Financial Market Report

1 • 2006

- Banks and insurance corporations display good profitability in 2005
- Rapid growth of credit derivatives – a threat to market infrastructure?
- Will removal of wealth tax boost savings flows into funds?
- Finland to join SEPA in 2008
- Deeper integration of Nordic securities systems

EUROJÄRJESTELMÄ
EUROSYSTEMET

Bank of Finland

Financial Markets and Statistics

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1 Financial intermediation

1.1 Non-financial corporations' domestic borrowing concentrated in bank loans

Pertti Pylkkönen – Jukka Vauhkonen

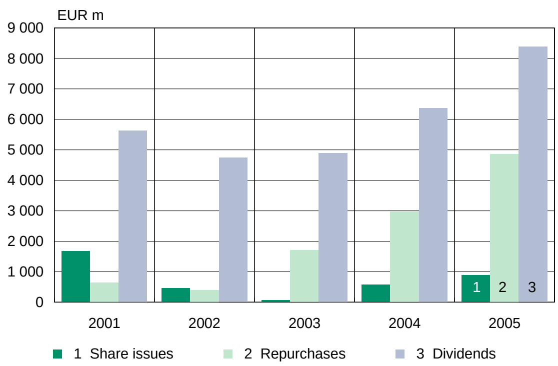
Listed companies' combined profitability improved in 2005. An increasing proportion of earnings is allocated to investors in the form of dividends or share repurchases

Finnish listed companies' combined operating profit (excl. financing and investment activities) improved in 2005 by about a fifth on 2004.

Financial performance varied across companies; for example, forestry companies' earnings fell significantly. The fall in earning was due to a lockout as well as a rise in energy and other input prices, and to weakness in product prices. The profitability of several listed companies in the electronics industry was also weak, and some companies even posted losses.

Listed companies' profitability slumped in the early years of the decade. However, year 2005 was already the fourth consecutive year of improving results. In the current decade, Finnish non-financial corporations have begun to allocate an increasing share of their earnings to investors in the form of dividends or share repurchases. The number of non-financial corporations repurchasing shares has remained low; those repurchasing or cancelling shares are mainly large companies. The number of non-financial corporations repurchasing shares is however growing, and in most listed companies, the board of directors has been granted authorisation by the annual general meeting to repurchase shares.

Chart 1. Listed companies' share issues, repurchases and dividends paid



Sources: Helsinki Stock Exchange and Bloomberg.

Due to good their profitability and low level of investment, non-financial corporations have generated most of their financing internally. There has been virtually no stock-market financing, and the growth of debt financing has been moderate.

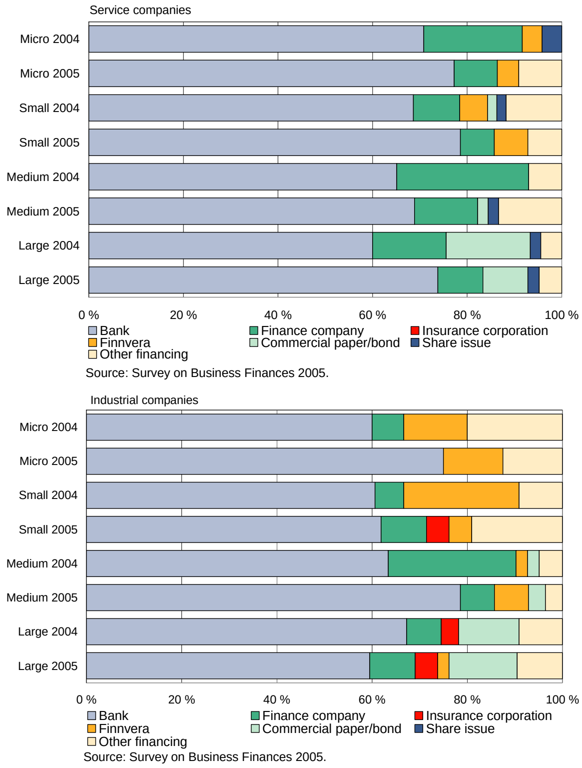
Non-financial corporations' domestic borrowing has recently centred on bank loans. In September, the growth rate of non-financial corporations' bank loans was over 8%, whereas growth in the total stock of corporate debt was less than 4%. For example, the role of insurance corporations as a source of new loans is currently insignificant.

Financing

The Survey on Business Finances published by the Bank of Finland and the Ministry of Trade and Industry shows that the availability of external financing to non-financial corporations has been good for several years already. A very small percentage of respondents reported difficulties in acquiring financing. Non-financial corporations having difficulties in obtaining financing are mostly small or new ones.

The results of the survey also confirm that the banks' status as a source of external finance for Finnish non-financial corporations is presently very strong, whereas market financing has been minor for some time.

Chart 2. Primary source of external financing (service and industrial companies)



The survey shows that the cost of debt financing has decreased. The interest rate margin on new loans has narrowed. A large proportion of companies reported that ancillary costs of borrowing have also fallen. This suggests that banks are encountering stiff competition for corporate customers.

2 Banks and insurance corporations

2.1 Banks' performance strong in 2005

Mervi Toivanen

Banks' performance was strong in 2005. Income increased more than expenses, which improved banks' cost efficiency. The profitability of retail banking is also reflected in the growth in return on equity. At the same time, capital adequacy remained sound on average.

The strong performance that had commenced already in early 2005 continued in the fourth quarter of 2005. Banks' operating profits improved, even though not all the results for 2004 and 2005 are fully comparable due to corporate restructuring. The total operating profits of Finnish banking groups[1] grew by 16.4%, to EUR 1,062 million. At the same time, the operating profits of financial conglomerates operating in Finland[2] improved by 17.5%, to EUR 5,089 million.

The measure of cost efficiency – expense-to-income ratio – decreased, ie banks' cost efficiency improved. Overall, aggregate expenses grew only slightly. Some banks' expenses rose sharply, in connection with corporate restructuring. Of the expense items, staff expenses grew most, as a result of a rise in the overall wage level.

Income items improved. Growth in net interest income was supported by an increase in lending and by a rise in the general interest rate level in late 2005. The growth in net interest income was, however, slowed by the narrowing of interest rate margins on loans. Fee income increased particularly for mutual funds, asset management, brokering and lending. The income of some banks was also boosted by non-recurring items. Financial groups' results were also improved by income from insurance business (see sub-section 2.3).

The increase in operating profits was bolstered not only by moderate developments in expenses and improved income but also by the low level of loan losses.

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[1] 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.

[2] Savings banks, Aktia Savings Bank Plc Group, local cooperative banks, Bank of Åland plc Group, Evli Group, eQ Group, OP Bank Group, Sampo Group, and Nordea Group.

Banks financial statements for 2005 are the first ones prepared in accordance with the new International Financial Reporting Standards (IFRS). The new standards apply to all quoted deposit banks. Unquoted deposit banks prepare their financial statements in accordance with the revised Finnish Credit Institutions Act. The first financial statements for the entire year suggest that the effects of the IFRS reform have been minimal. Nor have there been major changes in capital adequacy ratios. However, the true effects of the IFRS reform will become evident only over the long term.

Table 1. Banks' income statement items in 2005, EUR million

	Net interest income, EUR m		Other income, EUR m		Total expenses, EUR m		Operating profit, EUR m	
	1-12 2005	Change %	1-12 2005	Change %	1-12 2005	Change %	1-12 2005	Change %
Nordea Group	3 663	4.8 %	2 916	-0.5 %	3 668	0.4 %	3 048	11.0 %
Nordea Group, retail banking	3 051	4.7 %	1 624	10.2 %	2 578	1.3 %	2 194	17.9 %
Nordea retail banking in Finland	817	-	393	-	614	-	600	-
Nordea Bank Finland Group	1 210	7.9 %	652	8.1 %	902	8.5 %	915	4.7 %
Sampo Group	310	4.4 %	5 788	36.9 %	4 805	34.2 %	1 295	36.6 %
Sampo Group banking and investment services	341	5.9 %	392	12.3 %	420	4.2 %	316	15.3 %
Sampo Group, insurance business	-	-	-	-	-	-	1 034	-
Sampo Bank Group	339	8.9 %	300	1.7 %	389	1.4 %	252	8.9 %
OP Bank Group*	781	3.0 %	632	22.7 %	829	9.9 %	579	13.3 %
OKO Bank Consolidated*	143	-2.7 %	221	68.7 %	210	51.1 %	150	8.7 %
Savings banks (excl. Aktia) Total	116	4.4 %	45	17.7 %	107	2.6 %	53	22.8 %
Aktia Savings Bank plc Group	80	7.8 %	54	35.7 %	76	0.1 %	49	37.2 %
Local cooperative banks	79	5.2 %	22	1.8 %	68	-0.7 %	33	17.8 %
Bank of Åland plc (Group)	31	4.7 %	21	14.3 %	33	-1.2 %	19	34.5 %
Evli Group	1	-43.9 %	57	17.1 %	51	12.0 %	7	51.1 %
eQ Online Group	3	18.4 %	28	47.6 %	25	27.2 %	6	193.2 %
1. Finnish banking groups (excl. Nordea)	1 432	4.2 %	1 250	19.2 %	1 612	7.2 %	1 062	16.4 %
2. Finnish banking business	2 249	-	1 643	-	2 226	-	1 662	-
3. Financial conglomerates operating in Finland	5 064	4.5 %	9 562	21.7 %	9 665	16.0 %	5 089	17.5 %

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.

* OP Bank Group's (and OKO Bank's consolidated) income statement has been combined with Pohjola Group plc's figures for November-December 2005. The figures for Pohjola are not included in the income statement for 2004. The structure of OKO Bank has changed significantly with the acquisition of Pohjola, which has reduced the comparability of OP Bank Group's and OKO Bank's consolidated income statements for 2004 and 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' press releases.

Table 2. Banks' income-expense ratios and return on equity (ROE, %)

	Income-expense ratio, %		Return on equity, %	
	1-12 2004	1-12 2005	1-12 2004	1-12 2005
Nordea Group	60	56	16.9	18.0
Nordea retail banking in Finland	53	49	36.0	38.0
Nordea Bank Finland Group	49	48	5.5	5.6
Sampo Group	-	-	26.5	28.4
Sampo Group banking and investment services	60	57	13.7	23.1
Sampo Bank Group	63	61	16.6	18.4
OP Bank Group	55	55	12.0	11.2
OKO Bank Consolidated	47	46	13.9	19.8
Savings banks (excl. Aktia) Total	70	67	-	-
Aktia Savings Bank plc Group	67	57	11.2	16.3
Local cooperative banks	72	68	-	-
Bank of Åland plc (Group)	70	64	10.9	13.9
Evli Group	91	91	5.3	9.3
eQ Online Group	91	83	5.2	13.0

ROE %'s are not fully comparable. For Nordea retail banking in Finland, the figure gives the return on economic capital for Q4.
Savings banks (excl. Aktia) and local cooperative banks do not publish ROE.

Source: Banks' press releases.

2.2 Banks in the Nordic countries, Europe and the United States post healthy financial results in 2005

Sampo Alhonsuo

Banks and financial groups have posted good results in the Nordic and Baltic countries as well as in Europe and the United States. Improved results are mainly due to growth in income. Banks' total assets and business volumes have increased rapidly. Financial results show that banks' operating environment is currently favourable.

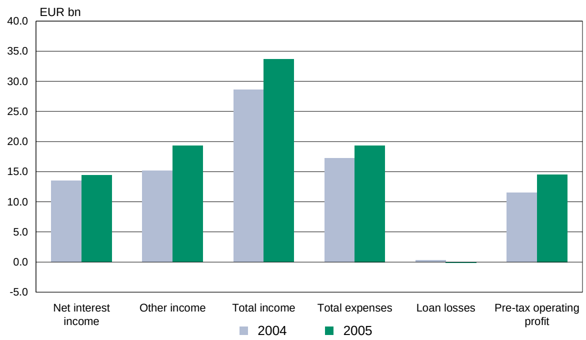
Combined pre-tax results of the largest **Nordic** banking and financial groups[3] increased in 2005 to EUR 14.5 billion. Results improved by more than EUR 3 billion, ie 27%, on 2004. The largest banking groups of the **Baltic countries** (as parts of Nordic financial groups) also posted better results.

Banks' good performance reflects the current favourable operating environment in the Nordic and Baltic countries. Banks' net interest income improved on 2004, despite a narrowing of deposit-lending rate spreads of several banks. An increase in lending stock compensated for the shrinking of margins. Demand for loans has remained robust in both Nordic and Baltic countries. For example, the lending stock of Hansapank, the largest bank in the Baltic countries, expanded by over 50% compared to the previous year. Other income has also increased as a result of favourable developments in the economy and capital markets. Fee income has been boosted by the growth of lending stock. Loan losses have generally been very low. For some banks (eg Danske Bank and Nordea), the amount of loan loss recoveries exceeded new loan losses recorded in 2005.

Although banks are still improving their efficiency, the total expenses of the largest groups increased on 2004. The rise in expenses was due to increased overall business operations and eg corporate buyouts.

Banks' lofty profits have raised their levels of equity capital.

Chart 3. Key income statement items of large Nordic financial groups



Sources: Financial groups' financial statements in February 2006.

Banks' total assets have grown by nearly 20% since 2004. The totals for the largest financial groups amounted to over EUR 1,400 billion at end-2005. In the same period, lending and deposits grew by 10 to 20%. The stock of lending in the balance sheets of large Nordic groups currently totals nearly EUR 800 billion, and the stock of deposits is about EUR 450 billion. The growing lending stock is increasingly being financed via the international financial markets.

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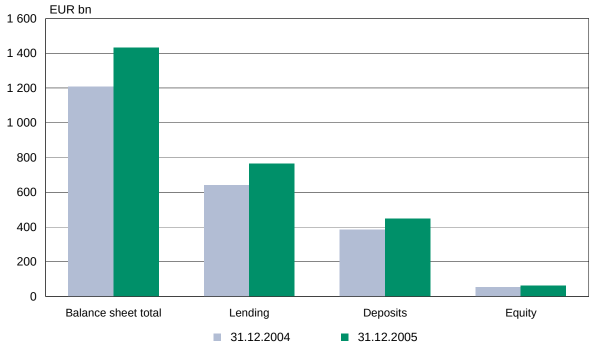
[3] Danske Bank, Nordea, SEB Group, Svenska Handelsbanken, DnBNOR Group, FöreningsSparbanken (Swedbank), OP Bank Group, Sampo Group, Kaupthing Bank and Jyske Bank. All the data is group-level. Income statement and balance sheet figures were converted into euro (respectively) at average and year end exchange rates for 2005. The data are derived from financial statements in February 2006.

Chart 4. Key balance sheet items of large Nordic financial groups



Sources: Financial groups' financial statements in February 2006

The key financial ratios of Nordic and Baltic financial groups were good or excellent. Both profitability and efficiency ratios improved on 2004. Return on equity was nearly 20%. Moreover, income-to-expense ratios remained excellent. Nevertheless, large groups' Tier 1 capital adequacy ratio fell in 2005.

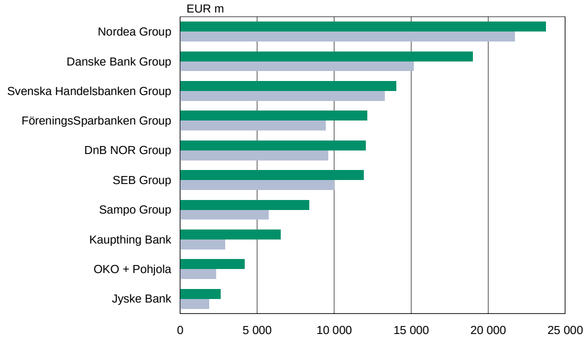
Table 3. Key financial ratios for Nordic financial groups

10 Nordic financial groups, averages	1-12 2004	1-12 2005	Range 2005
Profitability: ROE, %	16.7	18.9	(11,2 - 34,0)
Efficiency: income/expense, %	55.7	53.0	(34,1 - 65,0)
Capital adequacy: Tier 1, %*	8.0	7.5	(6,8 - 13,1)

*At end of period.
Averages weighted by balance sheet totals.
Sources: Financial groups' financial statements in February 2006.

Financial groups' market values have been boosted by strong financial performance. The aggregate market value of the 10 largest Nordic financial groups was EUR 115 billion at the turn of the year.

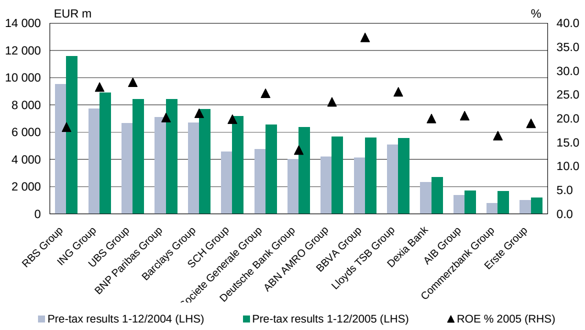
Chart 5. Market values of large Nordic financial groups



Source: Bloomberg.

Financial results show that in other parts of Europe, banking and financial groups' performance remained strong also in late 2005. Financial groups' profitability was good-to-excellent. Income-to-expense ratios developed favourably and loan losses remained low.

Chart 6. Pre-tax results and ROE of large European financial groups



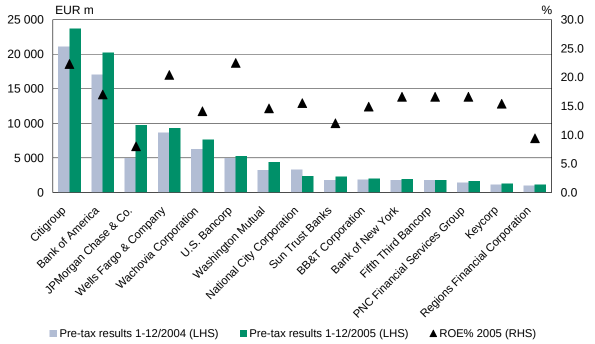
Sources: Groups' financial statements in February–March 2006.

In the United States, banks' income grew for already the fifth consecutive year. In late 2005, earnings were boosted particularly by an increase in net interest income. Moreover, expenses and loan losses have been low. For the whole banking sector, the amounts of loan losses and non-performing loans nevertheless increased slightly in 2005[4]. Despite the slight increase

[4] Federal Deposit Insurance Corporation, Quarterly Banking Profile, fourth quarter 2005.

in loan losses, the banking sector's profitability remained good.

Chart 7. Pre-tax results and ROE of large US banks



Source: FitchRatings U.S. Banking Quarterly Review - 4Q05.

2.3 Excellent year for the insurance sector

Pertti Pylkkönen

Performance in the insurance sector, as in the other parts of the financial sector, was good, and insurance corporations' average capital adequacy improved markedly.

The insurance industry is witnessing considerable changes. Globally, 2005 was one of the most severe years for natural disasters. The amount of financial damage caused by hurricanes in the United States is still unclear. It will, however, be one of the highest figures in the history of the insurance industry. For this reason, results in the global reinsurance business weakened significantly in 2005. Nevertheless, the industry has weathered the storm quite well. Finnish and Finnish-owned insurance corporations operate circumspectly or not at all in the international reinsurance market. Natural disasters had a minor impact on the results of Finnish insurance corporations in 2005.

The Finnish insurance sector underwent significant restructuring in 2005. At the start of the year, Suomi Mutual Life Assurance Company transferred a EUR 1.2 billion life insurance portfolio to Pohjola Life Insurance Company Ltd. At the same time, Suomi Mutual stopped selling new insurance policies. However, the company still manages a sizeable insurance portfolio, measured in terms of insurance savings, and still accounts for about 15% of domestic life insurance savings. In September 2005, OKO Bank and OP Bank Group made a bid for Pohjola Group plc. As a result, ownership of Pohjola Group plc was transferred to OP Bank Group. Pohjola Group plc sold its shares in Pohjola Life Insurance Company and Pohjola Fund Management Company Limited to OP Bank Group Central Cooperative in mid-January. OKO Bank will retain ownership of Pohjola Non-Life Insurance Company Ltd and Pohjola Asset Management Limited.

Sampo expanded its life-insurance operations to the Baltic countries, Sweden and Norway. On the other hand, it sold its Polish operations to Nordea.

Veritas Life Insurance Company acquired Aktia Life Assurance Ltd at the start of 2005, and it was merged with Veritas Life Insurance Company at the end of February 2006.

The insurance operations of life insurance corporation Kansa's receiver will wind down by the end of 2006.

Improved results

Year 2005 was a success story for insurance corporations in terms of both insurance and investment operations. A rise in share prices improved investment results significantly. The profitability of insurance business has mainly been good. For example, non-life insurers have been able to increase the efficiency of their operations and improve their expense ratios. The combined expense ratio has remained at the level of 2004 on average.

The profitability of investment operations boosted employee pension insurers' results to an exceptionally high level. Employee pension insurers' total operating profit doubled from EUR 2.2 billion in 2004 to EUR 4.4 billion in 2005. Positive developments in the financial markets also firmed the results of also other insurance corporations. The improvement in results was not, however, as noteworthy as in the case of employee pension insurers.

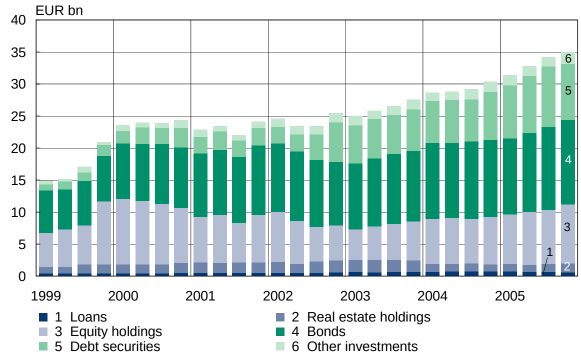
Insurance corporations' capital adequacy is becoming increasingly dependent on developments in stock markets and fixed-income markets. The value gains in investment assets in 2005 supported the considerable improvement in insurance corporations' capital adequacy. Life and pension insurers' capital adequacy was good at the end of 2005[5]. The capital adequacy of non-life insurers is also satisfactory on average but does fluctuate more than that of life and pension insurers.

Investment activities

The structure of life insurers' and non-life insurers' investments remained unchanged in 2005. Of life insurers' total investments of about EUR 35 billion, bonds accounted for more than half. Other fixed-income investments, ie money market paper and loans, accounted for less than one-fifth of total investments, ie for the same share as equity investments.

[5] Capital adequacy of insurance corporations and pension funds in 2005. Insurance Supervisory Authority. Press release 3/2006. www.vakuutusvalvonta.fi

Chart 8. Life insurers' investment portfolio



Source: Federation of Finnish Insurance Companies.

Of non-life insurers' total investments, equity investments accounted for a quarter and fixed-income investments for about two-thirds. Short-term investments weigh heavily in non-life insurers' investments.

The weight of equities in employee pension insurers' investment portfolios increased markedly in 2005[6]. The proportion of equity investment increased while the proportion of mainly fixed-income investments decreased correspondingly. Equity investments already account for one-third of total investments. For public sector pension institutions, the bulk of investments is in equities: at end-2005, equities accounted for more than half of their total investments.

Year 2005 was one of the most successful in the history of employee pension insurers' investment activities. The increase in investment income was mainly due to a sharp rise in share prices over the past year. The fall in long-term interest rates also fortified pension insurers' investment performance in 2005.

Regulation of the framework for investment activities of public sector pension insurers (The Local Government Pensions Institution and the State Pension Fund) allows greater flexibility in choosing investment strategies. For example, the weight of equities in total

[6] Source: The Finnish Pension Insurance Alliance (TELA).

investments increased, as a result of which the income of The Local Government Pensions Institution and State Pension Fund were higher than that of pension insurers in 2005 (Table 4).

Table 4. Net income from pension insurers' investment activities, 2004–2005, %

	2004	2005
Eläke-Fennia	7.4	11.8
Eläke-Tapiola	7.2	9.2
Ilmarinen	7.8	12.1
Varma	8.0	11.6
Veritas	8.4	10.7
Etera	8.7	11.7
The Local Government Pensions Institution	7.5	14.3
State Pension Fund	9.6	14.9

Source: Pension insurers.

3 Securities markets

3.1 Credit derivatives

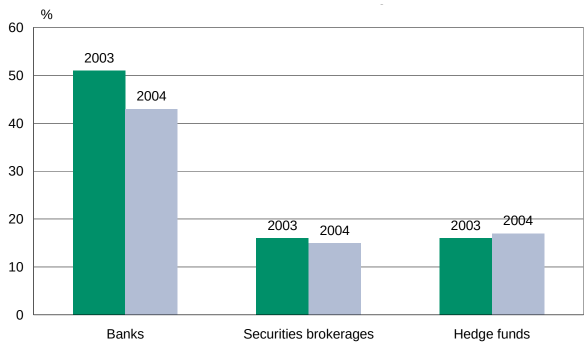
Katja Taipalus

Rapid growth of credit derivatives poses a challenge to market infrastructure.

Credit derivatives are derivative contracts whose value is based on changes in the credit risk of issuers of financial claims (typically debt instruments). Credit derivatives are traded on the OTC markets. BIS statistics show that in 2001 credit derivatives accounted for 0.7% of the total OTC market (USD 99.7 trillion), whereas in 2004 they already accounted for 2.1% of the total market (USD 220 trillion). Not surprisingly, in 2001–2004, the fastest growth in OTC derivatives trading was in credit derivatives (568%). The majority of credit derivatives are credit default swaps (CDS), CDS indices or collateralised debt obligations (CDO).

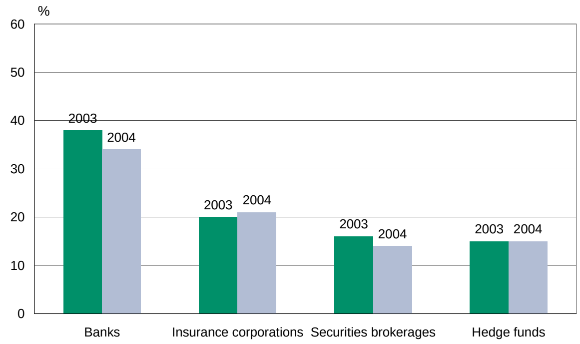
The main participants in the credit derivatives market are banks, insurance corporations and hedge funds (Charts 9 and 10). The market is still quite bank-centred.

Chart 9. Protection buyers (risk sellers) in 2003–2004, % of trading



Source: British Bankers' Association.

Chart 10. Protection sellers (risk buyers) in 2003–2004, % of trading



Source: British Bankers' Association.

Due to strong demand, new instruments continue to be launched on the credit derivatives market. Understanding the structure of new instruments poses a challenge to investors, as credit derivatives contracts are often complex.

The credit derivatives market is highly concentrated. The international ratings agency Fitch

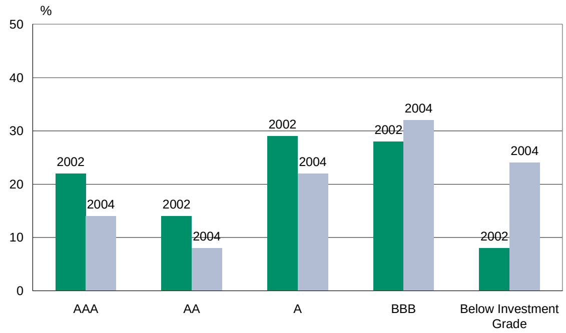
Ratings estimates that the 15 largest banks accounted for nearly 80% of the protection bought and sold in 2004. Reference assets for credit derivatives are also fairly concentrated: for the majority, the reference assets are corporate loans (over 60%), with financial institutions' credit accounting for less than 20%. The five largest companies whose loans are used as reference assets in the global derivatives market are General Motors, Ford Motor Co., Daimler Chrysler, France Telecom and Deutsche Telecom.

Trading volumes on the credit derivatives market have risen rapidly, and the market infrastructure has not kept up with the challenges posed by such rapid growth. This was reflected eg in the severe problems of the settlement of credit derivatives trades in connection with large corporate bankruptcies in 2005[7]. Market participants have, however, already taken measures to alleviate the problems of the infrastructure.

Risk premia on corporate debt have narrowed significantly in recent years. As a result, an increasing number of companies with low credit ratings have entered the debt market, attracted by inexpensive financing. This development is also clearly reflected in the credit derivatives market, as the proportion of reference-asset companies having low credit ratings has increased significantly in the past few years (Chart 11).

[7] Derivatives settlement in the form of cash or physical settlement, and trades may remain unconfirmed for several days. Back-office settlement of trades is also very time-consuming.

Chart 11. Change in credit ratings in global credit derivatives market, 2002 and 2004



Source: FitchRatings.

The credit derivatives market has long been hampered by a lack of information; sufficient statistical data has not yet become available. Increasing attention is, however, being paid to this issue, and participants are continually working to increase the amount of information on the credit derivatives market, and thereby to increase market transparency.

3.2 Will removal of wealth tax increase savings flows into funds?

Pertti Pylkkönen

Growth in mutual fund assets continues at a robust pace. In 2005, new investments accounted for more than half of the growth of fund assets. The start of 2006 has also been brisk.

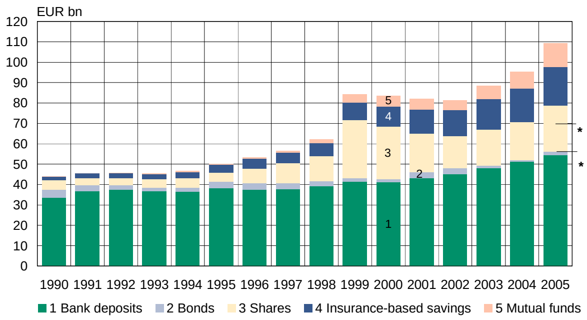
At the end of 2005, the assets of Finnish mutual funds totalled EUR 44.7 billion. At end-2005, 27 fund management companies operated in Finland, managing over 400 funds. The Finnish fund market is diverse. However, many funds are relatively small and the number of investors is modest.

Of fund assets, over half are in various types of money market and bond funds. At the turn of the year, assets of short-term funds totalled EUR 10.8 billion, which was slightly more than those of long-term funds.

Equity funds accounted for EUR 16.4 billion, ie for 37% of total fund assets at the end of December 2005. Equity fund assets grew by about EUR 5 billion in 2005, some EUR 1.5 billion of which was new money. New investment money focused on funds investing in the international market. Equity funds investing specifically in emerging markets attracted large amounts of new capital. The amount of capital in equity funds investing in Asia and Northern America decreased slightly. The average return for funds investing in emerging markets increased to about 60% in 2005, which was considerably higher than that for funds investing in other equity markets.

The importance of mutual funds among household financial assets continues to grow. At end-2005, the share of mutual funds in household financial assets rose to about 10%.

Chart 12. Household financial assets



*Preliminary. *Preliminary.

Sources: The Finnish Bankers' Association, Bank of Finland, Statistics Finland, Federation of Finnish Insurance Companies and Financial Supervision Authority.

The removal of the wealth tax as of tax-year 2006 should increase households' interest in fund investments. At the same time, competition among financial products available to households will tighten.

Despite the rapid growth, households' share of fund investments decreased slightly in 2005 and private persons accounted for 28%[8] of fund investments at year-end.

Over the past year, the most significant structural change in the funds market was the robust growth in funds of funds. By contrast, exchange-traded funds (ETFs), which have rapidly gained global popularity, have not yet attracted wide interest in Finland. Two ETFs currently operate in the Finnish market.

The start of 2006 has been good for the funds market. In January–February, net investments reached about EUR 3.4 billion and fund assets amounted to over EUR 50 billion, ie the amount of assets invested in funds is almost equal to that held in deposits.

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[8] www.rahoitustarkastus.fi/Eng/Statistics

4 Infrastructure

4.1 Banks announced their plans: Finland to join the single payments area in 2008

Timo Iivarinen

To promote the Single Euro Payments Area, Finnish banks published a SEPA implementation and migration plan on 15 March 2006. This national migration plan presents an overview of what transferring to a single payments area will mean to Finns. The plan is posted on the websites of banks, the Finnish Bankers Association, and the Bank of Finland.[9]

European banks, the European Central Bank and the European Commission are working to create an integrated payments area, known as the Single Euro Payments Area (SEPA). The objective is to develop payment services on a par with national payment services for the SEPA as a whole. Given major national differences in payment services, the establishment of a harmonised level of service throughout the area is a challenging undertaking. The single payments area covers only euro-denominated payments. The first task is to harmonise interbank payment procedures. This will provide a foundation for uniform basic services to be offered to customers. In addition to these basic services, banks will have the option of offering value added services which they deem necessary in order to compete in the market .

The first wave of basic services is scheduled for implementation at the beginning of 2008. By that date, services related to credit transfers, direct debit and payment cards should be available. The contents of these basic services have been harmonised throughout the payments area. As a result, the services do not entail execution of all types of payments. For example, Finnish payment transfers with reference numbers or salary and pension payments could not be executed via the uniform basic services. Therefore current Finnish payment services will initially operate in parallel with the new services.

Despite its shortcomings, Finnish banks consider the SEPA Electronic Credit Transfer Scheme, developed by the European Payments Council (EPC, a European cooperation forum between banks), to be a good basic model for payments. Banks want to ensure that authorising a SEPA credit transfer is as easy as currently authorising a domestic credit transfer. Services may differ between countries owing to differences in technical solutions.

Banks are sceptical about the suitability for the Finnish payment landscape of the SEPA Electronic Direct Debit Scheme defined by the European Payments Council. Moreover, using the services may

[9] www.bof.fi and www.pankkiyhdistys.fi

involve new types of risks. Therefore Finnish banks cannot commit to adopting the scheme as it is, and the payment concept needs to be supplemented with value added services. A bank must, however, enable paying customers to make payments Europe-wide via a direct debit service if the bank provides this service domestically and if the invoicing party offers this option to its customers. In addition, banks may offer internationally operating companies Europe-wide direct debit services for collection of payments.

Domestic payment cards no longer accepted

The harmonisation of European payments extends also to card payments. Banks must stop issuing cards that are used only for domestic payments.

At the beginning of 2008 banks will launch card services that comply with the requirements defined by the European Payments Council. At the same time, the use of domestic payment card will end. The changeover to the new services will take place bank by bank. Banks are working to promote greater acceptance of the cards in Finland. The banking sector is committed to implementing the national migration plan, under joint monitoring by the Bank of Finland and the banks. Each bank is responsible for implementing the plan in its own operations.

The national migration plan does not yet take account of the new payment services directive proposed by the European Commission. The directive precedes drafting of new national legislation, to enter into force in 2008. The national plan will be updated when the services are defined in more detail and when the enabling legislation is in place. The Eurosystem, which has required the drafting of national plans, issued an updated assessment on SEPA progress.[10]

[10] The assessment is available on http://www.ecb.int/pub/pdf/other/singleeuropaymentsarea200602en.pdf

5 Current developments in regulation and supervision

5.1 Implementation of Basel II framework in EU and Finnish legislation

Jukka Vauhkonen

The capital adequacy directive of the European Union ascribes a greater role for group-level supervisor of a banking group operating in several countries than does the new capital accord (Basel II) of the Basel Committee on Banking Supervision.

The European Parliament and EU Council adopted in September and October 2005, respectively, the EU Commission's proposal for a directive on capital adequacy requirements of investment firms and credit institutions. The directive is largely based on the Basel Committee on Banking Supervision's recommendation for a new capital adequacy framework for globally operating banks (Basel II), which was published in June 2004. The directive will take effect in stages, on 1 January 2007 and 1 January 2008. This section examines the key differences in the EU's capital adequacy directive and Basel II; ongoing projects of the Committee of European Banking Supervisors (CEBS) on harmonisation of national implementation of the directive and prudential supervision; and implementation of the directive in national legislation.[11]

The principles of the EU's capital adequacy directive are largely in line with the recommendation of the Basel Committee. There are nevertheless significant differences between the directive and the Basel framework. One of the key differences concerns the role of a consolidating supervisor responsible for group-level supervision of a banking group operating in several countries. Under the directive, the role of the consolidating supervisor is larger than under Basel II. The EU directive includes a key principle according to which the supervisory authority responsible for the supervision of a parent company can, without the subsidiary supervisor's explicit consent, decide on the approval of subject-to-approval methods of calculating capital adequacy requirements of a subsidiary credit institution located in another member state.

The enlarged role of the consolidating supervisor should reduce the financial groups' burdens of multiple supervision. The directive also seeks to promote convergence and transparency of supervisory methods by requiring supervisory disclosure eg of regulations

[11] See also Dierick et al (2005): The New Basel Capital Framework and its Implementation in the European Union. ECB Occasional Paper Series, No. 42, December 2004.

that are left to national discretion and on supervision methods applied in the supervisory review process under Pillar II. This supervision disclosure requirement is characteristic of the directive and is not included in the Basel II framework.

One of the key differences between Basel II and the directive is the treatment of residential and commercial real estate lending in the standardised approach for determining capital requirements for credit risk. Because residential and commercial real estate lending account for a considerable part of the lending stock of European banks, the treatment of residential and real estate lending is of great importance to them.

In the standardised approach to capital requirements for credit risk, residential real estate lending exposures are, under certain conditions, given a risk weight of 35% in both Basel II and the directive. Basel II and the directive diverge in that the criteria for the 35% risk weight are considerably tighter in the directive than in Basel II. By contrast, the criteria for the 50% risk weight for commercial real estate lending in the standardised approach are more lay in the directive than in Basel II.

Other key differences between the directive and Basel II include the treatment of covered bonds and banks' venture capital investments. Covered bonds (usually mortgage bonds) are issued by financial institutions. The most popular one is the German Pfandbrief bond. The directive includes specific capital adequacy requirements on covered bonds, in contrast to Basel II. The capital adequacy requirements on banks' investments in venture capital are slightly looser in the directive than in the Basel Committee's proposal.

The wide scope of Basel II, the national options included in the directive, and the ambiguity of some of the definitions in the directive, pose a major challenge for convergent national implementation of the directive. Characteristic of the EU is the Committee of European Banking Supervisors' (CEBS) role in promoting consistent implementation of the directive and convergent supervisory practices. In this context, the CEBS has in the past couple of months issued guidelines on i) supervisory disclosure; ii) cooperation between home and host country supervisors of financial groups operating in several countries; iii) the supervisory review process under Pillar II, and iv) the criteria for recognition of external credit assessment institutions (ECAI), which are permitted in the new capital adequacy framework.

In November 2005, the Finnish Government issued for parliamentary review a bill on the Credit Institutions Act and a bill on amending certain related acts. These acts will implement the EU's capital adequacy directive in national legislation.

The first act would give the Financial Supervisory Authority the right to issue regulations on implementation of technical and detailed regulations on the minimum capital requirement for credit institutions. Provisions regarding the choice of significant regulatory options for national discretion would be included in a decree issued by the Ministry of Finance.

Under the EU directive, a supervisory authority must have the right to set a higher capital adequacy requirement than the minimum for an individual institution whose capital adequacy management process does not meet the minimum criteria laid down in the directive. The Government bill includes a provision which would give the Financial Supervisory Authority the right to set a temporary above-minimum capital adequacy requirement for a credit institution if shortcomings are identified in the supervisory review process.

5.2 Directive on payment services

Risto Koponen

A single payment area across the EU would generate considerable cost savings and improve services. But creating a single payment area requires harmonised legislation. In December 2005, the European Commission issued a proposal for a directive on payment services which would almost totally harmonise legislation on payment services and the relationship between service provider and user in the EU.

In the internal market, executing cross-border payments should be as easy, inexpensive and safe as executing national payments. According to the European Commission, the current state of the payment systems is unsatisfactory, so that and the full potential of the internal market remains unrealised. Current markets for payment services are based on national borders and are regulated by differing national legislation. Payment systems are too expensive, due to a lack of competition between national systems and an inability to process cross-border payments as efficiently as domestic payments. The European Commission also finds that consumers have only limited access to payment instruments that are accepted EU-wide, and that consumers do not have access to service providers from other EU countries that might offer cheaper and swifter payment services. Lack of competition is also hurting retailers and other companies due to, for example, high charges on card payments and an inability to automatically reconcile invoicing with payments.

According to the Commission, payment systems, products and services must thus be further developed and harmonised. In addition, national payment services markets must be opened to new operators and a level playing field must be ensured for all service providers. These actions would enable users to enjoy increased choice and improved services and a high level of protection. The transparency of services and prices would also improve. A true single payments area might even generate savings in excess of EUR 100 billion a year in the EU.

The markets play a pivotal role in creating a single payments area. Providers of payment services need to find the best means of integrating national payment infrastructures and to develop the "best of breed" harmonised payment products and services. Banks thus have their own initiative for creating a single payment area (Single Euro Payments Area). A single payment area requires, however, a harmonised legal framework. In order to achieve this, the Commission has issued a proposal for a directive on payment services that would apply to all EU currencies, with a focus on electronic payment methods. It would not apply to paper-based means of payment (eg cash or cheques).

The proposal for a directive consists of three parts: i) the right to provide payment services to the public; ii) transparency and information requirements; and iii) rights and obligations of users and providers of payment services. The first part defines the entities that have the right to provide payment services. These include credit institutions within the meaning of Directive 2000/12/EC, electronic money institutions, post office giro institutions, and a new category of entities, ie payment institutions, as laid down in the directive. The authorisation requirements for payment institutions are quite lenient. For example, there are no capital requirements, or restrictions on business activities or investments. Nor are there any restrictions as to legal form; even a natural person can operate as a payment institution. Payment institutions could operate throughout the Community under a single authorisation ("European passport"). These regulations are designed to take account of market developments and to increase competition.

The second part of the directive specifies exactly what and when information must be provided on payment services. Such information includes rights and obligations of providers and users of payment services, execution times for payments, and service fees. The directive will eg increase price transparency because in cases where an aggregate fee (eg account management fee) is charged, the provider of payment services must specify the prices of the different service elements covered by the aggregate fee. The harmonised information requirements are intended to increase competition, consumer options and user protection.

The third part of the directive defines the rights and obligations of providers and users of payment services, eg regulations on the maximum execution time for a payment transaction. For example, as of 1 January 2010, a credit transfer is to be executed in one day. The third part also includes provisions on eg users' rights regarding refunds, and execution of payments in full, and users' rights and obligations vis-à-vis payment instruments.

The proposed directive is one of maximum harmonisation. Member states' regulations can deviate from directive provisions in two ways only. The euro liability of a payment instrument user, in the case of lost or stolen payment instrument, may be reduced, and a shorter execution time can be set for national payments than that laid down in the directive. Such exceptional national regulations cannot, however, be applied to service providers that have been granted authorisation in another member state.

6 Key corporate arrangements and events in the financial sector

Date	Event and description
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.

Date	*Event and description*
	A group headed by Royal Bank of Scotland acquires a 10% stake in the Bank of China, the second largest bank in China.
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.*

Date	*Event and description*
	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.
	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. SEC approved the merger in February 2006 and the new NYSE Group Inc. started operations in March 2006.*
	Pohjola Group plc sells Pohjola Fund Management Company Limited to OP Bank Group Central Cooperative.
January 2006	*Austrian bank Raiffeisen International announces it will acquire the Russian bank JSC Impexbank.*
	Insurance operations of life insurance corporation Kansa's receiver to wind down by end-2006.
	Pohjola Group plc sells Pohjola Asset Management Limited to OKO Bank and Pohjola Life Insurance Company to OP Bank Group Central Cooperative.
February 2006	*SOK Corporation's S-Bank Ltd granted a credit institution licence. Operations to start in 2007.*
	Savings Banks' Group and its member banks announce they have cancelled cooperation agreement with Pohjola Group plc and Suomi Mutual Life Assurance Company. Sp-Fund Management Company Ltd also terminated its funds' asset management agreements with Pohjola Group plc.

Date	*Event and description*
March 2006	*Aktia Life Assurance Ltd merges with Veritas Life Insurance Company.* *Ahlstrom Plc and Salcomp plc listed on the Helsinki Stock Exchange.* *Nasdaq makes an offer to buy the London Stock Exchange.*