



Financial Market Report

2 • 2005

- Strong demand for both housing loans and consumer credit
- Banks' results boosted by rapid growth of lending stock and stabilising of market interest rates
- The proportion of equity investment of pension insurers' investments is gradually increasing
- Bond investors are losing their appetite for risk
- The popularity of online banking and card payments continues to grow in Finland
- European securities marketplaces integrating – it is still difficult to envision the future market structure



Bank of Finland

Financial Markets and Statistics

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1 Financial intermediation

1.1 Robust demand for consumer credit

Hanna Putkuri

In Finland in recent years, demand has been strong for both housing loans and consumer credit. The stock of consumer credit relative to households' disposable income is gradually approaching its level of the late 1980s. The selection and price range for consumer credit are wide.

Household indebtedness and particularly the strong growth in the stock of lending for house purchase has recently been the subject of close attention in Finland. Demand for consumer credit has also been quite brisk in recent years. At the end of 2004, the stock of households' consumer credit totalled EUR 8.9 billion¹. In the past seven years, average annual growth of the stock of consumer credit has been approximately 10%. In 2004, the growth slowed somewhat on the previous year (Chart 1).

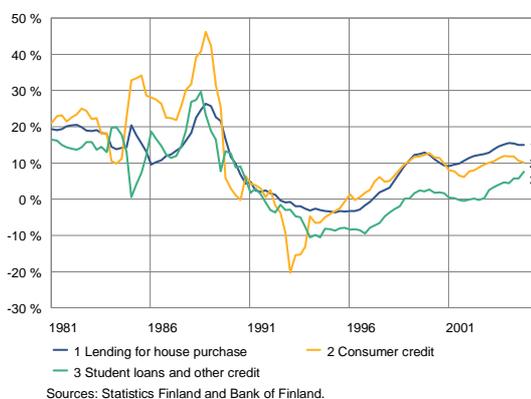
A survey by the Finnish Bankers' Association² shows that consumer credit is the most common form

¹ Statistics Finland, *Outstanding credit 2004*. The statistics include consumer credit granted by financial and insurance corporations and employee pension insurance companies operating in Finland.

² *Säästäminen ja luotonkäyttö (Survey on saving and use of credit)*, May 2005.

of credit used by private persons. The survey, which was done in April 2005, shows that 34% of 15 to 74 year-olds have consumer credit. Of 25 to 49 year-olds, 44% have consumer credit. This means that some 1.5 million Finns have consumer credit. Consumer credit has become more widespread in the past five years: in January 1999, 28% of respondents had consumer credit.

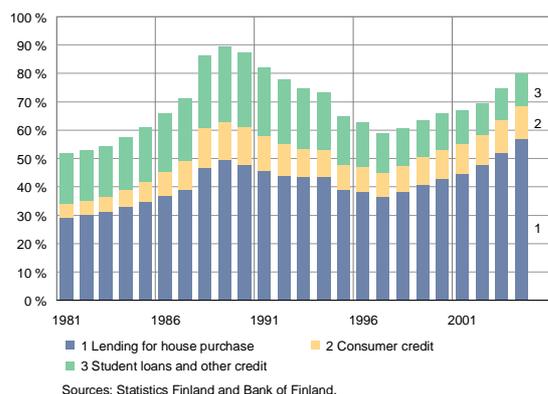
Chart 1. Stock of household credit, 1981–2004, % change on year-earlier quarter



Relative to households' disposable income, the stock of consumer credit, as well as lending for house purchase, has grown continuously since 1998 (Chart 2). In 2004, consumer credit accounted for about 12% of households' disposable annual income. In the late 1980s, when annual growth of consumer credit exceeded 20% for several years, the ratio peaked at some two percentage points above its current level. The share of consumer credit in the stock of household credit has remained at approximately 15% in recent

years. The share of lending for house purchase has increased to a full 70%. The share of student loans of total household credit has decreased to about 2% and the share of other credit to about 10%.

Chart 2. Stock of household credit, 1981–2004, % of disposable income



The statistics on outstanding credit show that over half of households' consumer credit is granted by deposit banks. A little over a third is granted by other MFIs involved in financial intermediation, such as finance and credit card companies, and approximately 10% by other financial institutions.

According to a survey by the Finnish Bankers' Association, 18% of 15 to 74 year-olds have consumer credit granted by a bank. Of that age group, 11% have credit linked to a bank account with an overdraft facility, 6% have credit linked to a loyalty card or retailers' consumer credit, 7% have other credit card credit (with repayment period of over 2 months, not Visa card), 5% have hire purchase credit, and 1% have other temporary credit. The average amount of consumer credit granted by a bank is EUR 8,600. In January 2003, the corresponding amount was approximately EUR 6,900.

New operators have recently entered the consumer credit market, which is tightening competition and increasing the supply and range of credit. The prices of

various types of credit differ considerably. The cheapest form of consumer credit is secured credit granted by a bank. In April, the interest rates offered by banks ranged between 4.70 and 5.81 percent³.

According to Bank of Finland statistics, the average interest rate on MFI's new consumer credit agreements was 4.45% in January–April (2004 average: 4.91%).

The majority of new consumer credit grants have interest rates fixed for up to 12 months. The annual interest rate on the various types on unsecured consumer credit ranges from 10 to 30%. The most expensive forms of credit are accounts with overdraft facility, offered by a mail order company, and individual loans. According to the National Consumer Research Centre, it might be difficult for a consumer to get a clear picture of the various types of credit options⁴.

Reform of EU legislation on consumer credit has been underway since 2002. In October 2004, the European Commission adopted a modified proposal on the consumer credit directive. The objective of the legislative initiative is to enable the creation of a more transparent and efficient consumer credit market, and to guarantee a level of consumer protection that enables free movement of credit in the best way for both lenders and consumers.

In Finland, the marketing of consumer credit is regulated by the Consumer Protection Act. During a market surveillance campaign by consumer authorities in November–December 2004, deficiencies were still

³ Taxpayers' Association of Finland, Taloustaito magazine 5/2005 (in Finnish). The comparison included interest rates offered by eight banks (19 April 2005) for consumer credit grants of EUR 10,000, with repayment period of three years.

⁴ A survey on the consumer credit market. National Consumer Research Centre's working papers 82/2004 (in Finnish).

found in the marketing of consumer credit on domestic appliances, furniture and cars⁵.

⁵ Consumer Agency's press release, 26 January 2005.

2 Banks

2.1 Banks' results boosted by rapid growth of lending stock

Mervi Toivanen

Banks' net interest income improved in January–March 2005, due to the rapid growth of lending stock and stabilising of market interest rates. Finnish banking groups' total operating profits thus improved by about 2%. The capital adequacy of banks has also remained high on average. IFRS standards for the accounting of quoted companies entered into force at the beginning of 2005.

In January–March 2005, banks' operating profits varied considerably. The operating profits of small banks decreased, whereas the results of large banks and banking groups improved. The total operating profits of Finnish banking groups⁶ nevertheless grew by 2%, to EUR 246 million (Table 1). Some of the banks introduced the International Financial Reporting Standards (IFRS) (see Section 2.2.) at the beginning of the year.

⁶ 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.

The operating profit of financial conglomerates⁷ operating in Finland, on the other hand, improved by almost 9%. Rise in aggregate result for January–March 2005 is however partly due to Sampo Group's structural change. If's results are now included in Sampo Group's operating profit, whereas in the reference period, If was an affiliate of Sampo.

Banks total net interest income increased. This reflects two counterbalancing factors: size of the lending stock and interest rates on loans. Over the past year, lending by Finnish MFIs has increased by more than 11%⁸. Brisk growth of the lending stock has thus improved banks' net interest income. The increase in net interest income has been slower than that of the lending stock, due to lower interest rates on loans. The 12-month EURIBOR, the most commonly used reference rate, has not declined significantly within the past year. Therefore the decrease in the level of interest rates on loans is mainly due to a narrowing of interest rate margins, which is largely a result of heightened price competition.

Developments in other income (incl. net fee income) have been mixed. Banks' fee income was boosted by services related to asset management and mutual fund investments, as well as by the sale of loan

⁷ Includes the following banks: savings banks, Aktia Savings Bank Plc Group, local cooperative banks, Bank of Åland plc Group, Evli Group, eQ Online Group, OP Bank Group, Sampo Group, and Nordea Group.

⁸ Financial Markets – Statistical Review 5/2005, Table 7.1.

payment protection insurances. The drop in other income of some banks was due to non-recurring items included in the reference year or to a decrease in fee income from payment transactions.

Banks' expenses have grown. Finnish banking groups' expenses increased by more than 4% compared to the period January–March 2004. This growth was driven by an almost 8% increase in staff expenses, which was due higher wages. Moreover, the number of staff has also increased in some banks compared to the previous year. The growth in other expenses is due to

an increase in other administrative (eg marketing, real estate and information technology) expenses.

Writedowns on loans were minor and had a negligible impact on banks' results for the first quarter of 2005. Similarly, banks' non-performing assets have remained low. Only the non-performing assets of local cooperative banks increased on the corresponding period of 2004.

The capital adequacy of banks has remained high on average.

Table 1. Banks' income statement items and key figures, Jan-Mar 2005

	Net interest income		Other income		Total expenses		Operating profit		Lending stock		Expenses, % of income	Capital adequacy, %	
	EUR m		EUR m		EUR m		EUR m		EUR m			Tier 1	Tier 1 + Tier 2
	1-3 2005	Change %	1-3 2005	Change %	1-3 2005	Change %	1-3 2005	Change %	31.3.2005	Change %	1-3/2005	capital %	capital %
Nordea Group	897	5.0 %	685	-4.2 %	900	-0.3 %	688	10.3 %	170 112	14.8 %	57	6.8	8.9
Nordea Group, retail banking	739	1.8 %	368	5.7 %	627	0.3 %	487	12.7 %	135 500	-	57	-	-
Nordea retail banking in Finland	196	-	88	-	148	-	137	-	32 400	-	52	-	-
Sampo Group	73	-9.9 %	1 315	196.2 %	1 158	244.6 %	227	12.9 %	-	-	-	-	-
Sampo Group, banking and investment services	82	2.5 %	84	9.1 %	105	1.9 %	62	10.7 %	15 619	11.6 %	68	6.8	10.1
Sampo Group, insurance business	-	-	-	-	-	-	177	-	-	-	-	-	-
OP Bank Group	194	4.9 %	149	7.2 %	196	5.4 %	145	3.6 %	31 643	12.7 %	53	13.9	15.5
OKO Bank Consolidated	38	5.6 %	40	42.9 %	38	11.8 %	39	30.0 %	8 796	15.1 %	49	7.9	11.3
Savings banks (excl. Aktia) Total	28	2.2 %	9	-24.8 %	25	1.6 %	12	-17.8 %	3 671	13.5 %	69	16.0	18.2
Aktia Savings Bank plc Group	19	6.8 %	10	-12.0 %	19	-2.1 %	11	10.3 %	2 956	10.8 %	65	9.4	14.3
Local cooperative banks	19	1.6 %	5	-5.4 %	17	1.8 %	7	-2.8 %	2 215	11.6 %	-	20.4	20.4
Bank of Åland plc (Group)	8	2.7 %	6	3.7 %	9	8.9 %	5	-2.1 %	1 588	13.1 %	67	7.7	11.5
Evli Group	0	-11.9 %	16	-13.8 %	13	8.1 %	3	-55.7 %	30	-34.1 %	83	21.3	20.8
eQ Online Group	1	26.9 %	8	27.2 %	7	62.2 %	2	-34.9 %	23	64.6 %	84	21.8	21.8
1. Finnish banking groups (excl. Nordea)	350	4.0 %	287	4.2 %	391	4.4 %	246	1.9 %					
2. Finnish banking business	546	-	375	-	539	-	383	-					
3. Financial conglomerates operating in Finland	1 238	3.9 %	2 203	62.3 %	2 344	55.2 %	1 099	8.8 %					

1. Includes Finnish banking groups and Sampo group banking and investment services.

2. Includes Finnish banking groups, Sampo group banking and investment services, and Nordea retail banking Finland.

3. Includes Finnish banking groups, Sampo group, and Nordea group.

Other income includes net fee income. Expenses include writedowns and depreciations. Nordea's expenses include profit and loss on the sale of tangible and intangible assets.

Lending stock refers to the balance sheet item claims on the public and public sector entities.

Sampo group's figures are not fully comparable due to the change in group structure as a result of if-related arrangements.

Capital adequacy ratios of Sampo group's banking and investment services refer to the Sampo Bank group.

"-" Data not available or published.

Source: Banks' interim reports.

2.2 Introduction of IFRS in Finland

Mervi Toivanen

The International Financial Reporting Standards (IFRS) for quoted companies entered into force at the beginning of 2005. These new regulations apply also to Finnish quoted deposit banks. The reform of financial reporting standards has had an impact on banks' income statements and balance sheets. Press releases concerning the transition show, however, that the reform has brought only moderate changes.

At the beginning of 2005, the International Financial Reporting Standards (IFRS) were introduced in the European Union. This reform directly concerns all quoted companies, including some Finnish deposit banks. Those deposit banks to which these standards do not directly apply prepare financial statements in accordance with the Finnish Credit Institutions Act. The Credit Institutions Act was amended to ensure that all credit institutions follow the same practices in preparing financial statements.

The new financial reporting requirements are reflected in banks' financial statements. The balance sheet and income statement have been changed in both layout and contents. One of the key changes concerns the measurement of financial instruments⁹, which in

⁹ A financial instrument is any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity.

future must be measured at fair value¹⁰. In practice, part of the value of financial assets will change in accordance with market value, whereas previously, financial assets (excl. those held for trading purposes) were measured at nominal value.

In the early part of 2005, banks have issued press releases concerning the transition and impact of the new financial accounting regulations on income statements and balance sheets. These press releases and interim reports for the first quarter 2005 indicate that the introduction of new accounting standards has not had a major impact on Finnish deposit banks.

The table below (Table 2) gives a comparison of several banks' financial statements for 2004, based on the old (FAS) and the new (IFRS) accounting practice. On the whole, it can be noted that balance sheet totals and loan stocks are generally larger under the new accounting practices. The loan stock is larger because it now includes financial leasing contracts. In future, loans will also be measured at amortised cost¹¹. The increases in balance sheet totals are due to the measuring of financial assets at fair value, the exclusion of goodwill amortisation, and the inclusion now of assets and liabilities of companies engaging in life insurance business, financial leasing contracts and defined pension benefit plans.

As a consequence of the reform, net interest income is lower than in the FAS-based accounting. For operating profits, changes are mixed and no general trend is observable. The new accounting practices have not yet had an impact on impairment losses, ie on the

¹⁰ Fair value = the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

¹¹ Amortised cost = purchase price + transaction cost +/- discount/premium amortisation – impairment.

earlier loan and guarantee losses. Nor have there been major changes in capital adequacy ratios.

The banking group that has reported the biggest changes in its income statement and balance sheet is Nordea Group. In 2004, Nordea Group's financial statements were prepared according to financial reporting principles approved in Sweden. The biggest differences between the Swedish regulations and the IFRS concern the reporting of life insurance business

and the treatment of goodwill amortisation and financial instruments. Earlier, the life insurance business was consolidated by using the capital method, whereas in IFRS financial statements it is consolidated line by line in the consolidated financial statements. Nordea's balance sheet was thus expanded by the consolidation of life insurance assets and liabilities of in the Group's balance sheet.

Table 2. Banks' income statement and balance sheet items for 2004, based on new and old accounting practices

	Nordea		Sampo Group's banking and investment services		OP Bank Group		Bank of Åland	
	IFRS	FAS	IFRS	FAS	IFRS	FAS	IFRS	FAS
Net interest income	3 495	3 510	323	394	758	783	29	30
Impairment loss	27	27	-11	-14	7	7	1	1
Operating profit	2 745	2 284	274	287	514	504	14	15
Deposits	104 704	104 424	10 985	10 985	25 107	25 128	1 249	1 249
Loans	161 295	161 148	15 747	15 277	30 952	30 645	1 632	1 632
Equity	12 708	12 549	3 465	3 517	3 339	3 863	109	109
Balance sheet total	277 597	276 040	-	-	41 463	38 229	1 998	1 984
Assets, banking and investment s	-	-	19 889	19 738	-	-	-	-
Liabilities, banking and investmen	-	-	18 817	18 121	-	-	-	-
Capital adequacy, %, Tier-1	7.3	7.3	-	-	14.1	14.4	7.8	8.2
Capital adequacy ratio	9.5	9.5	-	-	15.5	15.8	11.8	11.4

Loan and deposit stock refer to balance sheet items 'Receivables and liabilities on the public and public sector entities', based on the old accounting regulations.

In the case of Sampo, equity refers to the equity of the entire Group.

Negative impairment loss means that more reversals of write-downs have been entered than new impairment losses.

Negative impairment losses thus improve a group's results.

Source: Banks' financial statements for 2004 and interim reports for January–March 2005, and banks' press releases.

IFRS accounting no longer includes goodwill amortisation. In this connection, a reversal of goodwill amortisation increased Nordea's result by EUR 161 million, compared to a financial statement prepared in accordance with Swedish accounting regulations. Operating profit was also improved by changes in the way of entering net effects of real estate sales and related unrealised gains (+ EUR 300 million). In accordance with Swedish financial reporting standards,

Nordea entered the net effect after operating profit, as extraordinary income, whereas according to the IFRS, it belongs in the income statement, before operating profit. Measuring financial instruments and derivatives at fair value had an impact on the IFRS balance sheet via the changes in these items. All and all, the new measurement practice increased Nordea's balance sheet total by EUR 877 million. Nordea Group's equity was

increased mainly by the reversal of goodwill amortisation (+ EUR 161 million).

At Sampo Group, the impact of changes was mainly on the financial statements for life and non-life insurance and the holding company. The financial statement of Sampo Group's banking and investment services has changed only moderately. Regarding the assets of banking and investment services, the most significant changes in accounting practices have been the measurement of derivatives at fair value, the new way of treating leasing contracts, and the recognition of interest also after loans have been affected by impairment losses. Moreover, the goodwill previously recorded in the holding company's balance sheet is now recorded under banking and investment services' assets.

Banking and investment services liabilities now include capital loans previously entered in the Group's equity. The transfer of capital loans had a negative impact on Sampo Group's equity. On the other hand, equity was increased by the positive net effect of financial instruments measured at fair value.

For the OP Bank Group, the changes concern the balance sheet more than the income statement. In the balance sheet, the biggest changes are the line-by-line consolidation of life insurance business in the consolidated financial statements and the treatment of cooperative capital. With the introduction of IFRS, OP Life Assurance Ltd is now treated according to the cost method, instead of the previous equity method. In practice, all the balance sheet items of life insurance, except operating expenses and taxes, are to be presented in the OP Bank Group's income statement on the line 'net income from life insurance business'. The consolidation of life insurance business assets and liabilities in the OP Bank Group balance sheet expands the Group's balance sheet by almost EUR 3 billion.

The treatment of cooperative capital changes with the introduction of the IFRS. Earlier, cooperative capital was presented under equity, but now it is included in liabilities. The net effect of IFRS adjustment reduces OP Bank Group equity, with a net impact of approximately EUR 460 million. The measurement of financial instruments at fair value does not affect OP Bank Group's financial statement for 2004 because the Group introduced the new measurement method at the beginning of 2005, and thus comparative data was not required from the company. In the opening balance sheet for 2005, the total effect on equity of the new measurement practice for financial instruments was a positive EUR 75 million.

Regarding the Bank of Åland, the consolidated financial statements will include more companies than before. The group's equity will be affected mainly by the difference between the fair values of pension fund assets and pension liabilities, the measurement of head office real estate at fair value at the date of transition, and the dividing of capital loan into equity instruments and financial liability. The net effect of the change on equity is about EUR 2.6 million.

The true effects of the IFRS reform will become evident only in the long term. Measurement at fair value increases the volatility of banks' balance sheets. Net interest income and impairment loss are likely to increase because, according to IFRS regulations, interest is accrued by applying the effective interest method also on credit for which impairment loss has been entered.

2.3 Equity investment account for one-third of employee pension insurers' investments

Pertti Pylkkönen

The proportion of unit-linked pension insurance in life-insurance corporations' total premium income is growing rapidly. The weight of equity investment in pension insurers' investments is gradually increasing.

The growth of life insurance corporations' premium income continued to develop favourably during the first quarter of 2005. Premium income grew by almost 5%. The growth was based mainly on the increased popularity of endowment insurance. Premium income from guaranteed-return policies and unit-linked premiums each accounted for about half of premium income from endowment insurance¹². During the first quarter of 2004, households showed relatively little interest in insurance saving, due to the uncertainties regarding the taxation of insurance products.

The fall in share prices during the first year of the current decade dampened clients' interest in unit-linked insurance. Thus in 2001–2003 unit-linked life insurance accounted for only about one-fifth of total premium income. In 2004, customers' interest in unit-linked insurances was revived, which was supported by positive developments in the share market. Low interest rates also increased the attractiveness of unit-linked policies.

¹² Federation of Finnish Insurance Companies.

Premium income from personal pension plans was somewhat lower in the first quarter of 2005 than in the previous year. In this decade, unit-linked pension insurance has been more popular than unit-linked life insurance. The market share of unit-linked insurance in total pension insurance has also risen continuously. In the first quarter of 2005, unit-linked insurance accounted for more than half of personal pension plans.

Employee pension insurers' investment activities¹³

Employee pension insurers' investments totalled EUR 91 billion at the end of March 2005. Pension insurers account for almost 60% of total investments, pension funds for 8%, and special pension funds for almost a third.

Of pension insurers' investments, more than EUR 53 billion (61%) are in fixed-income instruments, mainly in bonds. In March, bonds accounted for almost half of pension insurers' total investments, money market paper for 4% and loans for 6%. Two-thirds of lending is relending to non-financial corporations.

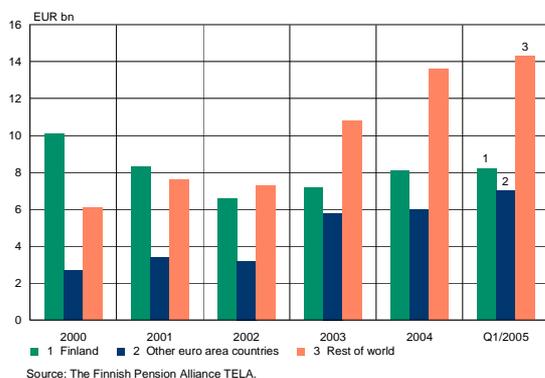
The focus of bond investments has shifted in the past couple of years from Finnish government bonds to issues of other euro area countries and to bonds denominated in other currencies. For example, because emissions activity in the Finnish corporate bond market has been subdued for quite some time, investments in the corporate bond market have necessarily concentrated on foreign bonds.

The importance of equity investment varies considerably between pension institutions. For employee pension insurers, the importance of equity

¹³ Based on information gathered by the Finnish Pension Alliance from its member institutions.

investment has increased in the past few years: in March, equity investment accounted for more than a fourth of total investments. Pension funds have slightly reduced the relative weight of equity investments. Currently, equities account for about a fourth of the investment portfolio of pension funds. Special pension funds have increased the share of equities in their investments. In March, equity investments accounted for 43% of their total investments.

Chart 3. Employee pension insurers' equity investments by geographic area



The geographic distribution of all pension insurers' total equity investments has changed considerably in the past five years. In 2000, more than 53% of equity investments were in domestic equities. By March 2005, the proportion of equity investments in domestic equities decreased to 28%. Outward equity investments were heavily focused beyond the euro area. Only about a third of outward investments were in the euro area.

The importance of domestic equities varies between the various pension institutions. The weight of outward equity investments in special pension funds' equity investments is greater than the average, and the weight in pension insurers' equity investments is somewhat smaller than the average.

In 2004, the net increase (sales – purchases) of pension insurers' equity investments was divided almost equally between domestic and foreign equities. Pension funds reduced their equity investments in 2004. The focus of equity sales was on domestic equities.

The share of real estate investments in pension insurers' total investments was less than 10%. The focus of investments was on the domestic market.

3 Securities markets

3.1 No clear direction on the stock markets

Jukka Topi

In the first few months of 2005, share prices on key markets developed without any clear direction. The long-standing decline in stock market volatility came to a halt. In Finland, the dispersion of equity returns between the different sectors has narrowed.

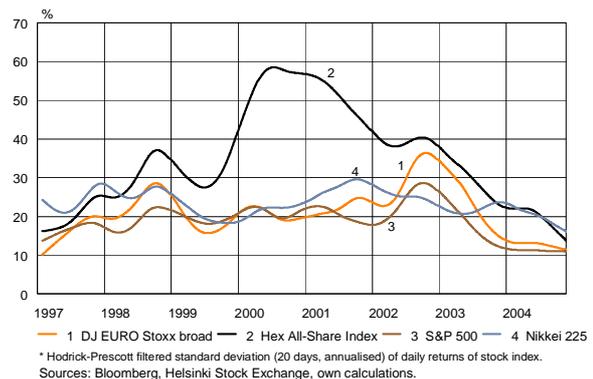
Developments in share prices varied considerably in the first few months of 2005. By mid-May, share prices in the euro area had risen by almost 2% and in Finland by some 9%, whereas in the United States and Japan, prices were down by about 4%¹⁴. In January–February, share prices generally increased in Finland and in the main global markets. In March–April, there was a major downturn in share prices. However, in early May, this downward trend seems to have been at least partly reversed. The performance of bank share prices in Europe, the United States and Japan was weaker than average in January–April. Insurance corporations' share prices have developed more favourably than those of banks. In the United States

¹⁴ Assessment of share prices is based on DJ Euro Stoxx broad index (euro area), S&P 500 index (United States), and Nikkei 225 (Japan).

and Japan, insurers' share prices have generally outperformed the market as a whole.

The fall in share prices in March–April reflected widespread doubts of investors about the strength of economic growth in the major economic regions, and to an extent a broadly visible nervousness in the securities markets, particularly in April. Market uncertainty was fuelled by problems concerning eg some major auto industry companies. However, the impact of these problems on stock market volatility was relatively small (Chart 4). Nevertheless, the decline in volatility that had continued for several years seemed to have come to a halt. Volatility has nonetheless remained relatively low.

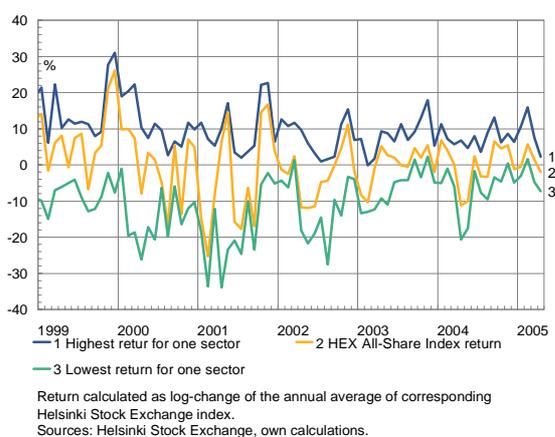
Chart 4. Historical volatility of share indices*



In Finland, the dispersion of equity returns between different sectors was fairly narrow in spring 2005 (Chart 5). The dispersion between different sectors has declined in recent years compared to the situation at the turn of the century, when the sharp rise in share

prices was uneven across the different sectors and the dispersion of equity returns was higher overall. The dispersion of equity returns between the strongest and weakest sectors has declined at given points in time, and the standard deviation between sectors has decreased.¹⁵

Chart 5. Fluctuations in equity returns on the Helsinki Stock Exchange



In 2004, the value of share trading increased on the major global markets compared to the previous year, after several years of decline. In the first quarter of 2005, share turnover increased in the United States by 6% and in Japan by 4%, whereas in the euro area it fell by almost 5%. In Finland, the value of shares traded has fluctuated widely: in 2004, the value of shares traded on the Helsinki Stock Exchange was about 24% higher than the year before, whereas in the first quarter of 2005, share turnover was 17% lower than in the year-earlier period.

¹⁵ The Helsinki Stock Exchange will introduce the new Global Industry Classification Standard in July 2005. See Section 4.3.

3.2 Bond investors are losing their appetite for risk

Jukka Vauhkonen

The narrowing of interest rate spreads between high- and low-risk bonds has been one of the clearest trends in the international bond markets in recent years. But interest rate spreads widened, at least temporarily, in the spring, triggered by the problems of American auto manufacturers Ford and General Motors.

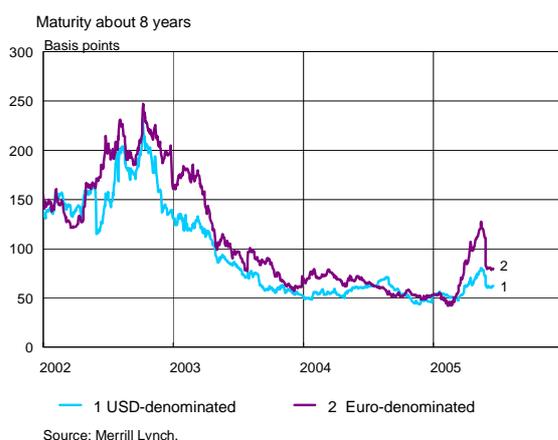
Low government bond yields have in recent years increased investors' interest in corporate bonds. As a result, interest rate spreads between high- and low-risk corporate bonds, in particular, were narrowing up until early spring 2005.

The narrowing of the spreads on corporate bonds reflects mainly companies' improved outlook for profitability and indebtedness, which has reduced companies' risk of financial difficulty. It may also be due to investors' aggressive risk taking in the search for yield. Investors' risk appetite has increased because of eg low yields on low-risk financial instruments and abundant liquidity in the global economy.

Several national central banks and international organisations in particular have expressed their concern about corporate bond prices not reflecting the risks involved and that at least the market for high-risk corporate bonds may be vulnerable to negative economic data. The risk tolerance of international corporate bond markets was tested in early spring 2005 when the weakened outlook for American auto manufacturers Ford and General Motors was revealed.

The profit warning of General Motors in mid-January increased investors' fears that the company's credit rating would be lowered, and resulted in a considerable widening of the interest rate spread between high- and low-risk corporate bonds (Chart 6). The rating agency Standard & Poor's then dropped the credit ratings of both General Motors and Ford below investment grade level in early May. The rating downgrades had a considerable market impact because auto manufacturers are one of the major issuers of corporate bonds and because the investment restrictions of some institutional investors prevent them from investing in bonds with lower ratings than investment grade.

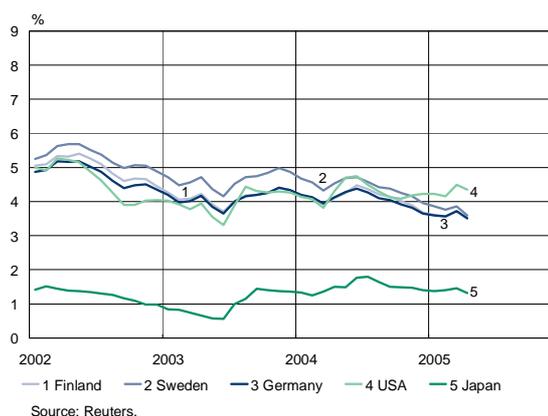
Chart 6. Interest rate differentials between AAA and BBB rated bonds



Increased uncertainty in the corporate bond market has dampened investors' interest in high-risk debt and other financial instruments. As a result, yields on bonds issued by developing countries have risen recently. The problems of auto manufacturers have also raised the prices of financial instruments that are used to hedge credit risk. Moreover, there are also concerns that some hedge funds may have suffered major losses due to price changes in auto manufacturers' shares and bonds. The extent of hedge funds' possible problems will be revealed only later.

Less risk taking by investors and the shifting of investments to lower-risk investment instruments may also be partly reflected in the yields on long-term government bonds of industrial countries, which have started to fall again after a short-term rise in the spring (Chart 7).

Chart 7. Yields on 10-year government bonds



3.3 Euro area mutual funds continued to grow in 2004

Pertti Pykkönen

Net assets of euro area mutual funds (UCITS) grew by 11% in 2004. Growth was fastest in Finland (37%). In the Netherlands, Italy and Germany, fund assets decreased slightly.

Finnish mutual funds

The Finnish mutual funds market expanded strongly in 2004 and growth continued at a brisk pace in 2005. At the end of April, the assets of Finnish mutual funds totalled about EUR 37 billion. Fund assets grew by

40% compared to the year-earlier period. Of fund assets, over 10% are in funds of funds¹⁶.

In Finland, new mutual fund investments have long focused on money market funds, which accounted for about a third of new investments. Equity funds have also attracted a considerable amount of new investment.

Of Finnish funds' total assets, more than a fourth is held by households.¹⁷ Another important investor group is the insurance corporations, particularly life-insurance corporations. In voluntary life and pension insurance saving, the share of unit-linked products continues to grow, and the focus of investments is on mutual funds.

Nordic funds market¹⁸

The growth of mutual funds was robust in all the Nordic countries in 2004. The increase in fund assets was most pronounced in Iceland and Finland, where fund assets increased by almost 40%. In addition to value increases in investments, new fund investments were central to the growth of fund assets in both countries. In Norway and Denmark, fund assets grew by more than a fifth in 2004. The slowest growth was registered in Sweden, where mutual funds grew by just over 10%. In the past five years, the Swedish fund market has been experiencing some difficulties. In fact, the value of fund assets was lower at the end of 2004 than in 2000.

The structure of the Swedish mutual funds market differs from that of the other Nordic countries in that the share of equity funds in total funds is considerable. For example, in late 2004 equity funds accounted for

¹⁶ Mutual Fund Report, May 2005. Finnish Association of Mutual Funds and Investment Research Finland.

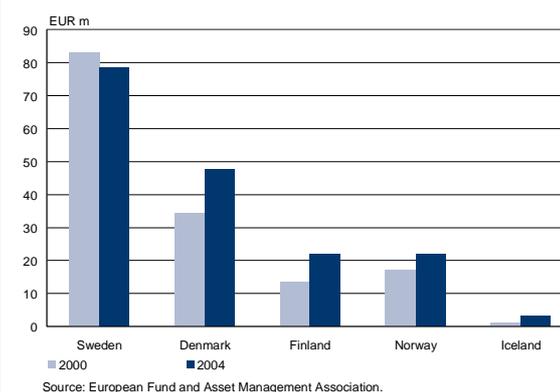
¹⁷ Finnish Financial Supervision Authority.

¹⁸ European Fund and Asset Management Association.

two-thirds of total fund assets. The persistent fall in share prices in the first years of this decade reduced the market value of equity funds, while at the same time investors withdrew money from equity funds. Investors' interest in equity funds has been slowly recovering. The Swedish mutual funds market differs from that of the other Nordic countries also in that the amount of investments in hedge funds is considerably higher than in the other Nordic countries. In recent years, another feature of the Swedish funds market has been the considerably higher growth of investments in foreign mutual funds compared to domestic funds.

In Norway, equity funds are quite popular: they account for about half of total fund assets. In recent years, the growth of fund assets has been slow also in Norway. In Finland and Denmark, equity funds account for about a third of total fund assets. In both countries, bond funds are more important than equity funds. In Denmark, bond fund investments are focused on long-term funds, whereas in Finland, they are focused primarily on money market funds.

Chart 8. Mutual fund (UCITS) assets in the Nordic countries



Euro area funds market

Net assets of euro area mutual funds (UCITS) grew by more than 10% in 2004. The development of fund

markets varied considerably across countries. The fastest growth was registered in Finland. The growth rate of Irish and Luxembourgian mutual funds was also high: fund assets grew by about a fifth in 2004. In Italy, the Netherlands and Germany, fund assets decreased slightly in 2004 compared to 2003.

Euro area mutual fund markets focus on money market papers and bonds. Equity funds accounted for 30% of total fund assets at the end of 2004. Belgium is the only country in which equity funds accounted for more than half of total fund assets: in 2004, equity funds' share of total fund assets was about 60%. In Germany, equity funds accounted for 45% and in Finland for little less than 40% of total fund assets. In Portugal, mutual fund investments focused almost entirely on various kinds of money market and bond funds. At the end of 2004, equity funds accounted for some 10% of total fund investments in Portugal.

The market structure of money market and bond funds also varies across countries. The focus of these investments is on long-term funds, with the exception of Greece, France and Finland, where money market funds have a bigger market share than long-term funds.

Euro area mutual fund markets are very fragmented compared to those of the United States. Currently, about 25,000 different types of funds operate in the euro area, with fund assets totalling EUR 3.5 billion at the end of 2004. In the United States, mutual fund assets totalled about EUR 6 billion and the number of funds was over 8,000 at the same time. The amount of assets in a US fund is on average fivefold compared to euro area funds¹⁹.

¹⁹ European Fund and Asset Management Association and 2005 Investment Company Fact Book, 45th Edition. Investment Company Institute.

3.4 Central banks' survey of foreign exchange and derivatives market activity in 2004

Jarmo Kariluoto

Turnover in the global foreign exchange and derivatives markets increased considerably in 2001–2004. The amounts outstanding of global derivatives contracts also grew substantially with the increase in trading. Finland's share of the global market remained small.

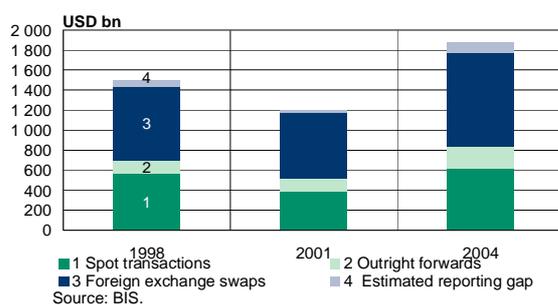
Every three years, the Bank for International Settlement, in cooperation with national central banks, carries out surveys of national foreign exchange and derivatives markets in order to determine the size and structure of global foreign exchange and derivatives markets. In 2004, 52 national central banks participated in the survey. Financial institutions operating in countries that participated in the survey were asked to provide data on their transactions in FX and derivative contracts in April 2004 and on outstanding contracts as at end-June 2004²⁰. Data on derivatives concerned the over-the-counter (OTC) markets. In this connection, the Bank of Finland conducted a study of financial institutions operating in Finland.

²⁰ The full global results of the survey are published and analysed in the report Bank for International Settlements (2005): Triennial Central Bank Survey. Foreign exchange and derivatives market activity in 2004. March 2005, Basel, Switzerland.

Upturn in global foreign exchange trading

In April 2004 the average daily notional turnover in global foreign exchange markets totalled USD 1,880 billion (Chart 9). Daily turnover increased by 57% compared to April 2001, based on current exchange rates. Daily turnover, calculated with fixed exchange rates, grew by 36%. In the previous three-year period (1998–2001), daily turnover had decreased by 19% and 14%, respectively. Of FX instruments, the biggest percentage gain, 60%, was recorded in spot transactions. The daily turnover in other traditional FX instruments, ie futures/forwards and currency swaps, also increased considerably.

Chart 9. Average daily notional turnover on global foreign exchange markets, April 1998, 2001 and 2004



Developments in the foreign exchange markets are founded in several complementary factors, which explain the strong growth of the markets²¹. Two of these factors relate to investment strategies. Firstly, the situation in the foreign exchange markets between 2001 and 2004, in which certain currencies (eg Australian dollar) followed an appreciating trend mainly against the US dollar, led investors to acquire large amounts of the appreciating currencies. Higher market volatility also increased the need to hedge

²¹ See Galati, G and Melvin, M: Why has global FX turnover surged? Explaining the 2004 triennial survey, BIS Quarterly Review, December 2004.

against foreign exchange rate movements, which increased the number of foreign exchange transactions. Secondly, persistent interest rate differentials and strengthening trends of some high-interest rate-currencies vs low-interest-rate currencies caused investors to invest in the former and build up debts in the latter. These operations necessarily assume that any changes in exchange rate trends would not neutralise the impact of interest rate differentials over the investment horizon. Moreover, it seems that particularly pension funds and insurance corporations have become increasingly interested in foreign exchange as an alternative to equity and fixed income investments.

There were no significant changes in the currency distribution of foreign exchange trades in 2001–2004. The US dollar maintained its position as clearly the most important currency: it was one of the currencies in 89% of all transactions. For the euro, the corresponding figure was 37%. The most frequently transacted currency pair was the euro–US dollar, with a 28% share of total trades.

The geographic distribution of foreign exchange trades also remained broadly unchanged. The United Kingdom is still the most important centre for international foreign exchange trading, accounting for 31% of total currency turnover. The United States accounted for 19% and Japan for 8%.

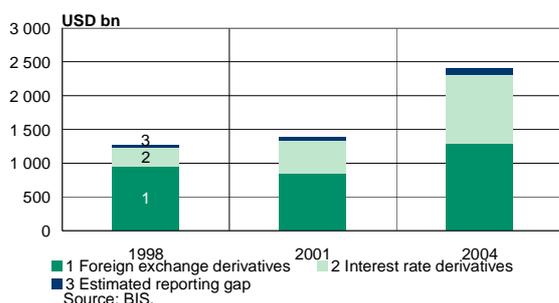
In April 2004, average daily turnover on the Finnish foreign exchange market was USD 1.8 billion, up some 12% on 2001, ie clearly less than globally. Transactions made in Finland thus accounted for only a minor share of global market turnover, ie some 0.1%. The size and relative proportion of the Finnish market had declined already in the 2001 survey, as a result of the introduction of the euro. Foreign exchange swaps accounted for most of turnover in April 2004, with

average daily turnover of USD 0.9 billion. Spot transactions amounted to USD 0.7 billion. The most traded currency in the Finnish foreign exchange market was the euro: it was involved in 85% of all transactions. The share of the US dollar–the euro currency pair in the Finnish market turnover was considerably higher (43%) than globally. The euro area (incl. Finland) accounted for 51% of total market turnover.

Accelerating growth in OTC derivatives markets

In April 2004, the average daily turnover on global OTC derivatives markets increased to USD 2,410 billion (Chart 10). Turnover grew by 74% on 2001, and by 51%, calculated on fixed exchange rates. As for market segments, turnover of interest rate derivatives grew as much as 110%, calculated on fair value, and the turnover of exchange rate derivatives by 51%²². The turnover of interest rate derivatives increased to USD 1,025 billion, ie close to the turnover of exchange rate derivatives (USD 1,292 billion).

Chart 10. Global OTC derivatives market turnover in April 1998, 2001 and 2004, daily average



²² In this article, the figures for exchange rate derivatives include futures/forwards and currency swaps. Therefore the data on OTC derivatives instruments and traditional derivatives instruments partly overlap.

Growth in foreign exchange derivatives turnover was largely due to the same factors that contributed to growth in the traditional foreign exchange markets. Interest rate derivatives growth was the result of changes in hedging and trading practices mainly in the US market, which were reflected particularly in an increase in turnover of interest rate swaps. On the other hand, increased volatility of short-term interest rates since the terrorist attack of September 2001 seems to have bolstered the demand for interest rate products in general.

In the exchange rate segment, the most traded instruments were outright forwards and foreign exchange swaps; their total turnover increased to USD 1,152 billion. Options turnover was USD 117 billion. The currency distribution of foreign exchange derivatives was quite similar to that of traditional foreign exchange trades: the US dollar was the most traded currency, being involved in almost 90% of total transactions.

In interest rate segment, the most traded instruments were interest rate swaps, with turnover of USD 621 billion. Daily turnovers for forward rate agreements and interest rate options were nearly the same (USD 233 billion and USD 177 billion). The market share of interest rates derivatives denominated in euro was 45%, with daily turnover of euro-denominated contracts totalling USD 461 billion. The daily turnover of US dollar-denominated contracts was USD 347 billion.

The United Kingdom has strengthened its position as the main centre for OTC derivatives trading: London's share of overall trading was 38% (34% in 2001). The second largest marketplace was New York (19%) and the third largest Paris (7%).

In April 2004, the average daily turnover on the Finnish OTC derivatives markets amounted to almost

1.4 billion, down by almost 19% from April 2001. The relative size of the Finnish OTC derivatives market was smaller than that of the traditional currency market: it accounted for less than 0.05% of global turnover. The substantial decrease in derivatives turnover was almost entirely due to a significant (48%) drop in turnover of interest rate derivatives – mainly interest rate swaps and OTC interest rate options.

In interpreting the results for the Finnish market it is interesting to note that, according to the BIS survey, the OTC derivatives markets of the other Nordic countries experienced robust growth in the same period. In Denmark, daily turnover grew by 76%, in Sweden by 45%, and in Norway by 29%. It seems that the decrease in turnover on the Finnish market is mainly due to country-specific arrangements concerning derivatives trading units, which were effected by multinational financial groups operating in the Nordic countries during the period between the surveys. It is therefore likely that some of the OTC derivatives trades carried out by Finnish financial institutions and non-financial corporations that are not included in the survey were reported in the surveys of the other Nordic countries. This is of no importance for the global results of the survey, but it does affect the results for individual countries or markets.

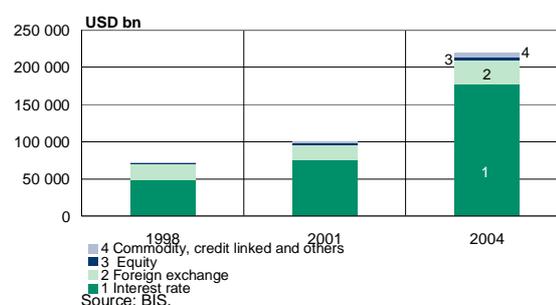
The daily turnover on Finnish OTC foreign exchange derivatives totalled USD 1.1 billion, the majority of which (almost 80%) was in currency swaps. The turnover of OTC interest rate derivatives amounted to USD 0.3 billion. The most important instruments were interest rate swaps, which accounted for 78% of the total daily turnover. In Finland, euro-denominated contracts amounted to 84% of the daily turnover of interest rate derivatives. Contracts with counterparties operating in the euro area (incl. Finland)

accounted for 54% of the daily turnover of interest rate derivatives.

Continued growth in notional amounts of outstanding OTC derivatives contracts

In the survey, data were collected²³ on the amounts outstanding and on the gross market value of derivatives contracts on 30 June 2004. The survey shows that the global total of notional amounts of outstanding OTC contracts was USD 220.1 trillion²⁴ (Chart 11). The notional amounts outstanding grew by 120% on 2001. The gross market value of contracts, ie the replacement value of contracts at market prices and exchange rates prevailing at the time of reporting, totalled USD 6.4 trillion. The ratio of gross market values to notional amounts outstanding was little less than 3%.

Chart 11. Global notional amounts outstanding of OTC derivatives contracts in late June 1998, 2001 and 2004



²³ Data on the amounts outstanding of derivatives contracts were reported on a consolidated basis – contrary to turnover data. Thus eg Finnish banking groups with foreign branch offices and subsidiaries reported their data to the Bank of Finland, whereas the branch offices and subsidiaries of foreign banks operating in Finland did not report to the Bank of Finland but rather to the national central bank of their parent company's home country. Due to the method of data compilation it is not meaningful to present and compare country-specific data.

²⁴ Trillion = 1,000 billion.

According to BIS estimates, for example, the global amounts outstanding of bonds and other interest-bearing securities (bonds and money market paper) totalled USD 53.5 trillion. Hence, the value of global notional amounts was fourfold compared to these securities. The value of notional amounts was more than tenfold the total claims of the global banking system (ca USD 19.9 trillion). The size of gross market values was, however, relatively small (12% of securities and 32% of claims).

Robust growth in amounts outstanding of OTC derivatives was naturally due to the considerable pick-up in derivatives turnover. Notional amounts were the largest in the interest rate segment, and these grew by 134% to USD 177.5 trillion. Notional amounts in the interest rate segment totalled USD 31.5 trillion, and the notional amounts outstanding of equity linked contracts totalled USD 5.1 trillion. However, in relative terms, the rate of growth of notional amounts outstanding was highest for credit-linked contracts, with the amounts outstanding growing sixfold to USD 4.7 trillion. The explosive growth of credit-related products reflects mainly the low level of amounts outstanding in 2001, which was due to the relatively rare use of credit-related products.

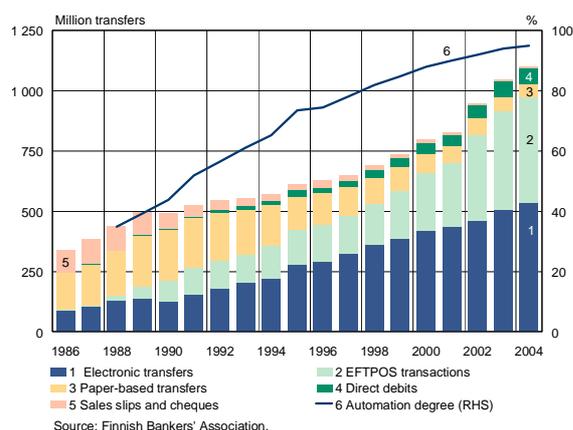
4 Infrastructure

4.1 Finns utilise modern payment technology

Timo Iivarinen

The popularity of online banking and card payments continues to grow in Finland. Domestic debit cards are the most popular of payment cards. In the next few years, a shift to the use of international debit cards directly linked to the payer's account may bring changes to the use of payment cards.

Chart 12. Banks' payment transfers and automation degree



A number of indicators show that Finns are prone to use the latest payment technology. This is clearly evident from statistical data published by the Finnish

Bankers' Association in spring 2005.²⁵ The situation is highly welcome since the use of modern technology promotes the efficiency of the entire payment system.

A study of the payment behaviour of banks' customers shows that in 2004, 95% of payments were transferred by using information technology. This 'automation degree' of payments has risen by 22 percentage points since 1995. The vast majority of payments are transferred to banks by electronic transfer. Electronic credit transfer is the most common method of payment used by companies. Companies' credit transfers are transmitted by using banking software. A technical standard agreed jointly by domestic banks is used in these credit transfers. Private customers typically use online banking services in credit transfers.

The number of 'multi-service agreements', which include eg all agreements on the use of online banking services, has increased considerably. In 2004, the number of multi-service agreements totalled 3,239,000. The number of transactions covered by multi-service agreements has also grown significantly: in 2004, their number totalled over 205 million. Compared to another growing method of payment – debit card payment – this corresponds to approximately half of the amount of EFTPOS transactions. The number of customers' paper-based

²⁵ See

http://www.pankkiyhdistys.fi/sisalto_eng/upload/pdf/statistics.pdf

transfers, as well as that of sales slips and cheques, is decreasing constantly.

The number of EFTPOS transactions, ie transactions in which the customer pays for his or her purchases by using a card, is increasing. Payments involving a sales slip are decreasing, which is due to the growing number of EFTPOS terminals. In the past two or three years, the number of EFTPOS terminals has increased by 43%. In 2000, the number of EFTPOS terminals totalled 67,000, and in 2004, the number had reached 96,000. The average value of debit card payments has decreased slightly in this decade, whereas the total value of payments has increased continuously. The annual increase in the total value of payments has been EUR 1 to 2 billion. In terms of the number of transactions, the easily most popular payment card in Finland is the domestic debit card. The value of debit card payments per card is also unparalleled. Domestic debit cards are being replaced by international payment cards which are based on a safer chip technology and are directly linked to the payer's account. It will be interesting to see what kind of changes the demise of national debit cards will bring.

In the POPS system for large-value payments maintained by Finnish banks, the number of

transferred payments has decreased slightly in 2000–2005 (from 3,000 to about 2,000 transactions per day, monthly average). A yearly peak in payments is caused by cheques given as presents to graduates. The ratio of gross to net settlements has also remained unchanged. The value of payments has increased slightly. In terms of value of payments transferred (in 2000–2005), the peak – about EUR 2.15 billion – was recorded in March 2005.

In the EURO 1 system maintained by European banks, the number of transactions has been constantly increasing. The value of payments has remained more or less unchanged. In 2004, the monthly average value of payments per day was about EUR 170.3 billion and the daily average number of payments was just over 151,000.

In May 2005, Bank for International Settlements (BIS) issued a publication on the new development in large-value payment systems (<http://www.bis.org/publ/cpss67.htm>). The Bank of Finland published a Discussion Paper on the same subject in September 2004, titled Large value payment systems – principles and recent and future developments (http://www.bof.fi/eng/6_julkaisut/6.1_SPn_julkaisut/index.stm).

4.2 EU decision on regulation of securities processing likely in early 2006 – some basic issues may remain open for years

Jenni Koskinen

The preparation of Community legislation on securities clearing and settlement systems has attracted wide interest. A decision on the need for and contents of legislation should be made a year from now. The principles of the Lamfalussy process and the action plan on better regulation form the framework for the legislative work.

The functioning of the internal market for securities clearing and settlement is in need of major improvements. The European Commission is currently studying the options for rectifying the deficiencies. The European Commission took the first steps for improving securities clearing and settlement already at the turn of the century. However, the Commission's main policy line was spelled out just a year ago in the Commission's consultation document.²⁶ The legislative initiative has a key role in the EU because it is linked to the Lisbon strategy²⁷ and the Financial Services Action Plan (FSAP)²⁸. The decisions to be

²⁶ Clearing and Settlement in the European Union – The way forward. See: http://europa.eu.int/comm/internal_market/financial-markets/clearing/index_en.htm#com

²⁷ http://europa.eu.int/growthandjobs/key/index_en.htm

²⁸ http://europa.eu.int/comm/internal_market/finances/actionplan/index_en.htm

taken will impact the operating environment of service providers because the objective of the initiative is to remove inconsistencies due to differences in national legislation and inefficiencies due to a lack of integration. This would provide end users a higher level of service and a greater number of options.

Before the Commission can propose new Community legislation, rationale must be provided on the necessity and contents of the legislation. Preparations for the clearing and settlement initiative are progressing, based on the division of tasks between EU institutions, and in cooperation with external experts. It appears that the European Parliament will opt for a wait-and-see attitude, instead of interfering with the Commission's right of initiative, before the Commission has finalised its impact assessment.²⁹

In the impact assessment, the Commission will analyse eg competition issues and assess regulatory and supervisory structures, corporate governance, and costs to system users caused by current inefficiencies.³⁰ According to the Commission, the annual costs on the European level total at least EUR 3 billion.³¹ In the long term, the costs will, however, be manifold because customers' behaviour is expected to change if transaction costs decrease.³² The growing interest for securities markets would be reflected in the growth of market size and transaction volume (and

²⁹ The matter has been discussed in the Committee on Economic and Monetary Affairs of the Parliament. See

http://www.europarl.eu.int/committees/econ_home.htm

³⁰ http://www.europa.eu.int/comm/internal_market/financial-markets/docs/cesame/ec-docs/20041025-structure-impact-assessment_en.pdf

³¹ http://europa.eu.int/comm/internal_market/financial-markets/docs/cesame/ec-docs/20050307-structure-impact-annex1_en.pdf

³² See eg London Economics (2002) Quantification of the Macroeconomic Impact of Integration of EU Financial Markets.

thus liquidity), and hence in the growth of clearing and settlement volumes.

The Commission will continue to study, in cooperation with expert groups, the special aspects of EU areas of jurisdiction, irrespective of the results of the impact assessment and the decisions based on it. This will provide an understanding of the reasons behind the barriers to integration. The Commission is also seeking ways to improve the efficiency and risk conditions of clearing and settlement systems on the EU level. The key issues are legal certainty and fiscal compliance relating to securities ownership (Table 3).

Table 3. Expert groups set up by the Commission to support the clearing and settlement initiative

CESAME Group³³

- Mandate: to monitor and assess the measures on bringing down the barriers to market integration and to report on them and eg to assist the Commission on assessing the benefits and costs of removing the barriers.
- Meetings: 16 July 2004, 25 October 2004 and 7 March 2005.

Legal Certainty Group³⁴

- Mandate: to analyse issues of legal uncertainty relating to the integration of EU securities clearing and settlement systems
- Meetings: 31 January 2005 and 24 April 2005.

FISCO (fiscal compliance) Group³⁵

- Mandate: to advise on the removal of fiscal compliance barriers to the clearing and settlement of cross-border securities transactions.
- Meeting: 15 April 2005.

³³ See http://www.europa.eu.int/comm/internal_market/financial-markets/clearing/cesame_en.htm

³⁴ See http://www.europa.eu.int/comm/internal_market/financial-markets/clearing/certainty_en.htm

The liberalisation and integration of the sector, and the resulting benefits to consumers can be achieved only with the cooperation of market operators and authorities. The removal of barriers to the creation of an internal market for securities clearing and settlement is moving ahead gradually. The issue has been promoted by eg SWIFT³⁶, a key service provider and developer of clearing and settlement communication technology and by the European Central Securities Depositories Association (ECSDA)³⁷.

³⁵ See http://www.europa.eu.int/comm/internal_market/financial-markets/clearing/compliance_en.htm

³⁶ See http://www.swift.com/index.cfm?item_id=43507

³⁷ See http://www.ecsda.com/portal/news_and_events/?id=14

4.3 Several reasons behind the consolidation of marketplaces – examples from European and American markets

Jenni Koskinen

European marketplaces are integrating and forming large and important markets as well as small regional markets. It is still difficult to envision the way the market will be structured.

The consolidation of marketplaces continues, and many of the benefits have already been realised. It is still difficult to foresee the dominant market structure in Europe even though some trends are already evident. Currently, regionally consolidated marketplaces are operating alongside large European marketplaces. It is also too early to assess what impact market consolidation will have on competition. It is nevertheless clear that consolidation can hinder competition and thus reduce the benefits to the users of marketplaces. For this reason, authorities are monitoring the impact of consolidation on competition.

Consolidation can bring many benefits, the most important of which are usually the economies of scale, which typically increase as the size of the operator increases and the operations expand. The marketplace user will benefit from the standardisation of the trading format, as a result of a common trading system, common rules and a single list. Harmonisation measures will enable the concentration of bids and offers, which will reduce simultaneous trading in the

same shares on several regional markets and the market fragmentation that characterises such trading.

Many projects involving marketplace consolidation are currently underway. Euronext, together with Borsa Italiana, as well as eSpeed, an operator of an electronic marketplace for US government benchmark bonds, have made competing bids for the MTS marketplace.³⁸ In Europe, the concentration of trading in government benchmark bonds in the MTS marketplaces has increased the volume and liquidity of trading. This is the result of the single trading platform and the primary dealer system of the MTS. Moreover, Euronext continues its efforts to acquire the London Stock Exchange (LSE).³⁹

OMX, which owns the Helsinki, Stockholm, Copenhagen and Baltic exchanges reported that the integration of OM and HEX has been completed, resulting in an annual cost reduction of SEK 150 million.⁴⁰ Synergy benefits with the Copenhagen Exchange are yet to be realised. The main objective of integration is to prevent marginalisation and to increase the attractiveness of the marketplaces. This would increase the trading volume and hence liquidity in the Nordic area. The comparability of companies quoted on various exchanges will be improved as a result of the harmonisation of industry classification: in July the Global Industry Classification (GICS), which is already applied on the other exchanges of the NOREX Alliance, will be introduced on the Helsinki, Baltic and Icelandic exchanges. The real benefits of consolidation will be available to customers only when the list structure and the quotation requirements are harmonised and multicurrency trading starts.

³⁸ eFinancial News, 27 May 2005.

³⁹ Reuters, 26 May 2005.

⁴⁰ OMX Interim Report for January – March 2005.

The European consolidation process is often compared to that of the United States. In the United States, the number of regional exchanges operating alongside the New York Stock Exchange (NYSE) decreased from more than a hundred to seven between the stock market crash of 1929 and the 1980s. Trading on local exchanges focused on the shares of local companies, much as in Europe today.⁴¹

The merger of NYSE and Archipelago⁴², an electronic marketplace, shows that exchanges on both sides of the Atlantic are eager to enter into new markets and to compete globally.⁴³ The merger will enable NYSE to revamp its governance model, and as a result to be more flexible and to expand its product range. This merger is important for Archipelago because its competitive position was considerably weakened recently when Nasdaq acquired Instinet (INet). Nasdaq and INet together account for about 60 to 65% of the OTC market, whereas Archipelago has about 22% of the market. Authorities in the United States are also monitoring the impact of consolidation.⁴⁴

⁴¹ Arnold, Tom, Philip Hersch, J. Harold Mulherin, ja Jeffrey Netter. 1999. 'Merging Markets.' *Journal of Finance* 54, no. 3 (June): 1083-1107 ja James McAndrews ja Chris Stefanadis 2002. 'The Consolidation of European Stock Exchanges.' *Current Issues in Economics and Finance*, Volume 8, Number 6 (June).

⁴² FESE, Focus n° 147.

⁴³ Arrangements on the derivatives markets are discussed in the *Financial Market Report 1/2005*, Section 4.3: 'Uphill and downhill for securities market infrastructure'.

⁴⁴ See eg Associated Press. 'NYSE, Nasdaq Prepare to Go Head-To-Head.', 21 April 2005 and TABB Group Perspective. 'NYSE/Arca: Is Inter-Market Competition Dead.', 21 April 2005.

5 Key corporate arrangements and events in the financial sector

	<i>Event and description</i>
<i>Date</i>	
Sep 2004	<p><i>eQ Bank Ltd starts operating as an account operator.</i></p> <p><i>Nordea sells Helsingin Pantti Oy, a Finnish pawnbroker.</i></p> <p><i>The trading platform SAXESS, already in use at the Stockholm Stock Exchange, is launched at Helsinki, Tallinn and Riga stock exchanges.</i></p> <p><i>Pohjola insurance company announces its plan to sell the business operations of its subsidiary, Conventum Securities Limited, to eQ Bank Limited, a subsidiary of eQ Online Corporation for EUR 2 million.</i></p> <p><i>S&P revises its outlook on Sampo Bank plc's rating from negative to stable.</i></p> <p><i>Sampo Credit plc merges with Sampo plc and Sampo Finance with Sampo Bank plc.</i></p>
Oct 2004	<p><i>Danish life and pension companies Codan Liv & Pension sold to SEB Tryg Liv Holding AB.</i></p> <p><i>SEB's Lithuanian subsidiary, Vilniaus Bankas, acquires more than 90% of the share capital of the Ukrainian bank, Bank Agio.</i></p> <p><i>Sampo plc acquires Varma Mutual Pension Insurance Company's shareholding in the Property and Casualty Insurance Company If (10.1% of the share capital). After the transaction, Sampo plc holds If's entire share capital.</i></p> <p><i>The Finnish state sells 14.6% of Sponda Plc's share capital. The state's stake in Sponda remains at 34.5%.</i></p>
Nov 2004	<p><i>OMX and Copenhagen Stock Exchange sign Letter of Intent on the combination of OMX and CSE.</i></p> <p><i>Islansbanki hf makes an offer to purchase all outstanding shares in the Norwegian bank BNbank.</i></p> <p><i>Sampo Bank plc acquires Maras Banka of Latvia.</i></p>

	<i>Event and description</i>
<i>Date</i>	
	<p><i>Citigroup Global Markets Ltd starts as a remote member at the Helsinki Stock Exchange.</i></p> <p><i>OMX and VPC announce that the Finnish Central Securities Depository and VPC have fulfilled the terms and conditions of their merger. Following the merger, the business area Settlement & Depository will be separated from OMX.</i></p> <p><i>Swedish investment bank Öhman Fondkommission announces that it will commence share trading and investment banking operations in Helsinki at the beginning of January.</i></p>
Dec 2004	<p><i>Danske Bank announced that it will acquire from National Australia Bank the National Irish Bank operating in Ireland and the Northern Bank operating in Northern Ireland at a price of EUR 1.4 billion.</i></p> <p><i>Derivatives trading ended at the Helsinki Stock Exchange and was transferred to Stockholm.</i></p> <p><i>Kaupthing Sofi Oyj was granted a banking licence. The new name of the bank is Kaupthing Bank Oyj, and it started operating at the beginning of 2005.</i></p> <p><i>Aktia Savings Bank and Veritas Life Insurance Company signed an agreement according to which Aktia Life Assurance will become a subsidiary of Veritas Life Insurance Company at the turn of the year. At the same time, the operations of the company Hiisi are transferred to Aktia Asset Management Ltd and Veritas' mutual fund management to Aktia Fund Management Company Ltd.</i></p>
Jan 2005	<p><i>Pohjola Life Insurance Company Ltd started operations. Suomi Mutual Life Assurance Company transferred a EUR 1.2 billion life insurance portfolio to Pohjola Life Insurance Company Ltd. Suomi Mutual stopped selling new life insurance policies.</i></p> <p><i>Aon Finland Oy, one of the largest insurance brokers in Finland, sold its life and investment insurance brokerage operations to Bon Life Oy.</i></p> <p><i>Standard Chartered Bank acquired Korea First Bank for USD 3.3 billion.</i></p> <p><i>Citigroup announced that it will sell its insurance company, Travellers Life & Annuity, to MetLife for USD 11.5 billion.</i></p>
Feb 2005	<p><i>The government sold 7.1% of its A shares of Sampo plc at EUR 10.75 per share. The State now holds 14% of Sampo's shares and 13.9% of its voting rights.</i></p> <p><i>Mitsubishi Tokyo Financial Group, Japan's second largest financial group, announced that it will acquire UFJ Holdingin, the country's fourth largest financial group.</i></p>
Mar 2005	<p><i>Amendments to the restrictions on the acquisition of own shares included in the Companies Act took effect. Consequently a public limited company can acquire an amount of own shares that does not exceed 10% of its share capital or total voting rights attached to its shares.</i></p> <p><i>The Spanish bank Banco Bilbao Vizcaya Argentaria made a EUR 7.6 billion bid for the Italian bank Banca Nazionale del Lavoro.</i></p>

<i>Date</i>	<i>Event and description</i>
	<p><i>ABN AMRO announced that it will acquire Bank Corluy, a Belgian private bank.</i></p> <p><i>Alfred Berg announced it will become a European Company within 2005.</i></p> <p><i>ABN Amro Holdings NV made a EUR 6.3 billion offer for majority holding of Banca Antonvenetta SpA, an Italian bank.</i></p> <p><i>Société Générale announced it had acquired Promek Bank, a Russian bank.</i></p>
Apr 2005	<p><i>Swedbank announced that it owns 98% of Hansapank's share capital osakekannasta. Hansapank will be withdrawn from the main list of the Tallinn exchange.</i></p> <p><i>Fortis AG and FB Insurance will merge. The new company, Fortis Insurance Belgium, will become the largest insurance company in Belgium.</i></p> <p><i>Sampo Life Insurance Company Ltd was granted an operating licence for establishing a subsidiary in Sweden. The name of the company will be If Livförsäkring Ab.</i></p> <p><i>New York Stock Exchange and Archipelago merged.</i></p> <p><i>Nasdaq acquired Instinet.</i></p> <p><i>Société Générale acquired Eurobank, a Polish consumer credit company.</i></p> <p><i>Kaupthing announced it will acquire British bank Singer & Friedlander Group plc for about GBP 550 million.</i></p>
May 2005	<p><i>Skandia Life announced that it will stop selling new insurance policies in Finland.</i></p> <p><i>E*Trade and Ameritrade to merge.</i></p> <p><i>SAXESS trading system was introduced at the Vilna Stock Exchange. The common trading system is now being used at all the exchanges in the OMX Group.</i></p>