Financial Market Report

2 • 2006

- Banking groups' profitability and cost efficiency improved in the first quarter
- Problems in the German real-estate fund market
- Over a third of Finnish shares owned by foreigners
- Card payments in 2005 amounted to 142 per person
- Is NYSE Euronext a model for future structuring of European markets?

Bank of Finland

Financial Markets and Statistics

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1 Financial intermediation

1.1 Expanding market for bonds issued by mortgage banks

Pertti Pylkkönen

Finnish mortgage banks are stepping up their operations. The market for covered bonds continues to grow rapidly in Europe.

Mortgage banks are slowly stepping up their operations also in Finland. Four mortgage banks currently operate in Finland[1], granting loans backed by shares in housing or real-estate companies. Mortgage banks acquire financing mainly by issuing bonds backed by loans and pledges. Bonds are also sometimes backed by loans to government entities. Bonds issued by Finnish mortgage banks amounted to just under EUR 2 billion at year-end 2005.

Mortgage banks' combined balance sheet amounted to EUR 2.6 billion at the end of 2005[2]. The balance sheet totals of institutions belonging to banking groups increased rapidly in 2005, whereas the balance sheet totals of the traditional Mortgage Society of Finland grew at a slower rate.

The continued robust demand for loans for house purchase has led banks to use their mortgage banks as an additional funding tool. One of the advantages of funding via mortgage banks is that they have lower risk ratings and can obtain cheaper long-term financing than their parent companies.

Bonds are issued mainly in the international euro-denominated market. Aktia Real Estate Mortgage Bank plc has issued three euro-denominated mortgage bonds totalling EUR 750 million, and Sampo Housing Loan Bank plc has issued one EUR 1 billion covered bond. Funding operations of OP Bank Group Mortgage Bank plc and Mortgage Society of Finland have been carried out in small phases, where bonds are sold mainly in the domestic markets. OP Bank Group Central Cooperative announced that it will purchase OP Bank Group Mortgage Bank plc's shares from the other cooperative banks in OP Bank Group and that it will focus on the operations of its mortgage bank.

In Europe, bonds issued by mortgage banks have previously been mainly German Pfandbrief issues. In the past few years, the markets for bonds issued by mortgage banks have, however expanded and diversified considerably.

The markets are generally referred to as markets for mortgage and covered bonds. The market for the Spanish cedulas hipotecaria bonds has grown particularly rapidly. Markets for covered bonds have

[1] Aktia Real Estate Mortgage Bank plc, OP Bank Group Mortgage Bank plc, Sampo Housing Loan Bank plc, and Mortgage Society of Finland.

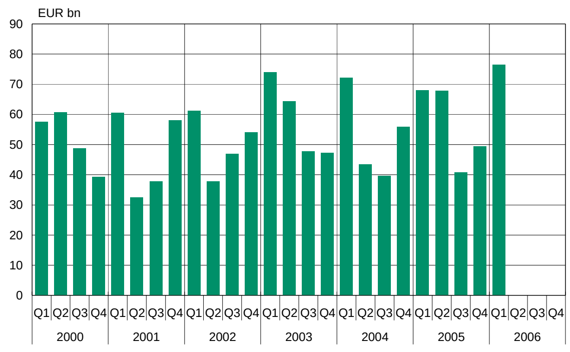
2 Mortgage banks' annual reports.

also started up in several other European countries, due to reforms of market legislation, or new legislation enabling the issuance of covered bonds.

In addition to several EU member states, many non-EU countries have adopted new legislation on covered bonds, and this has led to the start-up of these markets in nearly all the European countries. Legislation on covered bonds differs from legislation on mortgage banks eg in that formerly bonds covered by shares in housing or real-estate companies could be issued only by authorised mortgage banks. In the market for covered bonds, other authorised credit institutions are also allowed to operate.

In several European countries, the rapid growth of lending for house purchase is financed by deposits and by covered bonds. Financial institutions' traditional form of funding – deposits – is no longer sufficient to finance the growing demand for loans. Thus new tools for funding have been introduced (Chart 1).

Chart 1. Euro-denominated issues of covered and Pfandbrief bonds



Source: European Commission.

Moving housing and real estate loans off the balance sheet via securitisation has been another way of financing lending activity. However, for the issuer, covered bonds are a simpler and, in effect, cheaper means of funding than securitisation – hence the more extensive use of covered bonds.

For the investor, covered bonds are roughly comparable to government bonds in terms of credit risk. The risk premium on covered bonds, vis-à-vis government bonds, is small. The liquidity of covered Jumbo bonds is fairly good and they are traded mainly in the EuroMTS system.

1.2 Interest rate linkage of lending for house purchase

Kimmo Koskinen

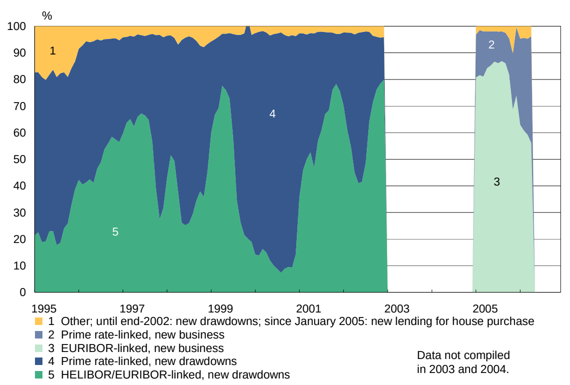
The portion of lending tied to monetary financial institutions' (MFI)[3] prime rates and other own reference rates in the outstanding amount of lending for house purchase is slowly increasing. Historical comparison is somewhat hampered by inconsistencies in time series due to changes in data collection.

MFIs' new lending for house purchase is increasingly prime-rate-tied, instead of EURIBOR-tied. The portion of loan agreements tied to prime rates in the total number of new house purchase loans was already 40.1% in April 2006, up from 11.5% in September 2005. This change has not yet had a major impact on the outstanding amount of lending for house purchase: 75% is currently EURIBOR-tied and 19.2% prime-rate-tied. Since autumn, the figure for EURIBOR-tied

[3] Before 2003 statistics were compiled only on the interest rate linkage of bank lending, whereas now the statistics cover lending by all MFIs. In lending for house purchase, the importance of credit institutions other than deposit banks is, however, minor. In April 2006 such lending accounted for about 4% of the outstanding amount of lending for house purchase.

loans has declined and that for prime-rate-tied loans has increased, each by a couple of percentage points. The distribution of interest linkages in the outstanding amount of lending changes slowly because monthly new business amounts to less than 4%, on average, of the outstanding amount of lending for house purchase. Past developments in interest rate linkage of new lending for house purchase are hard to evaluate precisely, due to the fact that before 2003 the Bank of Finland compiled statistics on interest rates on new drawdowns of loans for house purchase, instead of interest rates on new business. Since early 2005, the Bank of Finland has compiled statistics on interest rates on lending for house purchase (new business). In 2003 and 2004, data were not compiled on these interest rates.

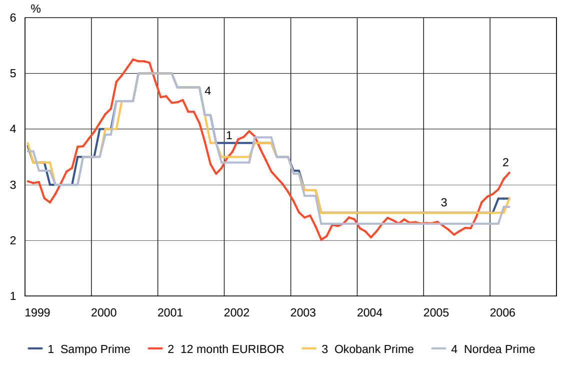
Chart 2. Interest rates on new drawdowns of loans for house purchase and on new business



Source: Bank of Finland.

Chart 2 shows that since 1995 over 90% of new drawdowns on bank loans for house purchase and MFI lending for house purchase (new business) have been linked to EURIBOR rates or banks' own prime rates. MFIs' prime rates have traditionally followed market rates with a lag. In recent months, the margin between the 12-month EURIBOR and banks' prime rates has thus begun to widen (Chart 3). Changes in the margin are immediately reflected in interest rate linkages of new drawdowns and new lending for house purchase. It is however difficult to assess the extent to which changes in interest linkages are due to new agreements concluded or to renegotiation of terms and conditions of existing loans.

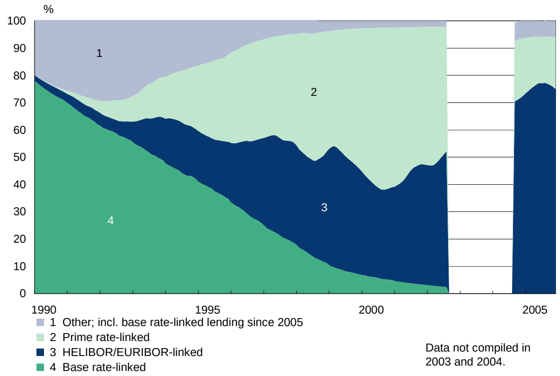
Chart 3. Banks' prime rates and the EURIBOR rate



Source: Bank of Finland.

When comparing new drawdowns to new business, the conceptual difference must be taken into consideration. This difference can be considered a rough estimate of loan renewals. The concept 'new business' includes all new loan agreements concluded for the first time, as well as agreements concluded as a result of renegotiating terms and conditions of existing loans, eg the interest rate linkage or the margin on the loan. The concept 'new drawdowns on loans for house purchase' includes drawdowns of loans during the period as well as agreement renewals in which key changes have been made to the terms and conditions. A change in interest rate linkage alone does not constitute a key change if all other terms and conditions remain unchanged. The amount of new business exceeds that of new drawdowns of loans for house purchase by about a third.

Chart 4. Interest rate linkage of lending for house purchase



Source: Bank of Finland.

Comparability of past developments in outstanding amounts is better than that of past developments in new business because the definition of the concepts 'linkage' and 'amount outstanding' have remained unchanged since the 1990s. As shown in Chart 4, the proportion of base-rate-tied lending for house purchase declined continuously and was nill by 2000. This was accompanied by a corresponding increase in the proportion of EURIBOR[4]- and prime rate-linked loans.

The proportion of prime-rate-linked lending was highest, almost 60%, in early 2001. This was followed by a sharp increase in the proportion of EURIBOR-linked lending for house purchase. In November 2005, already 77% of the outstanding amount was tied to EURIBOR rates. Since early 2006, there has been a slight upturn in the proportion of prime-rate-liked lending.

[4] To 1998: HELIBOR-tied.

2 Banks and insurance corporations

2.1 Market developments strengthened banks' results

Mervi Toivanen

In the first quarter of 2006, banks' pre-tax results improved considerably on the corresponding period of 2005. The significant rise in operating profits was due to an increase in income, loan loss recoveries and improved net investment income. Banks' good results boosted their profitability and cost efficiency.

In January–March 2006 banks' pre-tax results improved significantly year-on-year. The total operating profits of Finnish banking groups[5] grew by 44%, to EUR 354 million. When Nordea's retail banking business in Finland is included in the results of Finnish banking groups, banks' total operating profits increased by 39%, to EUR 531 million. At the same time, the operating profits of financial conglomerates operating in Finland[6] grew by 33%, to EUR 1,460 million. Comparability of results for the first quarter is, however, impaired by the merger of OP Bank Group and Pohjola[7].

Banks' net interest income continued to be supported by the further growth in lending stock, despite the negative impact of narrowing interest rate margins on loans. On the other hand, market rates have increased gradually during the first few months of the year, thus buoying banks' net interest income.

Banks' net fee income was supported by the rise in share prices in the first quarter of 2006 and positive market sentiment. Fee income increased for capital market-related services, such as asset management and brokering. Mutual fund investments are gaining popularity, which was reflected in increased fund assets and owners of fund units, and so also banks' fee income. Income from insurance business also grew. Some banks also received one-off gains from sales of shares and securities in January–March 2006.

Expenses grew, but at a slower rate than income. The growth in expenses was due to increased business

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[5] 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.

[6] 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.

[7] OP Bank Group's figures for January–March 2006 include figures for Pohjola. Those for January–March 2005 do not include Pohjola.

operations as well as growth in salaries and earnings-based benefits. In January–March 2006 the majority of banks recorded net loan loss recoveries.

In addition to the banking business, the insurance operations of financial groups posted good earnings. Operating profits from life and non-life insurance grew, which was due to improved net investment, supported by positive market developments. Moreover, premium income grew, particularly on unit-linked insurance; claims in connection with non-life insurance did not increase; and financial groups succeeded in curbing their operating costs.

Table 1. Banks' income statement items, Jan–Mar 2005 and 2006, EUR m

	Net interest income, EUR m		Other income, EUR m		Total expenses, EUR m		Operating profit, EUR m	
	1-3 2006	Change %	1-3 2006	Change %	1-3 2006	Change %	1-3 2006	Change %
Nordea Group	927	3.3 %	833	21.3 %	933	3.4 %	858	24.7 %
Retail banking	772	4.5 %	457	22.5 %	652	1.2 %	621	35.3 %
Retail banking in Finland	210	7.1 %	119	33.7 %	161	4.5 %	177	34.1 %
Sampo Group	72	-1.4 %	1 553	18.2 %	1 287	10.9 %	339	47.4 %
Banking and investment services	86	4.9 %	118	40.5 %	112	7.7 %	91	46.8 %
Life and non-life insurance services	-	-	-	-	-	-	261	45.8 %
OP Bank Group*	199	0.5 %	303	103.4 %	292	46.0 %	211	45.5 %
OKO Bank Group*	23	-39.5 %	149	282.1 %	104	166.7 %	69	76.9 %
Savings banks (excl. Aktia), total	30	5.6 %	13	34.7 %	27	4.6 %	16	30.0 %
Aktia Savings Bank plc (Group)	21	7.3 %	12	12.3 %	20	4.7 %	13	19.6 %
Local cooperative banks, total	21	9.5 %	8	52.8 %	18	2.3 %	11	63.8 %
Bank of Åland plc (Group)	8	5.2 %	7	30.4 %	9	6.9 %	6	33.3 %
Evli Group	0	0.0 %	14	-9.3 %	13	0.8 %	1	-51.9 %
eQ Online Group	1	35.7 %	11	40.8 %	7	5.0 %	5	196.5 %
1. Finnish banking and financial groups (excl. Nordea)	366	2.9 %	486	69.3 %	498	26.2 %	354	44.1 %
2. Finnish banking activities	576	4.4 %	605	60.9 %	659	20.1 %	531	38.6 %
3. Financial conglomerates operating in Finland	1 279	2.9 %	2 754	24.9 %	2 606	10.7 %	1 460	32.5 %

Other income includes net fee income, capital gains and losses from the sale of tangible and intangible assets, and shares in profits/losses of associated companies.
Expenses include depreciation and write-downs on tangible and intangible assets.
The various items do not equal operating profit, as some profit and loss account items have not been included.
The change % was calculated on the corresponding figures for 2005.

* The OP Bank Group (and OKO Bank Group) profit and loss account includes the result for Pohjola Group plc for January–March 2006. Pohjola's figures are not included in the comparative data on 2005. In addition, the substantial change in the structure of OKO Bank Group as a consequence of the Pohjola deal has weakened the comparability of OP Bank Group and OKO Bank Group figures for 2006 and 2005.

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

Source: Banks' interim reports.

2.2 Improved conditions in the Japanese banking sector – Chinese banks burdened by non-performing loans

Sampo Alhonsuo

Financial results of Japanese banks have improved. The amount of non-performing loans has declined to an average level by international standards. Data on the Chinese banking sector show that non-performing loans and related loan losses are still a major problem.

In the Japanese banking sector, profits began to improve markedly in the financial year that ended in March 2005[8], when the large volume of non-performing loans substantially declined. Banks' performance improved also in the latest financial year, ending in March 2006. The six largest banks in Japan recorded a combined operating profit of JPY 3.1 trillion (ca EUR 22 billion). Improved results are mainly due to a decline in the amount of loan losses recorded. Earnings were boosted also by favourable developments in fee income and growth in lending. Lending growth has improved banks' net interest income, despite a slight narrowing of lending margins.

The improved state of the banking sector is largely based on the recovery of the Japanese economy. Banks' credit portfolios are now significantly healthier than they were a few years ago. In the largest banks, non-performing loans currently account for only 0.6% of the stock of credit, which is normal by international standards.

Despite the improvement in results, the Japanese banking sector still faces challenges and pressures to adapt. One of the key issues is the repayment of government-provided capital support. In the past couple of years, banks' capital adequacy ratios have risen and the structure of banks' own funds has improved. The elevated capital adequacy ratios of large Japanese banks are, however, still dependent on capital support. In this respect, the Japanese banking sector still has not fully recovered from its problems of the 1990s.

Another big issue is the changing competitive situation, following a decision to privatise Japan Post, a large state-owned postal savings bank. Details of the privatisation process have not yet been disclosed. The elongated timetable for the privatisation process runs to 2017. Despite this, it is already affecting interbank competition eg in terms of product development and pricing. Large banks are likely to increasingly focus on retail banking.

The third current issue is the entry into force of the new capital adequacy requirements defined in the Basel II framework. Japan is the only Asian country that has taken part in the drafting of the new regulations. In Japan, the new capital adequacy requirements will be phased in, on 31 March 2007 and 31 March 2008. The largest and most internationally oriented banks are likely to adopt the more sophisticated methods of risk assessment allowed under the new regulations. For smaller banks operating only in the domestic market, the minimum capital adequacy requirement remains at just 4%. A separate capital adequacy requirement will, however, be set for operative risks.

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[8] See Standard & Poors: Financial Profiles Improved At Japan's Major Banks in FY05, 25 May 2006; FitchRatings: Major Japanese Banks – The Recovery Quickens, 1 March 2006.

In the Chinese banking system, one issue has been dominant in recent years: how large is the stock of non-performing loans? A recent official assessment[9] indicates that in the first quarter of 2006 non-performing loans in the Chinese banking system amounted to USD 164 billion (ca EUR 135 billion), which is some 8% of the amount of outstanding loans. According to market assessments[10], an almost equivalent amount of loans which fall into the 'grey area' can be added to the official figure for non-performing loans. The quality of these loans is difficult to assess.

The amount of non-performing loans will clearly be reflected in the amount of loan losses in the coming years. Much depends on the overall performance of the Chinese economy. It is however, clear that non-performing and 'grey area loans' will result in extensive loan losses, which will substantially burden banks' results and buffers against losses.

In recent years, Chinese banks have received sizeable financial support from the government. In 1998–2005, capital injections amounted to about USD 95 billion (ca EUR 78 billion). Moreover, claims and problem assets amounting to over USD 300 billion (ca EUR 250 billion) were transferred from banks' balance sheets to asset management companies in 1999–2005. This represents nearly 14% of Chinese GDP.

The Chinese banking system is highly-concentrated, with four state-owned banks having a key role. The operations of large banks in the loan markets are of great importance. Recent data indicate that their market share in lending has declined slightly. On the other hand, companies' profitability and productivity is still not as important a lending criteria for Chinese banks' as it should be[11].

[9] China Banking Regulatory Commission, www.cbrc.gov.cn, May 2006.

[10] For example, FitchRatings: China: Taking stock of Banking system NPLs, 30 May 2006.

[11] See IMF Working Paper WP/06/7: Progress in China's Banking Sector Reform: Has Bank Behavior Changed?, March 2006.

3 Securities markets

3.1 Problems in the German real-estate fund market

Jyrki Haajanen

Temporary closures of real-estate funds have caused uncertainty among German investors. Investors' confidence in investment instruments formerly considered virtually risk-free has faltered, and the situation is not expected to improve without major legislative changes.

In Germany, real-estate funds have in recent years been an extremely popular investment outlet. Households and other small-scale investors, in particular, have now discovered real-estate funds, which are considered a low-risk form of investment with a reasonable rate of return (ca 4-6%). Investments in open-ended real-estate funds have grown within a short time span to nearly EUR 90 billion. Real-estate funds are the third most popular investment instrument, after shares and bonds.

German real-estate funds are mainly open-ended funds, ie they buy back shares at net asset value upon request. In special cases, management companies do have the right to refuse to buy back the shares if their deposits and securities holdings do not cover the redemption price. In such a case, the fund must be closed for a fixed period. The fixed-period closure of a fund is an extreme measure, one that had never been resorted to in the funds' 40-year history. However, the situation changed at the end of 2005 when Deutsche Bank announced that irregularities had been found in the asset valuation of its subsidiary DB Real Estate, and that it would carry out a special audit. The announcement scared investors, who quickly began to dump their shares of the DB Real Estate fund. The fund's liquid assets were not sufficient to redeem the shares, so that the fund had to be temporarily closed.

Closure of the DB Real Estate fund caused a lot of confusion among investors and was immediately reflected on the other real-estate funds. The situation was aggravated by an announcement by Deutsche Bank's CEO that the bank is not liable for losses incurred on investments in the real estate fund. Although the announcement was later retracted, investors' confidence in the instruments – previously considered risk-free – was badly shaken. Since the closure of DB Real Estate fund, two other real-estate funds have been forced to close for fixed periods due to liquidity problems.

German real-estate funds' problems are mainly due to the way in which their real-estate holdings are valued. Each real-estate fund has an independent committee or appraiser who evaluates the fund's investment properties once a year. The appraisers' evaluation is based on a 'long-term sustainable growth' model.

The model is based on long-term prices (and rents paid), which means in effect that drastic changes in market prices get smoothed out. Many international funds, on the other hand, use market prices to value investment properties. Differences in the two methods can result in differences in estimated values of up to 50%. Moreover, German real-estate funds are not allowed to sell their assets for less than the committee's estimated value, so that a fall in market prices may result in situations in where the imputed value is considerably higher than the actual market price. If investors start to demand redemption of shares in such a market situation, the funds will quickly encounter liquidity problems.

The problems of real-estate funds have led to demands for changes in the current valuation method to correspond better with international praxis. Another issue raised is the position of independent committees and appraisers, because committee members are appointed by the funds themselves. The committees and appraisers have been reluctant to write down property values, despite pressures to do so. Following recent events, the Federal Ministry of Finance announced that it will investigate whether German legislation on real-estate funds should be amended.

3.2 Foreign ownership of Finnish shares has remained stable

Pertti Pylkkönen

Ownership structure of Finnish listed shares changed significantly in the 1990s. In recent years, changes have been company-specific and, in terms of shareholder groups, the changes have been negligible.

The ownership structure of Finnish listed shares changed drastically in the 1990s. Foreign ownership was restricted by legislation until 1993, when the law restricting foreign holdings[12] was repealed. According to the law, foreign holdings should not exceed a fifth of a company's total shares, without an exemption from the Ministry of Trade and Industry.

Repealment of the law took place during a deep recession, and therefore liberalisation of the Finnish stock market did not attract large numbers of foreign investors. Moreover, economic recovery – and Nokia's success in particular – boosted foreign investors' interest in Finnish shares in the mid-1990s, and foreign holdings grew rapidly in the second half of the decade.

The change in ownership structure was seen not only in the growth of foreigners' holdings but also eg in the sharp decline in banks' equity holdings. As a result of the banking crisis, banks actively sold their equity holdings, and thus their ownership position in Finnish listed companies diminished significantly. A large number of listed shares were acquired by foreign investors and by the state. Equity holdings of mutual funds, the insurance sector and pension institutions were still fairly low at that time.

The change in ownership structure was reflected in companies' operations in many ways. The formerly very close ties between banks and non-financial corporations have been largely severed, and the relationship is more bottom-line driven. The reorientation has also entailed major changes in corporate governance, bringing it closer to international and Anglo-Saxon practices. Moreover,

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[12] Law on the right of non-residents and certain foreign corporations to hold and manage fixed assets and shares (219/39).

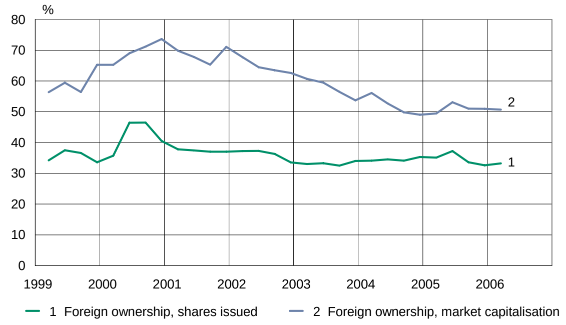
most companies no longer have a supervisory board, and the board of directors now plays a bigger role in the operations of a company. For the shareholder, the changes are seen eg in dividend payments as a larger portion of earnings is distributed sooner to shareholders.

In the late 1990s, there was a rapid upturn in foreign holdings as international investors became particularly interested in Finnish technology companies. In spring 2000, foreign holdings reached a peak: about 75% of the market value of listed companies was held by foreign investors. In terms market value of holdings, Nokia's role became crucial. About 90% of the company's shares were held by foreign investors, and its shares accounted for nearly 70% of the Helsinki Stock Exchange's total market capitalization. In terms of numbers of shares, foreign investors held about half of the shares of listed companies (Chart 5)[13].

Following the downturn in share prices in 2000, foreign investors resold large numbers of their shares to Finnish investors. An examination of the stock exchange list shows that foreign holdings in companies listed since 2002 has remained stable, ie they account for just over one-third of the number of shares.

[13] This is based on foreign ownership as reported by the Finnish Central Securities Depository (APK). The total amount of shares includes both Finnish shares and foreign shares in APK's links. The calculated ratio is thus considerably lower than that covering only Finnish shares. Source: www.apk.fi

Chart 5. Foreign ownership in the book-entry system: market capitalisation and number of shares, %



Source: Finnish Central Securities Depository (APK).

A breakdown by sector or company shows that some of the changes in ownership structure have been considerable. In the last couple of years shares in the materials sector in particular have been sold to foreign investors. The increase in foreign real estate investment is reflected in the growth of foreign holdings in real estate corporations. Foreign holdings have also increased in the energy sector.

Changes in the financial sector have been minor. The Finnish State has however, reduced its holdings in Sampo Oyj, and some of the shares are now owned by foreign investors.

Of domestic investor groups, state ownership in listed companies has declined during the current decade. At the turn of the century, the Finnish State held just over a fifth of the total number of shares. By March 2006, its holdings had fallen by about 15%.

Households' holdings in Finnish listed companies have remained fairly stable, at just under a fifth of the number of shares. Households have however slightly reduced their direct equity holdings and increasingly moved to indirect holdings, either through equity funds or life and pension insurance.

4 Infrastructure

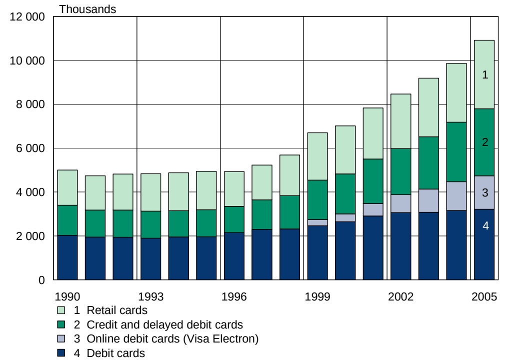
4.1 Visa Electron purchases grew by 64% last year

Kati Salminen

Payment flows increased in 2005 in Finland and other European countries. Payment card usage continued to expand in Finland. EMV chip technology[14] is increasingly incorporated in international cards.

Use of payment cards continues to expand in Finland, as revealed in the payment system statistics published by the Finnish Bankers' Association in April 2006[15]. Last year, the number of card payments was about 142 per inhabitant and about 68 per card. The cards that gained most in popularity were the domestic debit card and the online debit card Visa Electron, which is accepted both nationally and internationally. The number of debit card transactions increased by 12% on 2004 and Visa Electron transactions by a staggering 64%. In terms of value, the debit card is by far the most popular payment card; purchases by debit cards totalled EUR 17.8 billion in 2005. Payment cards also increased in number. Those distributed by banks numbered over EUR 5.3 million and, with credit and charge cards issued by financing companies and non-financial corporations included, the number goes above 10 million (see Chart 6 for a breakdown by feature). Payment cards have also become international: more than half of those distributed by banks are accepted abroad for payments or cash withdrawals. Domestic debit cards will be phased out in 2008–2010 with the introduction of the Single Euro Payments Area (SEPA).

Chart 6. Number of payment cards in Finland by feature



Source: Finnish Bankers' Association.

Increasing numbers of international payment cards with an EMV chip appeared in 2005. EMV is a new payment card standard developed by credit card companies to prevent counterfeiting and to reduce the abuse of cards. In making a payment, the customer inserts the card into a chip card reader and then enters his or her PIN to authorise the transaction. A signature is no longer required. Migration to EMV technology requires investments by retailers because payment terminals and cash registers must be upgraded for chip

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

[15] http://www.pankkiyhdistys.fi/sisalto_eng/upload/pdf/statistics.pdf

card use. On 1 July 2006, new liability regulations concerning payment card abuses will take effect. Under the new regulations, retailers – instead of credit card companies – are liable for purchases made with a stolen or counterfeit card if the retailers' chip card capabilities are not up to date.

The number of customer payments transferred by banks in Finland reached nearly 1.2 billion transactions. Payment transfer is very efficient: 95% of the payments were transferred electronically from customer to bank. The number of online banking agreements in Finland totals over 3.5 million. The proportion of payments transferred via online banking solutions continues to grow. In 2005, the number of payments effected online grew by over 38% year-on-year.

By contrast, the number of credit transfers made by giro ATMs continued to decline: in 2005, the number of transactions was only 42 million, which is only about 6% of total credit transfers. The number of giro ATMs and cash withdrawal ATMs continued to decline. The number of cash withdrawals totalled about 209 million, and the average value of a withdrawal was some EUR 81.

The number and value of transactions transferred in the PMJ interbank system have increased steadily. The number of debit transactions, ie card payment settlements, has surged in recent years, whereas their total value still accounts for just over 6% of the total value of transactions transferred via the PMJ. The number of credit transactions (credit transfers etc.) has remained more or less unchanged, while their value has increased slightly. A total of some 2 million transactions are transferred daily in the PMJ system, with a total daily value of EUR 780 million.

The average daily volume of payments transferred in the Finnish POPS system for interbank online express transfers and cheques remained broadly unchanged in 2005. The average daily number of transactions in the POPS system totalled 2,300 with a daily value of EUR 1.7 billion (average value of a transaction was about EUR 760,000).

Payment flows in the EU-wide payment system TARGET increased slightly in 2005. The daily number of payments transferred in TARGET was slightly under 300,000, and the daily average value was about EUR 1,900 billion. The number of customer payments and value of interbank payments, in particular, continued to increase. The volume of transactions transferred in BoF-RTGS, the Finnish TARGET component, increased slightly from the previous year. The majority of payments are incoming cross-border payments – in terms of both value and number. The number of payments in BoF-RTGS amounted to 472,000 in 2005, with a total value of nearly EUR 5,000 billion. The average value of an RTGS payment was EUR 10.6 million.

On the European level, payment flows increased particularly in the STEP2 system operated by the Euro Banking Association (EBA). Nearly a hundred banks from 23 countries (4 Finnish banks) have already joined the system. The daily volume of this system for transferring retail payments grew by over 50% in April 2004–April 2005.

Securities trading has picked up, which is reflected also in the increased number of share trades settled in APK's HEXClear system in 2005 compared to 2004. In the early 2006, settlement of share trades has again increased sharply from 2005: the volume and value of share trades settled grew by nearly 60% in January–April 2006, year-on-year. The daily number of trades settled was 36,000 and the daily value was EUR 2.7 billion.

The volume of settled money market instrument trades continued to decline slowly in 2005. By contrast, the number of trades settled has grown slightly in the early months of 2006, year-on-year. In January–April 2006, the average daily number of money market instrument trades was about 60, and the average daily value was EUR 0.6 billion.

4.2 Bidding war for stock exchanges heats up

Kirsi Ripatti

The search for economies of scale and increasing returns to scale is forcing stock exchanges to form larger alliances. The creation of NYSE Euronext is likely to pave the way for future European market infrastructure, towards a global operating environment.

The London Stock Exchange (LSE) has long been a focal point of stock exchange market integration. Bids for the LSE have been made by German (Deutsche Börse AG), central-European (Euronext), Australian (Macquarie Bank Ltd) and US (Nasdaq) stock exchanges. The technologically-oriented Nasdaq has been buying LSE shares from the market since LSE rejected its purchase offer, and it now owns 24.1% of LSE's share capital.[16]

Euronext N.V., which operates the Paris, Brussels, Amsterdam and Lisbon exchanges, rejected Deutsche Börse AG's bid[17]; instead, on 2 June 2006, its management announced its support of the almost EUR 7.8 billion bid by the NYSE Group (NYSE), which operates the New York Stock Exchange. If concluded Euronext and NYSE would comprise the world's premier stock exchange alliance – a combined market capitalization of about EUR 15 billion. For Deutsche Börse AG, formation of this new transatlantic stock exchange would be a bitter pill to swallow, and it has not renounced the possibility of bidding again. Another sizable stock exchange alliance will take place in Australia in July–August 2006, when the Australian Stock Exchange (ASX) and the Sydney Futures Exchanges (SFE) are merged[18].

In conjunction with the recovery of stock market activity, changes in the European and global operating environment and increased competition are having a growing impact also on the Nordic integration process. The Copenhagen Stock Exchange, which joined the OMX Group in February 2005, is expected to be followed by the other NOREX exchanges[19] sooner or later. Nor can cooperation with central and eastern-European exchanges be ruled out. The London Stock Exchange, facing a rash of buyout offers from other exchanges, has from time to time been described in the media as a potential buyer of OMX.

Speculation about structural changes is also reflected in share prices. Along with a boost from the highly favourable economic situation, recent merger rumours have also had a pronounced impact on the performance of large European stock exchange operators (Chart 7).

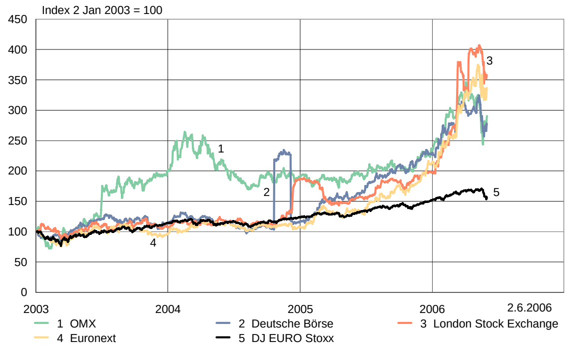
[16] According to UK legislation, the company cannot make a new offer before autumn.

[17] The merger was discussed at the Euronext Annual General Meeting on 23 May 2006.

[18] Thomas Murray, 24 May 2006.

[19] NOREX is an alliance of exchanges in Helsinki, Iceland, Copenhagen, Oslo, Riga, Tallinn, Stockholm, and Vilnius.

Chart 7. Share prices of large European stock exchange operators, 2003–2006



Source: Bloomberg.

Listing activity has picked up as a result of improved market conditions, which is also reflected in exchanges' own interest in getting listed. In March 2006, the New York Stock Exchange, a 200-plus-year-old association, was listed on the New York Stock Exchange. The listing – and creation of the NYSE Group – was a result of the merger between NYSE and the electronic marketplace (ECN) Archipelago at the start of the year. NYSE's rival in America, Nasdaq, had listed earlier. Listing of the Tokyo Stock Exchange, however, seems to have been postponed due to ADP problems. In Europe, listing of Borsa Italiana, which operates the Milan stock exchange, is in the preparatory stage and is expected to take place in early summer[20]. The Spanish exchange, Bolsa y Mercados Españoles, is also rumoured to be eager to list.

With increasing pressure for global consolidation, the European Commission has examined competition in securities trading and post-trading. It published its analysis of the current situation, for comments, on 24 May 2006.[21]

[20] La Tribune, 6 April 2006.

[21] Competition in EU securities trading and post-trading, Issues Paper. Consultation ends on 3 June 2006.

4.3 ECB and European Commission agree that SEPA must be forward-looking

Timo Iivarinen

The ECB and the European Commission issued a joint statement on the Single Euro Payments Area (SEPA). Market-driven development of infrastructure is the way to go.

The statement presents the authorities' common vision for SEPA. Despite the euro's functioning as the single currency, the single euro payments area is still not a fact of life. Payment services are still based on national systems. According to the common vision, the single euro payments area will be realised only when consumers, businesses and other parties are able to make payments throughout the euro area from their own account as easily, efficiently and safely as domestic payments are currently effected.

The goal will be achieved by creating open and uniform standards that overcome current technical and commercial barriers. SEPA will improve efficiency of payments and increase competition in the field. Thus it is of importance to the EU economy as a whole.

To achieve these goals, payments-related products must utilise modern technology. Thus, in addition to the ongoing planning of core services, new opportunities provided by technological advances should be exploited as efficiently as possible. The development of new services should be an ongoing process that takes account of the rapid pace of technological advance. E-invoicing, for example, could make the payment process even more efficient.

New services cannot be created without standardisation. In order to make standards as useful as possible, users of payment services must also be involved in formulating the standards.

The Commission and ECB affirm their support for the work of the European Payments Council (EPC), a joint body of banks, in developing SEPA. The credit transfer and direct debit defined by EPC and the issuing of payment cards that are acceptable throughout the entire SEPA provide a solid foundation for future work. New services must be as good as existing services – or even better – in order to generate the maximum demand for SEPA products.

The statement of the European Commission and ECB underlines their full support for self-regulation of the industry. However, the European Commission reserves the right to introduce or propose necessary legislation to achieve a satisfactory outcome.

4.4 Report by the European Commission: market for card payments still too domestically oriented

Kari Kemppainen

Payment card markets are still nationally segmented and cross-border competition is virtually nonexistent. The European Commission estimates that increased competition could save the EU economy between EUR 50 and 100 billion per year. The Commission is thus ready to take regulatory actions, if necessary.

These findings are included in a report[22] issued by the European Commission on 12 April 2006. The report examines the market structure and degree of competition in card payments. According to the report, payment card markets are still too national in nature, and cross-border competition is nonexistent. For example, in many countries monopolistic features are evident in the credit card business, which guarantees excessive profits for market participants, in the absence of competition.

In the press conference on the publication of the report Neelie Kroes, European Commissioner for Competition Policy, expressed her deep concern about the development of card payments in the EU. According to the Commissioner, the current situation is extremely challenging in terms of achieving a true Single Euro Payments Area (SEPA). The

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[22]See http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/

Commissioner emphasised that there is a clear need for a Europe-wide payment scheme able to compete with MasterCard and Visa.

The Commission's report shows that breaking the monopolies in national card schemes and increasing cross-border competition would save the EU economy between EUR 50 and 100 billion per year. The large potential savings are explained by the extensive use of payment cards in the EU: 23 billion card payments are made annually, at a total value of EUR 1,350 billion.

The report lists several obvious barriers to increasing competition in the payment card business. Structural barriers include vertical integration, which is typical of the industry, as well as networks formed by payment service providers, which make entry impossible – or at least very expensive – for competitors. Moreover, lack of competition gives providers of payment card services considerable powers in respect of merchant fees and interchange fees, and the merchants have to adjust to the situation. Technical barriers to competition include diverging technical standards, which hinder providers of payment card services from operating on a pan-European scale.

In addition to the above-mentioned barriers, established practices regarding card payment services also restrict competition. These types of behavioural barriers include criteria for entering payment schemes, high entry fees, and other system governance-related arrangements. The Commission presents regulatory action as a possible solution for these competition policy problems.

Before taking regulatory action the Commission will continue discussions with operators in the payment card industry. To this end, the report raises 25 questions, which will form a basis for the discussions with market participants. Overall, the Commission considers this type of thorough investigation to be one means of promoting competition in the European financial markets, and first and foremost, of motivating payment services providers to strive even harder to create a single European payments area.

5 Key corporate arrangements and events in the financial sector

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.
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).
	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.
	Aktia Life Assurance Ltd merges with Veritas Life Insurance Company.

Date	*Event and description*
March 2006	*Ahlstrom Plc and Salcomp plc listed on the Helsinki Stock Exchange.*
	Nasdaq makes a bid for the London Stock Exchange (LSE), but withdraws from it at the end of the month.
April 2006	*Nasdaq purchases 16% of the shares in LSE. In May, it owned ca 25% of LSE's share capital.*
	Sampo Bank announces it will acquire Profibanbk (Industry and Finance Bank) operating in St. Petersburg.
	The Australian Stock Exchange announces it will acquire the country's largest futures trading place, the Sydney Futures Exchange, for AUD 2.3 billion.
May 2006	*Savings banks announce they will start co-operation with Fennia Life and start selling Fennia Life's endowment and pension insurance policies.*
	The Government of Austria announces it will issue a framework guarantee in the amount of EUR 900 million to save the BAWAG PSK bank. In addition, a consortium of Austrian banks will grant an EUR 450 million loan to BAWAG.
	NYSE Group makes an EUR 8 billlion bid for Euronext. Deutsche Börse makes a competing bid of EUR 8.5 billion. A decision on the merger of NYSE and Euronext was taken in early June. The new company will be called NYSE Euronext.
	FIM Group Corporation announces it will establish a subsidiary in Russia that will engage in asset management and mutual fund operations.
	If P&C Holding Ltd announces it is planning to establish a non-life insurance corporation in Russia. The company has had a representative office in St. Petersburg since 1995.
	OP Bank Group Central Cooperative announces it will purchase OP Bank Group Mortgage Bank plc shares held by OP Bank Group member banks.