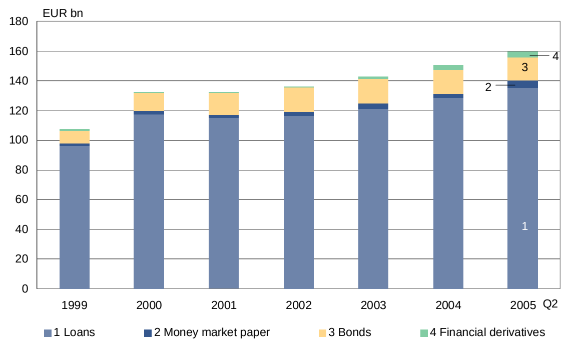
Non-financial corporations' financial liabilities

Financial accounts show that the corporate sector's liabilities amounted to EUR 447 billion at the end of 1999. Actual financial liabilities (excl. market value of share capital, which is included in non-financial corporations' liabilities in the financial accounts) amounted to EUR 107 billion at the end of 1999. This increased in 2000 by more than a fifth and remained stable for several years. In the past couple of years, the annual growth rate of financial liabilities has been approximately 5%, and the growth rate has accelerated in the course of 2005.

Currently, the majority of corporate borrowing is bank loans. The annual growth rate of non-financial corporations' bank loans is now about 9%. The amount of loans obtained from other financial corporations has remained stable for a number of years, nor has the amount of loans from general government increased in recent years. By contrast, the volume of foreign loans decreased in 2004 and in 2005.

The amount of corporate financing obtained from the money market began to increase in 2005. The volume of financing obtained from the commercial paper market is growing rapidly. Non-financial corporations have not issued bonds for several years.

Chart 2. Non-financial corporations' liabilities



Source: Bank of Finland.

2 Banks and insurance corporations

2.1 Continued growth in operating profits

Mervi Toivanen

Banks' operating profits continued to improve in January–September 2005. Income increased more than expenses, and banks recorded low impairment losses on loans. Capital adequacy ratios in the Finnish banking sector remained high on average.

In the first three quarters of 2005, banks posted higher operating profits than in January–September 2004. The total operating profit of Finnish banking groups[2] was EUR 805 million, ie 10% higher than a year ago. The total operating profit of financial conglomerates operating in Finland[3] also improved, by almost 20% to EUR 3.9 billion.

The improved performance was based on income growth. Net interest income improved, due to continued growth in lending stock, and particularly to the large number of households' loans for house purchase. On the other hand, interest rate margins continued to narrow in January–September, which slowed the growth in net interest income. Other income was boosted particularly by net fee income on asset management, mutual funds and investment products as well as lending and cards.

Developments in banks' expenses have been mixed. Staff expenses grew strongly, following an increase in staff numbers and wages. Banks tried to offset the increase in these expenses with tighter control on other expenses. Consequently, the majority of banks recorded decreases in other expenses.

Banks recorded low impairment losses on loans, and some banks continued to record reversals of previously recorded impairment losses. In addition, banking groups' non-performing and zero-interest assets remained small, accounting for 0.3–1.1% of lending stock. For a few banks, non-performing assets grew slightly compared to January–September 2004.

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[2] Finnish banking groups: savings banks, Aktia Savings Bank Plc Group, local cooperative banks, Bank of Åland plc Group, Evli Group, eQ Online Group, OP Bank Group, and Sampo Group banking and investment services.

[3] Includes the following banks: savings banks, Aktia Savings Bank Plc Group, local cooperative banks, Bank of Åland plc Group, Evli Group, eQ Online Group, OP Bank Group, Sampo Group, and Nordea Group.

Healthy incomes and curbing of expenses have improved banks' profitability (measured by return on equity, ROE). There was also an improvement in cost-efficiency (measured by the income-expense ratio). In addition, banks' capital adequacy ratios remained high on average.

Table 1. Banks' income statement items, Jan–Sep 2005

	Net interest income, EUR m		Other income, EUR m		Total expenses, EUR m		Operating profit, EUR m	
	1-9 2005	Change %	1-9 2005	Change %	1-9 2005	Change %	1-9 2005	Change %
Nordea Group	2 730	6.0 %	2 152	-2.4 %	2 712	1.3 %	2 300	11.2 %
*Nordea Group, retail banking	2 268	5.3 %	1 161	9.5 %	1 889	0.7 %	1 592	19.3 %
*Nordea retail banking in Finland	608	-	278	-	454	-	424	-
Sampo Group	225	0.9 %	4 305	49.2 %	3 528	44.2 %	1 007	50.7 %
*Sampo Group banking and investment services	251	5.0 %	274	0.0 %	303	2.0 %	229	1.8 %
*Sampo Group, insurance business	-	-	-	-	-	-	812	-
OP Bank Group	589	5.0 %	420	9.7 %	554	2.4 %	452	11.9 %
*OKO Bank Consolidated	117	8.3 %	111	19.4 %	112	9.8 %	115	15.0 %
Savings banks (excl. Aktia) Total	85	4.4 %	32	6.7 %	76	0.9 %	41	15.5 %
Aktia Savings Bank plc Group	58	8.4 %	30	1.4 %	54	-0.7 %	34	22.7 %
Local cooperative banks	57	5.4 %	18	8.0 %	49	0.2 %	26	19.3 %
Bank of Åland plc (Group)	23	5.5 %	16	10.7 %	26	4.1 %	14	27.4 %
Evli Group	0	-59.9 %	42	8.1 %	36	14.2 %	6	-25.9 %
eQ Online Group	2	22.9 %	20	83.2 %	18	48.6 %	4	120.9 %
1. Finnish banking groups (excl. Nordea)	1 066	5.1 %	850	6.8 %	1 116	2.8 %	805	9.7 %
2. Finnish banking business	1 674	-	1 128	-	1 570	-	1 229	-
3. Financial conglomerates operating in Finland	3 770	5.5 %	7 033	25.3 %	7 053	19.3 %	3 883	19.7 %

Other income includes net fee income, profit and loss on sales of tangible and intangible assets, and shares of profit/losses of associated companies.
Total expenses include write-downs and depreciations on tangible and intangible assets.
The items of the table do not add up to the operating profit, as not all the banks' income statement items are included.
The change % was calculated on the corresponding figures for 2004.
The figures for Pohjola Group plc January–September 2005 have not been consolidated with OP Bank Group's (or OKO Bank's consolidated) income statement for January–September 2005 or with the balance sheet for 30 September 2005.

Finnish banking business includes the Finnish banking groups, Sampo Group banking and investment services, and Nordea retail banking Finland.
Financial conglomerates operating in Finland include the Finnish banking groups, Sampo group and Nordea group.

Source: Banks' interim reports.

2.2 Nordic financial groups post good results in many countries

Sampo Alhonsuo

The largest Nordic financial groups have continued to turn in strong performances. They generally operate in several countries, and foreign operations now account for a significant part of the overall results. Further internationalisation of their operations is likely to continue.

Recent data show that Nordic financial groups continue to post strong results. Several groups improved by tens of per cents, compared to 2004.

The improvement in results is due to favourable developments in income and cost control. The groups' stock of lending has grown at a rapid pace, which has increased net interest income. Business has grown eg in mutual funds, insurance and capital market operations, and this has boosted profits. The increase in expenses has been slower (or nil) than the growth of income. Nordic financial groups have did not have to record significant loan losses in the first three quarters of 2005.

In many financial groups, capital gains or new business acquisitions also contributed to the improved results. The groups' profitability, measured by return on equity, is high. At the end of September, the capital adequacy ratios of most large financial groups were lower than at the end of 2004.

Table 2. Operating profit, ROE and capital adequacy (Tier 1) of Nordic financial groups

	Operating profit 1-9/2005, EUR m	Operating profit 1-9/2004, EUR m	Year-on-year change %	Return on equity (ROE), % 1-9/2005	Capital adequacy Tier 1 %, 30.9.2005	Capital adequacy Tier 1 %, 31.12.2004
Nordea Group	2 300	2 068	11.2	18.6	7.0	7.3
Danske Bank Group	1 708	1 182	44.4	17.8	6.5	7.7
SEB Group	934	786	18.9	16.5	7.8	7.8
Svenska Handelsbanken Group	1 185	1 087	9.0	17.0	7.4	7.6
DnB NOR Group	1 209	984	22.8	17.8	6.9	7.6
FöreningsSparbanken Group	1 284	821	56.4	27.3	6.5	8.2
OP Bank Group	452	404	11.9	12.5	13.5	14.1
Sampo Group*	1 007	668	50.7	32.3	7.0	7.1
Kaupthing Bank Group	562	216	-	32.3	9.2	11.5
Jyske Bank Group	221	164	35.2	20.0	7.9	8.9
Total (operating profit) and average** (return on equity and capital adequacy)	10 863	8 380	29.6	19.2	7.3	7.9

* Capital adequacy of Sampo Bank Group.
** Average, weighted by balance sheet totals.
Figures converted to euro at end-September exchange rates.
Sources: Banks' interim reports.

The operations of many financial groups are highly internationally oriented. In many financial groups, not only banking operations but also insurance operations in several countries play a key role.

In recent years, the importance of international operations has increased for Nordic financial groups, for several reasons. Some large financial groups are keen to take advantage of opportunities afforded by strong economic growth in the new EU member states. The groups hope to achieve major benefits from modern banking technology. Rapid growth could ease cost and profitability pressures, and all the groups are looking to benefit from economies of scale. Growth based solely on the domestic markets may be extremely hard to achieve.

In some cases, international operations account for more than 20% of financial groups' operating profits. For some groups, retail lending and deposits outside the host country already account for 20–25% of total lending and deposits. All the largest financial groups have life insurance operations in several countries, and the Sampo Group has significant non-life insurance operations abroad.

The table below illustrates the importance of international operations to Nordic financial groups. In reality, the groups' international operations are even more extensive than the figures indicate, due to the fact that reported results for many business areas besides retail banking – eg treasury, corporate banking, asset management, leasing, and life insurance – cover several countries. The groups do not, however, break down or publish all data by country.

Table 3. International banking operations and total insurance operations, % of group total

Financial Group	International banking operations			Total insurance operations
	Operating profit	Lending	Deposits	Operating profit
Nordea Group**	82	75	80	5
Danske Bank Group	11	23	25	9
SEB Group	23	-	-	8
Svenska Handelsbanken Group	12	20	18	4
FöreningsSparbanken Group***	15	10	18	5
Sampo Group****	1	-	-	81

Figures for January–September or end-September 2005.
* Domestic and foreign life-insurance operations only; figures for Sampo cover both life and non-life insurance operations.
** For Nordea, "international banking operations" does not include operating profit and lending and deposits of its regional banks in Sweden.
*** FöreningsSparbanken's "international banking operations" include HansaBank. Insurance operations' operating profit includes the results for the whole Robur Group.
**** Operating profit for January–June.
\- = Data not available.
Sources: Banks' interim reports.

In recent years, Nordic financial groups have expanded their operations to various countries via acquisitions and establishment of subsidiaries and branches. The key countries involved are the Nordic and Baltic countries, as well as Poland, Germany, and the United Kingdom. For the SEB Group, Ukraine is an important market. In 2004, Danske Bank acquired two banks, one in Ireland and one in Northern Ireland. As a result, Danske Bank's stock of lending and stock of deposits grew by over 10%. The Norwegian DnBNOR and German Norddeutsche Landesbank have established a joint venture bank that will operate in the Baltic countries, Poland, Finland, and Denmark. Recently, several groups have reported that they will expand their operations into Russia.

2.3 Comparison of EU banking sectors

Karlo Kauko

New data on EU countries' banking sectors indicate much similarity in the structure of income in almost all the countries. There are significant differences in funding sources. Differences in accounting practices still hamper cross-country comparisons.

Aggregate data on the banking sectors of different countries are usually calculated from unconsolidated data, which excludes the banks' subsidiaries. Normally, each business activity is included in the data of the host country, irrespective of the bank's home country. The ECB has recently published[4] new country-specific data on EU banks. The consolidated data has been provided by member organisations of the Banking Supervision Committee of the ESCB.

The data include information on EU banks' balance sheets and income statements for 2004. The figures have been calculated for banking groups – not for individual banks (excl. subsidiaries). The ECB has published two types of country-specific aggregate data:

- all banking groups operating in the country in question
- domestic banking groups, which are not in foreign banking groups

These consolidated data do not include insurance corporations.

The data show that there is a fairly small difference in income structures of the EU-25 and EU-15 banking sectors. In both groupings, net interest income (difference between interest income and interest expense) accounted for 60 to 70% of total income. There is only one EU country in which the banks' income structure differs significantly from that of the other EU banking sectors: in France, banks' net interest income accounted for only 27% of total income. The exceptionally low figure is probably due to national accounting practices. In Finland, the proportion of banks' net interest income of total income, 67%, was slightly higher than in the other EU countries on average.

On the whole, banks' profitability was good. In 2004, average return on equity was 12.2%. Profitability was weakest in Germany and Cyprus, where return on equity was less than 4%. In the other countries, domestic banking groups' return on equity was either over 10% or the number of such banks was so small that their profitability is irrelevant. None of the banking sectors posted negative results.

The cost-to-income ratio is lower in the United Kingdom (about 42%) than in any other member states.

Analysis of only domestic banking groups shows that in terms of total assets, Finland is an exception in the EU. Loans to customers accounted for 78% of total assets, ie for a higher proportion than in any of the other EU countries.

[4] EU Banking Sector Stability, ECB, October 2005, Statistical Annex.

Cross-country differences in banks' funding sources were more pronounced than in claims and investments. The ratio of amounts owed to customers (mainly deposits) to balance sheet total varied from 22% in Denmark to 84% in Cyprus.

Comparison is hampered by differences in accounting practices. For example, there are major differences in accounting for loan loss provisions and taxes, which should be taken into consideration in data comparisons. Comparison will become easier as the International Financial Reporting Standards become more widely applied. Comparison of data for 2005 is considerably easier because these standards are mandatory to all listed banks.

Table 4. Key indicators of banking groups, EU-15 (2004)

	Net interest income (% of total income	Return on equity, ROE	Cost-to-income ratio	Loans to customers, % of total assets	Amounts owed to customers, % of total assets
Finland domestic groups	66.7 %	11.2 %	57 %	78.0 %	59.1 %
Finland, all groups	67.1 %	8.0 %	57 %	53.2 %	40.2 %
Germany	55.9 %	3.9 %	69 %	42.9 %	35.2 %
France	27.1 %	12.6 %	66 %	39.5 %	32.9 %
Italy	61.2 %	10.6 %	58 %	59.4 %	44.6 %
Spain	62.5 %	15.5 %	54 %	64.7 %	56.5 %
Netherlands	58.2 %	13.2 %	68 %	55.7 %	47.5 %
Belgium	60.3 %	14.1 %	64 %	42.6 %	49.6 %
Portugal	59.1 %	12.1 %	61 %	68.5 %	54.8 %
Greece	70.3 %	10.5 %	60 %	63.4 %	70.0 %
Austria	69.3 %	14.9 %	63 %	50.3 %	42.9 %
Ireland	59.3 %	20.9 %	53 %	53.1 %	31.6 %
Sweden	62.6 %	16.1 %	58 %	62.3 %	28.9 %
Denmark	67.1 %	12.4 %	55 %	59.4 %	22.1 %
UK	70.0 %	18.0 %	42 %	58.0 %	51.1 %
EU average	***56.6 %***	***12.2 %***	***59 %***	***50.7 %***	***41.7 %***

The figures refer to domestic banking groups. For Finland, figures for all banking groups operating in Finland are reported because domestic banking groups account for an exceptionally small share of total assets, compared to other EU-15 countries. In the data for Finland, Nordea Bank Finland group is considered a foreign banking group.

Data for Luxembourg are excluded due to the exceptional structure of the country's banking sector.
Return on equity is calculated as banks' profits after tax and extraordinary items relative to Tier 1 assets.

3 Securities markets

3.1 Indicators of integration in the European securities markets

Jukka Vauhkonen

The heterogeneity of corporate bonds and equities complicates the assessment of integration of these markets. But new advanced integration indicators have reduced the assessment problems.

In recent years, indicators of financial integration have been actively developed in Europe. This subsection examines indicators based on market prices of corporate bonds and equities and the progress of integration in these markets in Europe.

Financial integration can be defined in several ways. According to the simplest definition, financial markets are fully integrated when the 'law of one price' holds. In the securities markets, the law holds if the prices of securities generating identical cash flows are the same irrespective of the country of issuance.

The measurement of integration of securities markets is hampered by the heterogeneity of securities. In the European government bond markets, this is a relatively small problem. Long-term government bonds are fairly homogeneous in terms of credit risk, liquidity and market practice.[5] In contrast, corporate bonds differ significantly by sector and in terms of cash flow structure, liquidity and credit rating. The differences are even more significant for equities. Thus different measures of integration are generally used in the corporate bond and equity markets than in the government bond markets.

A new annual survey[6] published by the ECB assesses the development in recent years of three price-based integration indicators for the corporate bond market and three price-based indicators for the equity market.[7] These indicators are econometric-model-based and hence make use of statistical methods. The following paragraphs describe these indicators in a simplified way and examine their evolution in recent years.

The progress of integration in the European bond market can be analysed using a regression model. The first stage involves assessment of the impact of systematic factors on corporate bond yields (above risk-free reference yield). These factors include

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[5] For information on progress in the integration of European government bond markets, see eg M. Pagano and E. von Thadden (2004): The European bond markets under EMU. Oxford Review of Economic Policy, Vol. 20, No. 4.

[6] ECB (2005): Indicators of financial integration in the euro area, September.

[7] On quantity-based indicators of integration in securities markets, see eg P. Pylkkönen (2004): Securities markets integration, in H. Koskenkylä (ed.) *Financial integration*, Bank of Finland Studies, A:107.

remaining maturity, coupon rate and liquidity as well as issuer's sector and credit rating. In the next stage of the analysis, regression residuals are tested, ie the part of the corporate bond yield that cannot be explained by systematic factors. In a fully integrated market, the residuals should not depend on the country of issue.

Results show that the impact of country-specific factors on adjusted corporate bond yields was relatively small in the period of 1998–2005 in the seven euro area countries[8] studied. Another integration indicator for the corporate bond market is the standard deviation of the country-dummy coefficients. If the standard deviation decreases over time, this would suggest a possible deepening of integration in the corporate bond market. But in recent years the standard deviation has actually decreased. The third indicator gives the proportion of the variance of corporate bond yield spread that is explained by systematic factors and the proportion explained by country-specific factors. In a fully integrated market, the country-specific impact should be close to zero. The results show that the country-specific impact is very small.

Overall, the new price-based indicators for corporate bond markets suggest a high level of integration in the bond markets of the euro area countries studied. The indicators, however, do not show that integration deepened in the review period (1998–2005).

Price-based integration indicators for equity markets are used to examine the relative importance of country- vs sector-specific factors and global (or Europe-level) vs local factors in explaining equity returns. In fully integrated equity markets, the equity returns of an individual company should be based mainly on the profitability of its sector and not on its home country. If this is the case, sector-based portfolio diversification will produce greater benefits than a country diversification strategy.

Country and sector dispersions of monthly euro area equity returns for 1975–2005 show that up to 2001, the cross-country dispersion of stock index returns was greater than the cross-sector dispersion. These findings suggest that, most of the time, country diversification has been superior to sector diversification. Since 2001, the dispersion effect of a sector diversification strategy has exceeded that of a country diversification strategy, which would suggest a deepening of integration in the European equity markets in recent years.

Another way to assess progress in equity market integration is to analyse the impact of Europe-level and local factors on equity returns. The profitability of European listed companies is expected to converge with deepening integration of the European economy and financial markets. If this is the case, we should see parallel movements in equity returns across the EU countries. Indicators do in fact show that the index of EU-wide equity returns now explains more accurately the returns on EU countries' national stock indices.

A third indicator of integration of equity markets shows the increasing importance of Europe-wide shocks (vs shocks in US equity markets) in explaining the variance of domestic equity returns in EU countries.

Overall, the indicators examined suggest a high degree of integration in European corporate bond markets, and that major progress is being made in the integration of European equity markets. Strong growth in recent years in euro area corporate bond and equity markets, as well as diversification of bond investments across the entire euro area (instead of just in domestic

[8] Netherlands, Spain, Íreland, Italy, Austria, Germany, and France.

markets), suggest also a deepening of integration in these markets.[9]

3.2 Securitised markets

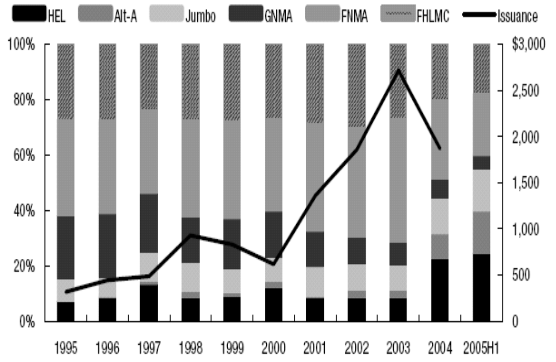
Katja Taipalus

Securitisation of new types of mortgages growing rapidly in the United States.

This year, mortgage banks have again stepped up their activity in the domestic financial market. Bonds have been issued eg by Aktia Hypoteksbank and Sampo Housing Loan Bank plc. This is a positive development since it enables banks to spread the risks of housing loans.

In the United States, the stock of lending for house purchase has grown with the rise in housing prices. Between 2004 Q2 and 2005 Q2, housing prices rose by 13.4% – the biggest increase in 25 years. In the United States, the majority of mortgages are securitised by the government agencies Fannie Mae and Freddie Mac[10]. Mortgages sold to government agencies, (often called conforming loans) have had excellent credit ratings and thus meet strict quality criteria. Loans associated with considerably higher risks are called non-conforming loans. These include, for example, prime jumbo loans, loans with insufficient documentation, home equity loans, as well as interest-only loans on which only interest is paid during the first years of the loan period. In the past few years, the share of these innovative loan types in total securitised mortgage loan issuances has increased rapidly in the United States.

Chart 3. Securitised mortgage loans, 1995–June 2005



In the Chart 3, HEL, Alt-A and Jumbo are new loan types and GNMA, FNMA and FHLMC are government agencies. The chart shows that the share of innovative loans in total securitised mortgage loan issuances grew rapidly in 2004 and the first half of 2005. Source: Citigroup.

Despite the growth in the share of innovative loans, they still account for only a few per cent of banks' total assets. It is however noteworthy that the largest market participants are moving these loans off their balance sheet via securitisation, in contrast to the smaller banks. The proportion of items securitised by government agencies of new securitisations has also been decreasing (Chart 3).[11]

Housing prices and the stock of lending for house purchase have increased strongly in Europe as well. In the United Kingdom, the proportion of non-conforming[12] loans in securitised loans has been increasing since 2002: in 2004, they accounted for

[9] See European Commission (2005). Financial integration monitor, http://europa.eu.int/comm/internal/finances/fim/index_en.htm.

[10] Currently, only Ginnie Mae is a true government agency, but due to their close connections, it is assumed that securities issued by Freddie Mac and Fannie Mae are implicitly guaranteed by the US government.

[11] In 2004, items securitised by agencies accounted for just 54% of all securitised loans (compared to the previous 75%).

[12] In the United Kingdom, non-conforming loans are defined differently than in the United States.

38% of total securitised mortgage-backed bonds. On the other hand, in Spain – another country with sharply rising housing prices – the majority (about 60%) of securitisations are still collateralised debt obligations, followed by residential mortgage backed securities, which accounted for 35% of securitisations in 2004.

Impact of banks' capital adequacy reform on the availability of bank loans to SMEs – is securitisation the solution?

As a consequence of the capital adequacy reform applicable to banks (Basel II), having risk-prone customers will become more expensive to banks because banks need more capital than before to cover the loans to these customers. SMEs have thus been concerned about a possible increase in the cost of financing.

In Europe, SMEs play a significant role in the economy: over 90% of companies are SMEs. For bank-centred financial systems, the key question in the new capital adequacy framework is how to minimise the potential harmful impact of the reform on the availability of financing to SMEs.

The European Commission and European Investment Fund (EIF) have studied the possible impacts of securitisation on the transfer of SME credit risks away from banks and on the cost of SME financing. Deutsche Bank was the first bank in Europe to securitize SME loans (1999). Since then, loans have been securitised particularly in Spain and Germany, where programme-form securitisation is applied. In Germany, securitisation transactions are synthetic, whereas in Spain, a special purpose vehicle is used in the securitisation process.

Securitisation seems to have a positive impact on the availability of financing for SMEs. In several countries, government support measures for the securitisation of SME loans have thus been considered, and studies have been conducted on effectiveness of various support measures. Most recently, in spring 2005, SME loans were securitised in Portugal. These securitised loans were guaranteed by both the European Investment Fund and a government agency. The issuance attracted Europe-wide interest and the majority of subscriptions were in France and Germany.

Since 2000, the European Investment Fund has issued guarantees on the securitisation of SME loans. According to estimates by the European Investment Fund, approximately 145,000 SME loans in eg Austria, Belgium, France, Spain, and Italy had been securitised by the end of 2004. The European Investment Fund has estimated that lending to SMEs consequently increased in these countries, as lending limits became available for new loans.

Barclays of United Kingdom recently announced a record size securitisation of SME loans. Loans worth GBP 5 billion will be securitised in the form of a synthetic collateralised loan obligation. ABN AMRO also announced that it will securitize a large amount of SME loans: Dutch SME loans worth EUR 6.75 billion will be securitised by synthetic securitisation.

3.3 Expansion of the Finnish venture capital market has come to a halt

Pertti Pylkkönen

Venture capital investments in Finland totalled EUR 369 million in 2004. Relative to GDP, these investments fell below the European average in 2004.

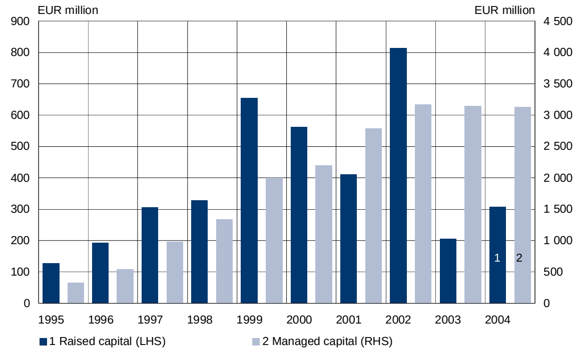
In the past few years, activity in the Finnish capital investment market has been very subdued. There has been almost no accumulation of new capital, the amount of capital under management has decreased, and the amount of non-invested capital is high.

In 2004, the amount of new funds raised for capital investment totalled 309 million[13] – about 50% more than in the previous year. The sources for new funds have changed in recent years. In the first years of the current decade, insurance corporations and employee pension insurers were the major sources of new funds. In 2003 and 2004, the insurance sector's new venture capital investments were channelled mainly into foreign, rather than domestic companies. The amount of funds obtained from the public sector has also been moderate in recent years. In 2004, the major sources of funding were capital markets and captive investors.

The amount invested totalled EUR 369 million and the number of investments rose to over 400. In line with previous years' trend, the focus was on initial investments, in monetary terms, and on follow-on investments, in number terms.

[13] Finnish Venture Capital Association. Yearbook 2004.

Chart 4. Amounts of raised and managed capital



Source: The Finnish Venture Capital Association.

The industry distribution of total investment has for several years focused on the traditional industrial products and services industries. The technology sector accounted for a very modest share of capital investments.

Capital investments in Finland accounted for less than 1% of total capital investments in Europe (approximately EUR 37 billion).

Divestments increased in number, and their amount at cost was EUR 262 million. In 2003, the amount divested was EUR 231 million. The year 2005 saw the first exit via initial public offering in several years, when AffectoGenimap Oyj was added to the Helsinki Stock Exchange main list. Setec, the majority of which is owned by venture capitalists, was sold to the company Gemplus of Luxembourg, which is quoted on the Euronext in Paris. The possibility of exist via initial public offering is an important prerequisite for the development of venture capital markets. Lack of opportunities for listing weaken investors' interest in venture capital investment.

The amount of capital under management decreased in 2004, to EUR 3,129 million at year-end. Of the total amount of capital under management, 59% was invested in companies at year-end. The remaining capital under management is available for new investments and follow-on investment rounds.

In Finland fairly small amounts are placed in seed and early-stage investments, as well as in technology. Private and public sector venture capitalists have recently started projects that may improve the availability of early-stage venture capital. Moreover, the process of turning an innovation into a profitable business idea or product is fairly inefficient in Finland, which is a problem.

A study published by the European Private Equity and Venture Capital Association (EVCA)[14] in 2004 shows that the competitiveness of Finland as an operating environment for growth companies is weak by European standards. The study examined the tax and legal environment for European growth companies. In the comparison of 21 countries, Finland ranked 17th. According to the study, for example, current legislation hampers private venture capital investment. In Finland there is very little venture capital investment by business angels.

Since the study was conducted, there has been a significant change in the operating environment. In June, the Finnish Parliament passed an amendment to the act on the taxation of foreign capital investors. The tax treatment of a capital investment is now the same as that of a direct investment. This amendment should bolser foreign venture capitalists' interest in the Finnish capital investment market.

[14] Benchmarking European Tax and Legal Environment; Indicators of Tax & Legal Environments Favouring the Development of Private Equity and Venture Capital and Entrepreneurship in Europe. May 2004. EVCA.

4 Infrastructure

4.1 Finland to join TARGET2 in February 2008

Heli Snellman

The integration of both retail and large-value payment systems is on course. Finland will join TARGET2 in February 2008. Technological advancement improves efficiency but may also bring new risks.

In October, the ECB published the second progress report on TARGET2[15]. This payment system will replace the current TARGET, which is the Eurosystem's automated real-time gross settlement system for large-value payments. The start-up date for the new system is 19 November 2007. Countries will change over to TARGET2 in three waves: the first group of countries will migrate on 19 November 2007, the second on 18 February 2008 and the third on 19 May 2008. Finland is in the group that will migrate in February 2008. The report also discusses the system's pricing and operational day. According to the pricing proposal, participants can choose between a small monthly fee plus a fixed transaction fee, or a higher monthly fee plus a declining transaction fee. The latter option is optimal for 5,750 or more transactions per month. Besides euro area countries, the other EU countries can also join TARGET2. But not all countries using the current TARGET system will join the new system. Sweden, for example, decided in February 2005 not to join TARGET2.[16]

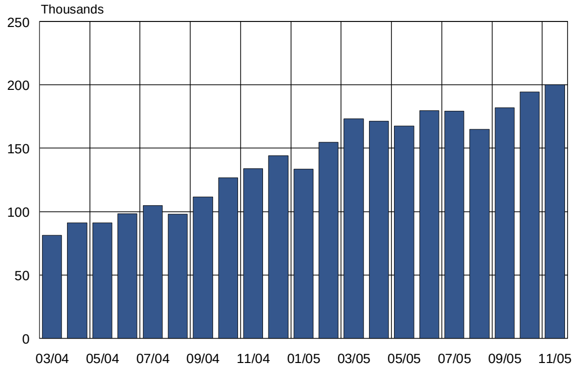
Integration is also progressing in respect of retail payment systems. Banks in Luxembourg have decided to handle all their domestic credit transfers via the STEP2 platform by September 2006.[17] So far STEP2 is the only pan-European automated clearing house (ACH). It is operated in Italy and managed by the Euro Banking Association (EBA). Italian and Spanish banks are also considering the possibility of handling their domestic credit transfers via the STEP2 platform. The volume of payments processed in the system is still relatively small (Chart 5). For example, the daily average number of payments processed in the Finnish retail payment system PMJ is tenfold compared to that of STEP2. On 2 January 2006, the maximum payment size for STEP2 transfers increased from EUR 12,500 to EUR 50,000. Since 1 January 2006, Regulation (EC) No 2560/2001 of the European Parliament and of the Council on cross-border payments in euro has also applied to payments of up to EUR 50,000.

[15] http://www.ecb.int/pub/pub/paym/html/index.en.html

[16] http://www.riksbank.com/templates/Page.aspx?id=12761

[17] http://www.finextra.com/sibosonline/fullstory.asp?id=14365

Chart 5. Volume of payments in STEP2, daily average



Source: Euro Banking Association.

European banks are preparing the Single Euro Payments Area (SEPA). The European Payments Council (EPC) in September announced their targets[18] for creating a SEPA. The aim is to have a SEPA for citizens by the year 2008, by which time common payment methods will be available to all Europeans, in line with the SEPA initiative. Domestic payment methods would continue to be available. Domestic debit cards, credit transfers and direct debits could be used until 2010, when a fully-harmonised SEPA should be in place. The timetable is demanding. A Single Euro Payments Area is also being promoted by national central banks, the ECB and the European Commission. The ECB expects each country to prepare a national migration plan for implementing SEPA. In this context, also Finnish banks will have to take a stand on the future processing of domestic payments.

Changes in systems and payment instruments may sometimes cause operational disturbances. In November, it was reported that Nordea will withdraw some 30,000 new Visa payment cards from the market, and replace them with new ones in January 2006. The cards' holographic magnetic stripe has caused disturbances in the operation of some EFTPOS terminals.

Technological efficiency and risks

In November, the Bank of Finland arranged an international technology seminar. Technology-driven efficiencies and risks were discussed from various perspectives by participants such as academic researchers and company representatives. The Bank of Finland will publish a book of articles based on the seminar presentations.

In his opening speech[19], Governor Erkki Liikanen emphasised that Europe needs growth. With an ageing population, growth cannot be achieved via increased labour contribution. Therefore, labour productivity must be increased, which will require a higher level of investment and a faster rate of technological advance. Competition is also very important because it forces the participants of an integrating market to improve efficiency. Issuing regulations may sometimes be necessary for markets to improve at a sufficiently rapid pace. With technological progress, the risk profile of financial institutions will change and contagion can take new forms. Thus authorities must also understand the risks and possibilities that progress may entail.

18 http://www.europeanpaymentscouncil.org/documentation.htm

19 http://www.bof.fi/fin/1_suomen_pankki/1.8_puheet/1.8.1_SPpuheet/2005/index.asp?page=intro.stm

4.2 New directive on payment services to facilitate cross-border payments in the EU

Heli Snellman

On 1 December 2005, the European Commission issued a proposal for a directive on payment services[20]. The aim is to remove the remaining legal barriers and to create a single payment market in the European Union. The proposal covers the euro and the other currencies of the European Union.

The European Commission's recent proposal for a directive is intended to make cross-border payments within the EU as easy, inexpensive and safe as domestic payments. The proposal for a directive focuses on electronic payment methods, and would not be applied eg to cash or cheque transactions. According to the Commission, payments between the separate payment systems of EU member states have involved significant annual costs. Moreover, there are significant differences in fees paid by different nationals for the same services. The aim of the directive proposal is to create a more efficient market, which in turn will increase competition and reduce fees on basic banking services. In addition, the new directive will ensure fair and open access to payment markets and improve and harmonise consumer protection.

The new directive will be applied in all EU member states and to all EU currencies. For example, the regulation on cross-border retail payments issued by the Commission in 2001 applied only to payments in euro. The directive proposal also provides a legal framework for the Single Euro Payments Area (SEPA), which is being prepared by the European banks (see Subsection 4.1).

According to the Commission, the major benefits of the new directive will be increased competition and market transparency. Competition will increase with the opening up of the national payment services markets for all service providers and with the ensuring of a level playing field that will enhance operations and promote innovation. Transparency of the market will be enhanced by replacing current national information requirements by fully-harmonised EU-wide rules. As a result of the harmonisation of regulation, all users and providers of payment services will have the same rights and obligations in every EU country. A major obligation for banks will be to execute payments within one day, as from 2010. The directive will also introduce cross-border direct debits. So far, direct debit services between EU member states have not been available. It is noteworthy that the Commission issued a proposal for a directive instead of a regulation, as was the case regarding cross-border retail payments in euro.

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20 http://europa.eu.int/comm/internal_market/payments/docs/framework/com_2005_603_en.pdf

5 Key corporate arrangements and events in the financial sector

Date	Event and description
Mar 2005	*Amendments to the restrictions on the acquisition of own shares included in the Companies Act took effect. Consequently a public limited company can acquire an amount of own shares that does not exceed 10% of its share capital or total voting rights attached to its shares.*
	The Spanish bank Banco Bilbao Vizcaya Argentaria made a EUR 7.6 billion bid for the Italian bank Banca Nazionale del Lavoro.
	ABN AMRO announced that it will acquire Bank Corluy, a Belgian private bank.
	Alfred Berg announced it will become a European Company within 2005.
	ABN Amro Holdings NV made a EUR 6.3 billion offer for majority holding of Banca Antonvenetta SpA, an Italian bank.
	Société Générale announced it had acquired Promek Bank, a Russian bank.
Apr 2005	*Swedbank announced that it owns 98% of Hansapank's share capital osakekannasta. Hansapank will be withdrawn from the main list of the Tallinn exchange.*
	Fortis AG and FB Insurance will merge. The new company, Fortis Insurance Belgium, will become the largest insurance company in Belgium.
	Sampo Life Insurance Company Ltd was granted an operating licence for establishing a subsidiary in Sweden. The name of the company will be If Livförsäkring Ab.
	New York Stock Exchange and Archipelago merged.
	Nasdaq acquired Instinet.
	Société Générale acquired Eurobank, a Polish consumer credit company.
	Kaupthing announced it will acquire British bank Singer & Friedlander Group plc for about GBP 550 million.
May 2005	*Skandia Life announced that it will stop selling new insurance policies in Finland.*

Date	Event and description
	E*Trade and Ameritrade to merge.
	SAXESS trading system was introduced at the Vilna Stock Exchange. The common trading system is now being used at all the exchanges in the OMX Group.
	Helaba acquires Frankfurter Sparkasse
	WestLB announces that it will acquire Weber Bank.
June 2005	Unicredito Italiano announces that it will acquire the German bank HypoVereinsbank (HVB) and its subsidiaries for EUR 19.2 billion.
	SEB Unibanka, a subsidiary of SEB, acquires 100% of the shares in the Latvian life insurance company Balta Life from Codan's subsidiary for EUR 7.7 million.
	BNP Paribas acquires the US bank Commercial Federal Corporation, headquartered in Nebraska.
	Bank of America Corporation announces that it will purchase 9% of the shares in China Construction Bank. Also Temasek Holdings, a Singaporean state-owned investment company, purchased CCB shares.
	The Norwegian DnB NOR and the German Norddeutsche Landesbank annouce that they will establish a joint venture bank, operating in the Baltic countries, Poland, Finland, and Denmark.
	Nordea announces that it will acquire Sampo's Polish life and pension insurance companies for EUR 95 million.
	Bank of America acquires MBNA Corporation.
July 2005	Helsinki Stock Exchange starts the calculation of new industry indices.
	Standard & Poor's upgraded OKO Bank's ratings as follows: short-term rating to A1+ from A1 and long-term rating to AA- from A+
August 2005	Sampo Bank announces that it will transfer a EUR 1.1 billion housing loan portfolio to its subsidiary Sampo Housing Loan Bank.
	Nordea and The Bank of New York enter into a strategic agreement to provide global custody and clearing services to Nordea's institutional clients in the Nordic and Baltic Sea region.
	A group headed by Royal Bank of Scotland acquires a 10% stake in the Bank of China, the second largest bank in China.

Date	*Event and description*
September 2005	*OKO Bank acquires a majority stake (58.5%) in Pohjola Group plc. OKO Bank will retain ownership of Pohjola Non-Life Insurance Company Ltd, and Pohjola Life Insurance Company Ltd and Pohjola Fund Management Company Limited will be sold to the OP Bank Group Central Cooperative.*
	Old Mutual of South Africa makes an offer for Skandia.
	Standard & Poor's affirms A1+ and AAA ratings on Finnish government bonds.
	Banca Popolare decides to sell a 30% stake in Banca Antonveneta to the Dutch ABN Amro.
	Elcoteq Network Corporation converts into a European Company (Societas Europaea).
	Landsbanki Islands purchases 81% stake in Kepler Equities SA. Kepler previously operated under the name Julius Bär Brokerage.
October 2005	*ABN Amro NV acquires 39.4% stake in the Italian bank Banca Antonveneta SpA, from Banca Popolare Italiana SpA and its partners.*
	Merger of Mtsubishi-Tokyo Financial Group and UFJ Holdings enters into force 1 October 2005. Merger of Bank of Tokyo-Mitsubishi and UFJ Bank to enter into force in January 2006.
	FöreningsSparbanken (Swedbank) sells 3 million shares of Aktia Sparbank, for approximately EUR 21 million. Its ownership in Aktia Sparbank thus decreased from 9.5% to 1.1%.
	OMX announces it will launch a Danish marketplace for small companies.
	Alfred Berg Finland Oyj Abp merges with its parent company Alfred Berg Fondkomission AB. At the same time, the company – owned by ABN Amro – becomes a European Company (Societas Europaea, SE). The new name of the company is Alfred Berg SE.
	Elcoteq Network Corporation becomes a European Company. The new name of the company is Elcoteq SE.
	Danske Bank sells its finance company HandelsFinance A/S to the French company LaSer/Cofinoga.
November 2005	*Sampo Life Insurance Company Limited obtains a license to operate in Norway. Sampo Life will establish a branch in Norway, the products of which will be distributed by Sampo's another subsidiary, If P&C.*
	Commerzbank announces it will acquire 66.2% stake in Eurohypo AG, from Allianz (28.5%) and Deutsche Bank (37.7%). Commerzbank currently has a 31.8% stake in Eurohypo.

Date	*Event and description*
	Swiss Re, the world's second largest re-insurer, announces it will acquire GE Insurance Solutions, a reinsurance company owned by General Electric Company (GE).
	Nokia announces it will acquire Intellisync Corporation, a provider of wireless email services, for approx. USD 430 million.
	Swedbank opens a branch in Helsinki. Swedbank Helsinki will provide corporate banking services.
	SEB Finans AB purchases ABB Credit Oy, a leasing company, from ABB Oy.
	The Icelandic Stock Exchange announces it will not continue merger negotiations with OMX.
	Japanese Parliament approves privatisation of post office system.
	Sampo Group transfers its investment services companies to Sampo Bank.
	S&P upgrades Sampo Bank's ratings as follows: short-term rating from A2 to A1 and long-term from A- to A.
	S&P upgrades Nordea's ratings as follows: short-term rating from A1 to A1+ and long-term from A+ to AA-.
December 2005	*Members of New York Stock Exchange approve merger of New York Stock Exchange with Archipelago.*