



# Financial Market Report

## 4 • 2008

- Companies face problems as financing becomes hard to get and expensive
- Domestic banks post fairly good results in the third quarter
- Regulatory measures for crisis prevention are in the works



Bank of Finland

Financial Markets and Statistics

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# 1 Financial intermediation

## 1.1 Companies face financing problems

**Karlo Kauko**

**The amount of corporate loans on banks' balance sheets continued to grow rapidly in autumn 2008. Use of other sources of finance has become more difficult, and companies are anticipating liquidity problems.**

For most of the current decade, bank lending to companies has increased slowly. The situation changed in the second part of 2007 when the stock of corporate loans started to grow more rapidly. At the end of October 2008, Finnish MFI loans to euro area non-financial corporations (excl. financial and insurance corporations) totalled ca EUR 57 billion, up by ca 20% on the previous year. Growth was most pronounced in the stock of shortest-term loans. Bank lending to companies cannot continue to grow this rapidly for much longer unless banks acquire additional capital. Capital adequacy regulations limit banks' possibilities of increasing risks on their balance sheet. Corporate loans typically burden the capital adequacy ratio more than household loans. The stock of corporate loans granted by employee pension insurers has also increased in the past year, by ca EUR 1 billion.

The rapid growth of corporate loan stock may be due to eg the increasing difficulties in obtaining other financing. Corporate bond issues with long maturities

have declined materially since 2007. At the end of October 2008, bond issuance amounted to EUR 212 million, which is only about one-third of the issuance in the corresponding period of 2007. The stock of corporate bonds has however remained fairly stable.

The stock of short-term corporate bonds declined by EUR 1.7 billion between October 2007 and October 2008. The declining use of commercial paper is due to the weakening demand for these instruments. In 2008, over EUR 7.5 billion in investments has been withdrawn from fixed-income funds in Finland alone. These funds usually invest in debt instruments issued by companies, eg commercial paper. These markets are fairly global and so the shrinking of fixed-income funds in other countries too reduces the demand for debt instruments issued by Finnish companies.

The largest companies usually take out syndicated loans granted jointly by a group of banks. Available data show that the amount of syndicated loan programmes granted to Finnish companies between January and September 2008 decreased by 27% on the year-earlier period.<sup>1</sup> Obtaining a syndicated loan has become more difficult. However, the statistics do not show how many of these programmes have been used or how many contracts for old loan programmes have expired.

Companies have not needed unusual amounts of loans to finance investments. Statistics for October however suggest that companies have increased their deposits by over EUR 5 billion in the past year, probably in anticipation of liquidity problems due to increased uncertainty. Corporate investments in money

<sup>1</sup> BIS Quarterly Review, December 2008, Statistica annex A82.

market funds have declined sharply, by ca EUR 1.6 billion, since September 2007, so that looking only at bank deposits may give a distorted picture of developments in companies' financial assets.

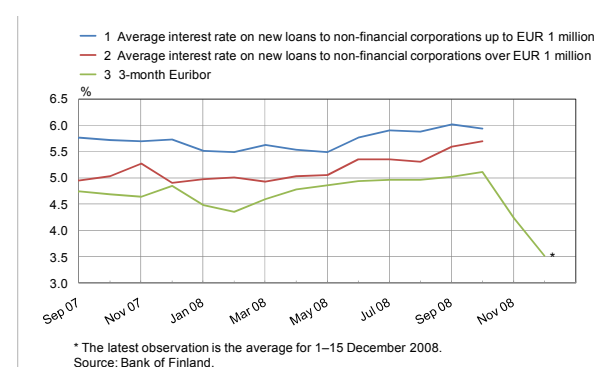
### Price of financing has risen

The price of financing obtained from the securities market has increased. Investors are more cautious about companies' credit risks, which is reflected in the prices of credit derivatives. The interest rates paid by companies issuing bonds rose sharply in autumn 2008, by as much as several percentage points.

Banks and securities markets are not isolated from each other, and hence the interest rates on bank loans have also risen. The interest rates on bank loans have thus far risen only moderately. Between the end of December 2007 and the end of October 2008, the average interest rate on the stock of Finnish MFI loans to euro area non-financial corporations increased by nearly 0.5 percentage point, and interest rates on new loans increased almost as much. The average interest rate on new loans of over EUR 1 million increased by more than that on smaller loans (Chart 1).

Comparisons between periods of time may however be problematic because the composition of the group of companies that have withdrawn loans may have changed in many ways, which also affects the average interest rates. According to newspaper reports, the margin on loans granted for acquisitions have risen by 50–100 basis points in just over a year (Kauppalehti, 8 December 2008, p. 6). In addition, most reference rates were higher in October 2008 than in December 2007. Since October, money market rates have fallen precipitously. Statistics on interest rates on new loans are not yet available for November and December.

Chart 1. Interest rates on loans to non-financial corporations and money market interest rate



According to the latest Business financing survey<sup>2</sup> the availability of financing deteriorated already in August 2008. Particularly the smallest companies had financing problems. The terms and conditions of financing, eg collateral requirements, had tightened, which is an indication of receding credit supplies.

Financing problems rather increased than decreased in late autumn. According to some corporate managers, many companies are delaying the payment of invoices even more than usual, to improve their financial position. As a result, sub-contractors may involuntarily become their customers' source of financing. The possibilities for new corporate customers to obtain a bank loan are weak because many banks give priority to the financing needs of their old customers.

Recent news on bankruptcies support the view that companies' financing problems have worsened. For the first time in several years, a company on the main list of the Helsinki stock exchange has gone bankrupt: Stromsdal Corporation's Board of Directors decided on 27 November to file for bankruptcy. The bankruptcy was directly due to the financial crisis; the company however also suffered from weak profitability. The Norwegian owner of Finlayson

<sup>2</sup> Confederation of Finnish Industries, Ministry of Employment and the Economy and the Bank of Finland, 1 December 2008.

Forssa, a manufacturer of workwear fabrics, announced that it will file for bankruptcy because the company was unable to obtain additional operating finance from the financial markets.

In addition to supply factors, also factors related to the demand for loans may slow the growth of the loan stock. According to the latest Bank Barometer<sup>3</sup>, 61% of bank managers estimated that between July 2008 and June 2009 companies' propensity to borrow will decline compared to the year-earlier period.

Expectations for the demand for corporate loans have not been this low since 1999.

Authorities have taken measures to improve companies' financing possibilities, by upgrading Finnvera's ability to provide financing. Finnvera plc is a specialised financing company owned by the State of Finland. It provides companies with loans, guarantees, venture capital, and export credit guarantees. The Cabinet Committee on Economic Policy proposed raising Finnvera's ceilings on outstanding commitments, to expedite the financing of companies<sup>4</sup>. The ceiling on outstanding commitments for export financing would be raised from EUR 7.9 billion to EUR 10 billion, and the ceiling on outstanding commitments for domestic financing would be raised from EUR 2.6 billion to EUR 3.2 billion. The increases in the ceilings require a legislative amendment and approval by the Finnish Parliament.

Mauri Pekkarinen, Minister of Economic Affairs, invited Minister Antti Tanskanen to examine the financial outlook, especially for corporate financing. Minister Tanskanen is to present a proposal on possible further government measures to improve the financing of companies.

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<sup>3</sup> Federation of Finnish Financial Services, 3/2008.

<sup>4</sup> Finnvera plc press release 18 November 2008.

## 2 Banks and insurance corporations

### 2.1 Results plummet in US and European banking sectors

**Mervi Toivanen**

**The third quarter of 2008 did not see a change in the financial performance of the US and European banking sectors. Instead there was a continuation of the trend of the first part of the year. Operating profits weakened mainly as a result of burgeoning loan losses.**

**In the United States**, the total operating profit of commercial and savings banks supervised by the FDIC<sup>5</sup> decreased in January–September 2008 by 64%, to ca EUR 35 billion. The weaker results are largely due to rapid growth of recorded loan losses. In the first three quarters of 2008, the ratio of loan losses to lending stock was 1.18% (0.5% in January–September 2007). Aggregate income also decreased while expenses increased. In the weak market situation, the only bright spot was net interest income, which grew by 4.9% on January–September 2007. Return-on-equity nevertheless fell to 3.35%.

In the third quarter of 2008, problems continued in the US banking sector. Citigroup announced that it will receive ca EUR 27 billion in the form of

<sup>5</sup> Federal Deposit Insurance Corporation is a federal government body that insures deposits in over 8,400 commercial and savings banks in the USA and manages the closures of problem banks. See the FDIC Quarterly Banking Profile, third quarter 2008.

additional capital support. Main Street Bank and Meridian Bank were taken over by supervisory authorities, and Citigroup and Wells Fargo skirmished over the right to purchase Wachovian. In addition, the insurance corporation AIG was granted an additional loan of ca EUR 25 billion by the US Federal Reserve.

The US banking sector's nonperforming assets continue to grow, totalling ca EUR 121 billion at the end of September 2008. At the same time, the proportion of nonperforming loans in the lending stock increased to 2.31% – the highest ratio since the third quarter of 1993. The authorities' list of problem banks currently includes 171 banks (with a combined balance sheet of EUR 77 billion). Measured in US dollars, the combined balance sheet exceeded USD 100 billion for the first time since 1994.

Also in **Europe**, the banking sector's operating profits are decreasing. For example, the combined results of 11 large European financial groups for January–September 2008 halved on the year earlier period. Weaker results are due to lower income and expanding loan losses. The banks' combined income decreased by 24%, and combined expenses increased by 3%. In Europe, the decrease in income was more pronounced than in the United States while the increase in expenses was slightly smaller. The earnings performance however varied considerably between banks.

The financial market crisis deepened in Europe in the third quarter of 2008. Many banks were unable to renew or acquire additional market funding and thus had to be rescued by governments. The first ones to be rescued were the Icelandic banks Glitnir, Landsbanki

and Kaupthing, which were taken over by the Icelandic government. Dexia, the world's largest lender in local public finance, was rumoured to need new capital, and as a result, the Benelux countries had to provide the bank with a government guarantee. The Benelux countries also rescued the insurance and banking group Fortis with EUR 11.2 billion. The UK government rescued Royal Bank of Scotland, HBOS, and Lloyds with ca EUR 43 billion, and the Austrian government supported Erste Bank with EUR 2.7 billion. Commerzbank received EUR 8.2 billion from the German Government's Financial Markets Stabilization Fund, ING received a EUR 10 billion cash injection from the Dutch government, and KBC

got EUR 3.7 billion from the Belgian government. The Swiss government assumed liability for USB's bad loans worth ca EUR 40 billion. The French government gave a EUR 10.5 billion cash injection to BNP Paribas, Societe General and four other French banks. In addition, the Dutch insurance corporation Aegon received EUR 3 billion in capital support from the Dutch government.

The market values of the European financial groups included in the comparison shrank by 50% in January 2008–December 2008. The largest decrease was posted by UniCredit group and ING and the smallest by BNP Paribas.

Table 1. Large European and US financial groups' results, January–September 2008<sup>1</sup>

	Income, total		Expenses, total		Loan losses		Pre-tax results	
	1-9/2008 EUR m	Change, %	1-9/2008 EUR m	Change, %	1-9/2008 EUR m	Change, %	1-9/2008 EUR m	Change, %
Deutsche Bank Group	14 375	-18	13 409	-15	485	71	481	-93
BNP Paribas Group	23 184	-6	14 092	0	3 200	227	5 892	-38
UBS Group	3 916	-72	13 648	-15	426	..	-10 157	..
ING Group	..	..	..	..	..	..	3 591	-56
Grupo Santander (SCH Group)	22 339	14	9 358	3	4 079	69	8 903	10
Credit Suisse Group	8 689	-55	10 686	-10	203	803	-2 200	..
Commerzbank Group	5 593	-17	3 957	0	1 217	191	419	-82
BBVA group	16 775	19	6 504	13	2 115	58	6 041	6
Credit Agricole S.A.	21 738	-14	15 244	2	2 502	81	3 992	-55
Societe Generale Group	17 030	-6	11 559	6	1 672	177	3 813	-14
UniCredit Group	20 825	-9	12 627	3	2 705	27	5 493	-36
JPMorgan Chase & Co.	32 877	-7	21 192	4	8 981	216	2 704	-78
Wells Fargo	21 294	11	11 067	-1	4 952	224	5 275	-19
Bank of America	37 528	6	20 099	13	12 020	260	5 409	-62
Merrill Lynch	4 695	-63	13 471	18	4 147	..	-7 734	-672
Citigroup	31 019	-35	30 129	5	14 471	115	-13 581	-214
FDIC banks*	293 828	-1	180 286	3	81 833	235	34 921	-64

<sup>1</sup> Items do not necessarily add up to totals because not all the income statement items are included in the table.

\* Combined data on banks supervised by US supervisor FDIC.

.. = data not available or change not meaningful.

Sources: Banks' interim reports and the FDIC's report Quarterly Banking Profile, third quarter 2008.

## 2.2 Growing impairment losses in Nordic countries

Mervi Toivanen

**In January–September 2008, the operating profits of large Nordic financial groups decreased on the corresponding period of 2007, as a result of growing impairment losses and less income from trading and investment activities. The market values of Nordic financial groups have deteriorated about as much as the market values of European banks.**

The financial results of large Nordic financial groups deteriorated in January–September 2008 by 21% on average, on the corresponding period of 2007. (Chart 2)<sup>6</sup>. The decrease in operating profits was most pronounced for the Danish banks Danske Bank and Jyske Bank. The smallest decline in results was witnessed for Swedbank; its results were nearly as high as in January–September 2007.

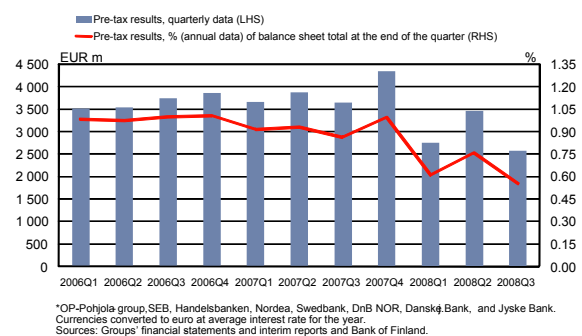
The weakening of results, which commenced in the first half of 2008, continued in the third quarter. Weaker results were due to growing impairment losses and a decrease in income from trading and investment. Combined impairment losses for January–September totalled EUR 1.2 billion, which is 0.11% of the groups' combined lending stock. On the individual bank level, losses amounted to 0.07–0.22% of lending stock. Impairment losses were due to losses in the Baltic countries, the fact that Lehman Brothers filed for Chapter 11, the general weakening of the economy, and particularly to the deteriorating housing market. In

<sup>6</sup> The results do not include Icelandic financial groups since they have been taken over by the Icelandic government and have not published their latest interim report.

their interim reports, banks did not express concern over the growth in loan losses. They nevertheless forecast an increase in loan losses, due to the slowing of economic growth.

The groups' net interest income grew as a result of rising interest rates, while other income, eg net fee income and income from trading and investment, declined sharply. This was accompanied by an increase in expenses.

Chart 2. Large Nordic financial groups<sup>\*†</sup> pre-tax results, quarterly



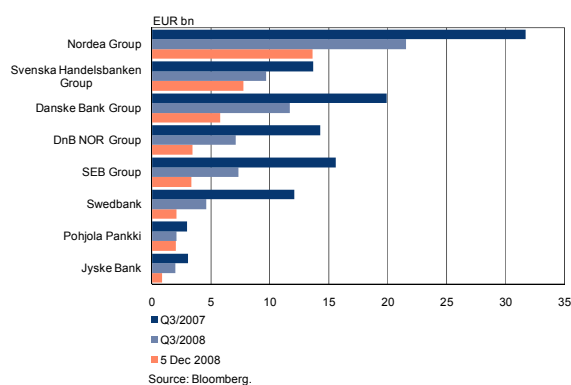
Despite its good results, Swedbank applied for a loan guarantee from the Swedish government because it had experienced difficulties in acquiring new market funding. The markets have doubts about Swedbank's ability to service its loans; there is concern about the possibility of Swedbank incurring credit losses in the Baltic countries. Swedbank has issued three bonds under the State guarantee scheme, for EUR 2 billion, CHF 200 million and SEK 14 billion. Swedbank has also issued new preference shares in order to raise EUR 1.2 billion in new capital. DnB NOR also announced that it will acquire ca EUR 11 billion in additional funding via the liquidity package offered by the Norwegian government. The group is planning to withdraw EUR 3.7 billion first and the rest later.

The crisis on the global money market is currently reflected particularly in the market value of financial



groups (Chart 3). In the past year, the market values of all the large Nordic financial groups decreased. In the period between January 2008 and early December 2008, the largest declines were in the market values of Swedbank and DnB NOR. The smallest change in market value was witnessed for Pohjola Bank. Since the beginning of 2008, the market value of Nordic financial groups has decreased by 61% on average. In the same period, the market value of 11 large European financial groups has fallen by 63%.

Chart 3. Market value of large Nordic financial groups



## 2.3 Finnish banks' income developments remain mixed

Hanna Putkuri

**Banks operating in Finland have thus far suffered less from the financial crisis than banks in other European countries and the United States. In January–September 2008, growth in net interest income counterbalanced the decrease in other income. Results were weakened by rising expenses and loan losses. Profitability remained fairly good but has begun to decline.**

The aggregate pre-tax profits of Finnish banking operations for January–September 2008 declined by ca 15% on the year-earlier period (see Table 1). In July–September, the pre-tax profits declined slightly on the previous quarter but were higher than in the first quarter of the year (Chart 4). Results for the first nine months of the year are reasonable, considering developments in the operating environment and the record-high results in the reference period.

Banks' income developments remained mixed in the third quarter of the year. Net interest income expanded on rising interest rates and continued robust growth in loans and deposits. Other income shrank sharply compared to the previous quarter. Negative developments in the investment market had a particularly adverse effect on net fee income and income from trading and investment activities.

As a result of the mixed developments, the aggregate income from banking remained virtually unchanged on the previous year. Short-term market

rates have since started to decline and asset prices continued to fall, which will weaken banks' income in the fourth quarter.

**Chart 4. Income and pre-tax profits for Finnish banking, quarterly data\***



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

Expenses increased substantially in the first three quarters of the year. As a result, the expenses-to-income ratio (the cost-effectiveness indicator for banking) increased. Banks are likely to pay increasing attention to cost cutting, due to the negative developments in income.

Net impairment losses on loans and other receivables grew significantly in January–September, particularly for the larger banks. In 2007, this item had a positive impact on profits, as recoveries exceeded new write-offs.

Banks have been cautious in their projections for the remainder of 2008. It appears that the results for 2008 will be significantly weaker than in 2007. The negative developments in the operating environment have thus far weakened particularly the profitability of small banks specialising in investment services. Credit risk assumes greater importance as economic growth slows.

According to the Financial Supervision Authority, Finnish banks' capital adequacy and liquidity have remained good. Short-term funding (under 12 months) is available, whereas long-term funding has become scarcer since mid-September.<sup>7</sup>

**Table 2. Key items from banks' income statements, January–September 2008, and changes on year-earlier period**

	Net interest income		Other income, net		Total expenses		Loan losses, net		Profit before tax	
	EUR m	Change	EUR m	Change	EUR m	Change	EUR m	Change	EUR m	Change
Nordea Group	3 707	18 %	2 242	-14 %	3 188	7 %	146	..	2 615	-7 %
Nordic Banking	3 096	15 %	1 663	-3 %	2 330	6 %	89	..	2 340	2 %
Banking in Finland	856	9 %	441	-8 %	578	6 %	27	..	692	-10 %
Danske Bank Group	2 634	9 %	1 524	-28 %	2 516	1 %	387	..	1 255	-38 %
Banking	2 613	8 %	1 094	-4 %	2 133	2 %	311	..	1 262	-12 %
Banking in Finland	325	18 %	130	-7 %	402	25 %	16	..	36	-54 %
OP-Pohjola Group	873	13 %	639	-29 %	1 017	12 %	27	..	466	-38 %
Banking and investment services	837	11 %	407	-9 %	744	13 %	27	..	473	-12 %
*Pohjola Bank	120	41 %	338	-27 %	337	2 %	8	..	114	-48 %
Savings banks	122.0	3 %	27.4	-42 %	94.9	9 %	-0.8	..	55.3	-29 %
Aktia Group	74.3	14 %	122.9	-8 %	159.6	15 %	0.3	..	37.3	-38 %
Retail banking	46.7	1 %	26.4	10 %	62.3	17 %	0.3	..	10.5	-38 %
Local cooperative banks	82.8	4 %	16.0	-22 %	54.4	3 %	0.1	..	44.4	-4 %
Bank of Åland plc (Group)	31.4	9 %	22.9	-12 %	37.5	13 %	0.5	..	16.3	-20 %
Evli Bank Group	-0.7	..	43.8	-29 %	42.7	-11 %	0.0	..	0.5	-96 %
eQ Group	4.5	-17 %	17.6	-44 %	23.9	-8 %	0.0	..	-1.7	..
1. Finnish banking	2 304	10 %	1 132	-11 %	2 040	12 %	70	..	1 327	-15 %
2. Financial groups operating in Finland	7 528	13 %	4 656	-22 %	7 134	5 %	560	..	4 488	-23 %

Other income includes eg net fee income, capital gains/losses from sale of tangible and intangible assets, capital gains from sale of wound-up operations, and shares in profit/losses of associated companies. Expenses include depreciations and write-downs on tangible and intangible assets, refunds to shareholders and profit distribution to staff. Negative loan losses: recoveries exceed new write-offs.

1. Savings banks, Aktia Savings Bank Group's retail banking, local cooperative banks, Bank of Åland Group, Evli Bank Group, eQ Group, OP-Pohjola Group's banking and investment services, Danske Bank Group's banking operations in Finland and Nordea Group's banking operations in Finland.

2. Savings banks, Aktia Savings Bank Group, local cooperative banks, Bank of Åland Group, Evli Bank Group, eQ Group, OP-Pohjola Group, Sampo Bank Group and Nordea Bank Finland Group.

3. Nordea Group, Danske Bank Group and Finnish financial groups (excl. Sampo Bank and Nordea Bank Finland).

Sources: Banks' interim reports.

<sup>7</sup> See material on the Financial Supervision Authority's website (3 December 2008, in Finnish).

## 3 Securities markets

### 3.1 Rapid decline in mutual fund assets

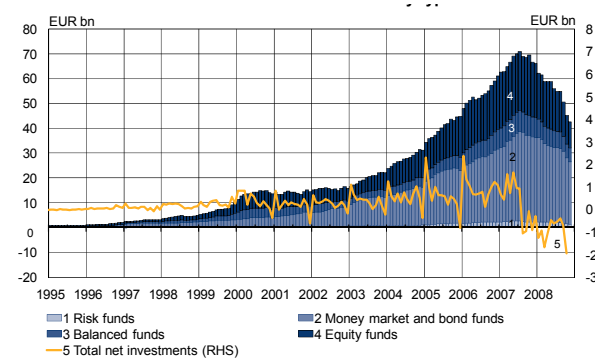
**Pertti Pyökkönen**

**The financial crisis has reduced investors' interest in fund investments all over Europe. In Finland, fund assets have declined by nearly EUR 30 bn since July 2007.**

The global financial market crisis hit the Finnish financial market first via the mutual fund market in August 2007. In July 2007, assets of mutual funds registered in Finland totalled EUR 71 billion. Net subscriptions have subsequently been negative up to November 2008, and investors have withdrawn assets worth EUR 14 billion since July 2007. Moreover, the market value of funds has declined somewhat further. The value of investments in Finnish funds has declined by ca 40% from its peak in August 2007, to less than EUR 43 billion.

In the past year, Finnish mutual funds' total assets have declined by over EUR 23 billion. Negative net subscriptions account for ca half of the decline in assets. Most of the assets were withdrawn from short-term funds: the value of their assets has decreased by nearly EUR 6.5 billion. The decline in assets is mainly due to investor withdrawals. The market value of many short-term funds has also decreased due to negative returns on investments.

Chart 5. Size of funds



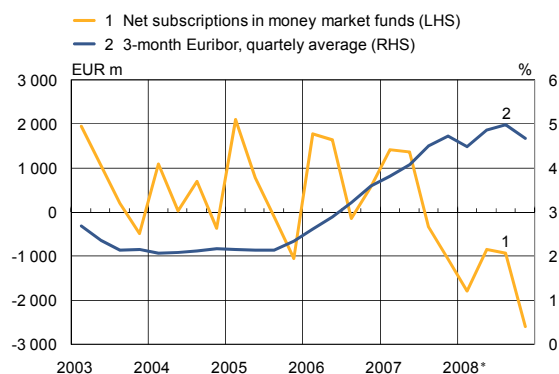
Sources: OMX Nordic Exchange Helsinki Oy and Finnish Association of Mutual Funds.

All investor groups have made withdrawals from short-term funds. Non-financial corporations have withdrawn a considerable amount of their cash holdings from short-term funds. A large number of households have also exited from the short-term fund market. During the autumn, non-financial corporations and households transferred assets to fixed-term deposits with higher returns which have increased at an exceptionally rapid pace. Institutional investors have reduced their money market investments by less than non-financial corporations and households.

The investment strategies of short-term funds differ considerably. Only a few short-term funds have generated returns as high as short-term market rates, eg the 3-month Euribor. At the end of November 2008, the annual return on the best short-term funds was nearly 5%. The annual return on most short-term fund investments has however remained negative. In November, the worst fund generated an annual return of minus 60%.

Chart 6. Net subscriptions in short-term funds and the 3-month Euribor

Net subscriptions in short-term funds and the 3-month Euribor



\* Fourth quarter of 2008 includes October and November.  
Sources: Statistics Finland, the Finnish Association of Mutual Funds and Reuters.

The weighted average annual return on Finnish euro area short-term funds in November was ca 5% minus<sup>8</sup>. Most large short-term funds have generated a fairly weak return.

The assets of long-term funds have remained virtually unchanged in 2008. The average annual return on long-term funds investing in the euro area was ca 3% in November. Of the domestic funds, they have been the most successful, also in terms of the return-to-risk ratio (Sharpe<sup>9</sup>).

Short-term funds account for ca 30% of the total investments in the Finnish mutual fund market. Of the euro area countries, the proportion of short-term funds is higher only in Greece and France. For example in the German fund market, short-term funds are of relatively minor importance. Several special mutual funds operate in the German market, investing eg in real-estate.

As a result of the equity market collapse, the investment assets of Finnish equity funds have

declined by over 50% since July 2007, when equity fund assets totalled nearly EUR 24 billion. By November 2008, the value of equity funds had decreased to less than EUR 11 billion. Investors investing in the equity market via funds have however not restarted to panic sales. Since July 2007, net sales of equity fund investments have amounted to only slightly over EUR 3 billion.

<sup>8</sup> Mutual Fund Report, December 2008. Finnish Association of Mutual Funds and Investment Research Finland.

<sup>9</sup> The Sharpe ratio describes the fund's excess risk-free return relative to the fund's risks. The higher the ratio, the higher the fund's historical return relative to its risks.

### 3.2 Government guarantees support banks' issuance of debt instruments

**Jarmo Pesola**

**Many governments have begun to guarantee banks' funding to improve their possibilities of obtaining finance in today's risk averse markets. But the opportunities provided by huge guarantee programmes have been of little avail.**

The financial market crisis has notably hampered banks' market-based funding. To prevent the drying up of market liquidity, several governments have begun to guarantee banks' funding, in addition to the fact that central banks have injected over EUR 2,000 of liquidity into the market since summer 2007. The EU member states agreed on overall principles of government guarantees on 12 October 2008.

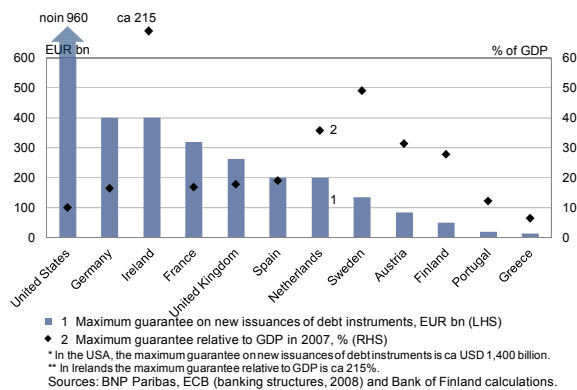
In general, the government guarantee programmes aim to temporarily guarantee new short- and medium-term financial instruments issued by banks. For example in the United Kingdom and Germany, the maximum maturity for these debt instruments is 36 months. The fee for the guarantee will be set at a level that will not distort the markets. In a number of countries, the annual fee for a guarantee consists of a fixed fee (usually 0.5% of the guarantee), and a fee which is tied to the pre-crisis credit default swaps (CDS) of the financial institution applying for the guarantee. The terms and conditions of the guarantees differ between countries.

As an example of the total pricing of a debt instrument consider the government guaranteed EUR 1-billion bond with a maturity of 2.5 years, issued by a

British bank in early December. The price of the bond consists of the reference price for low-risk instruments commonly used in the market (in this case the so-called mid-swap price of papers issued by banks with a risk rating of AA) – 102 basis points – plus a bank-specific additional yield requirement of 30 basis points. In addition to these 132 basis points, the costs of the bank issuing the bond also include the above-mentioned guarantee fee. In this case, the guarantee fee consists of eg a 75 basis point CDS and a fixed fee of 50 basis points.

The chart below shows the estimated or agreed size (EUR bn) of the guarantee programmes of the key countries, and the size of the programme relative to the countries' GDP. The largest single package – the US Federal Deposit Insurance Corporation's (FDIC) ca USD 1,400 billion (ca EUR 1,000 bn) Temporary Liquidity Guarantee Program – is only ca 10% of the GDP of the United States, and in this respect significantly smaller than the EUR 400 billion package of the Irish government (over 200% of GDP). The guarantee granted by the Irish government covers in practice also all interbank money flows, including interbank deposits. The corresponding packages of the largest EU countries are usually slightly over 15% of GDP, and those of the smallest EU countries (excl. Ireland) vary between nearly 50% (Sweden) to less than 10% (Greece) of GDP. The Finnish government's guarantee scheme is estimated to be at most EUR 50 billion (less than 30% of GDP).

Chart 7. Maximum guarantee on new issues of debt instruments in selected countries



The issuance of debt instruments under the government guarantees has thus far been fairly modest. For example in the United Kingdom, the value of debt instruments issued under the government guarantee by the start of December totalled less than EUR 22 billion, ie nearly 8% of the GBP 250 billion (ca EUR 280 bn) government guarantee package. In Germany, an estimated 15 banks and insurance corporations have issued instruments worth EUR 90 under the government guarantee scheme. This is nearly 23% of

the German package. In France, the Société de Financement de l'Economie Française (SFEF) fund, established by the French government and issuing government guaranteed debt instruments on behalf of banks, had by 10 December 2008 issued debt instruments totalling EUR 11 billion. In the large European countries, issuance has so far been rather sluggish. It is noteworthy that in Sweden, the only issuance thus far has been a EUR 2 billion by Swedbank in late November. This is less than 15% of the SEK 1,500 billion (ca EUR 140 bn) Swedish programme.

According to an estimate by Barclays Capital, in the United States, guaranteed debt instruments with a maturity of over one year and worth a total of USD 350–450 billion will be issued in the first half of 2009. This would be ca 25–32% of the estimated support package.

## 4 Infrastructure

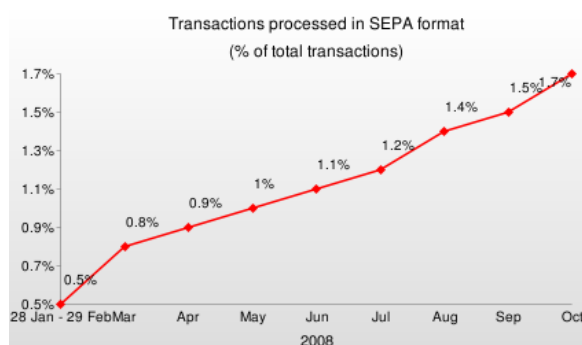
### 4.1 Single Euro Payments Area – a long-term project

**Päivi Heikkinen**

**The European credit transfer was introduced throughout Europe in January 2008. Thus far it has been mainly used for cross-border payments in Europe, and only marginally for domestic payments. Efforts to expand its use must be continued: the Eurosystem progress report sets out the critical areas of focus<sup>10</sup>.**

According to ECB statistics, less than 2% of credit transfers processed in Europe meet the standards of the Single Euro Payments Area (SEPA)<sup>11</sup>.

**Chart 8. Number of European SEPA credit transfers**



Source: [www.ecb.europa.eu/paym/sepa/timeline](http://www.ecb.europa.eu/paym/sepa/timeline)

Modifying payment systems is not simple, and banks need to continue their efforts, particularly to develop

<sup>10</sup> ECB's sixth progress report on the implementation of the Single Euro Payments Area, published on 24 November 2008, <http://www.ecb.europa.eu/paym/sepa/html/index.en.html>

<sup>11</sup> <http://www.ecb.europa.eu/paym/sepa/timeline/html/index.en.html>

services provided to customers and to introduce them to all customer groups. In Finland, the additional services agreed between banks guarantee that the information content of credit transfers corresponds to that of the traditional domestic credit transfer.

Therefore there are no obstacles to the use of the European credit transfer. Central governments are setting a good example by converting to European credit transfers for all payments in 2009–2010.

Implementation of the European direct debit has encountered a number of practical problems, eg how to adapt the authorisation and fee practices of the various countries to the common European procedures. For example, in some countries the current national authorisations may be used for European direct debits, whereas in some countries, the authorisations must be renewed. Rapidly solving the conflicts between the various practices is the only way of introducing the European direct debit to the customers by the end of 2009, as originally planned. Finnish banks have not yet announced how they will implement the SEPA direct debit service.

Companies' electronic payments and automated bookings enhance companies' financial management. Common European payment standards must thus be further developed vis-à-vis the electronic services between banks and customers. For example, common standards must be developed for transmission feedback and account statements. The Eurosystem encourages all banks to provide, at a minimum, their

corporate customers with SEPA-standardised payment services. This would serve also as a basis for developing common e-invoicing services.

The final migration to common European payment methods probably requires the setting of a deadline for total discontinuation of domestic credit transfers and direct debits. Such a deadline would force all the parties to implement the services. The Eurosystem is examining whether market participants can come to an agreement or whether it will require regulation.

Card payments are also being harmonised in Europe. Banks and trade associations have prepared standards which will harmonise the operation of the payment terminal and acquiring. The work is based on global standards, and it is important that European parties are active in the continued development of these standards. The development of common European standards has progressed slowly. The Eurosystem is nevertheless confident that they will be finalised by the end of 2009. Common standards also support the creation of new European payment card systems.

SEPA also has to cover future payment methods, such as online and mobile payments. At the same time, the data security of payments must be ensured, and

providers of payment services must commit to common principles that will ensure the reliability and usability of their services. Securing operations based on open data networks requires that banks cooperate with both customers and authorities. For example, legislation on European network crime should be harmonized.

The participation of customers in the development of common European payment instruments is key to its' success. Customers' possibilities of obtaining information and participating in the development and administration of payment instruments should be improved.

To clarify its views, the Eurosystem published, as an annex to the SEPA progress report, a list of concrete milestones that should be fulfilled between the first quarter of 2009 and the end of 2010. The majority of the tasks are the responsibility of banks, ie the providers of payment services. But the users of payment services should also actively adopt common payment methods. The list of tasks is not exhaustive but does include necessary measures identified at this stage of the SEPA project.



## 5 Key regulatory and supervisory initiatives

### 5.1 Financial market crisis brings significant international regulatory reforms

**Jyrki Haajanen – Jukka Topi**

**As a result of the financial market crisis, the authorities of various countries have taken a number of measures to strengthen the functioning of the financial system in the long term and to ensure financial stability even in an acute crisis.**

The financial market crisis has triggered numerous proposals for enhancing regulation and supervision of the financial markets. Proposals have come from both the international community and national authorities. These measures aim at ensuring that such crises do not occur in the future. As a result of international cooperation, the action plans include the same elements and differ from each other only in terms of priorities and the detail of the contents.

The Financial Stability Forum (FSF) published in April 2008 a report which lists a large number of measures to improve the stability of the financial markets.

1. Strengthening prudential oversight of banks' capital, liquidity and risk management;
2. enhancing transparency;

3. reassessing the role of credit rating agencies;
4. strengthening monitoring and cooperation among authorities, and
5. enhancing the resilience of financial markets.

The G20 issued in November 2008 a declaration calling for decisive and extensive action to restore the stability of the financial markets. The European Union has also prepared an action plan, a so-called roadmap, that includes several short- and long-term proposals for action to enhance financial market regulation and supervision. The United States has its own action plan, which focuses on common issues and certain characteristics of the US financial markets.

The European Commission has on several occasions emphasised the importance of international cooperation and coordination in the development of financial market regulation and supervision. The aim has been to coordinate the contents and timetable of the work on European regulation with the other international regulatory work on the international financial architecture. The regulatory initiatives in Europe have progressed rapidly and the Commission is committed to presenting several concrete proposals and legislative initiatives in 2009. In its communication published in early December 2008, the Ecofin Council announced that it is expecting significant progress in the following areas of the roadmap: (a) the supervision of credit institutions, (b) capital requirements directive on banks and the Solvency II directive on insurance corporations, (c) the valuation of balance sheet items on banks' financial

statements, (d) regulatory framework on authorities' early intervention, (e) the strengthening of supervisory cooperation, (f) counterparty and operative risks of credit derivatives, and (g) corporate management bonus schemes.

### Temporary measures to alleviate the effects of the financial crisis in the EU

In October 2008, the heads of state of the euro area and other EU countries agreed on several temporary measures to combat the negative effects of the escalated financial market crisis. The key measures are (1) government guarantee for banks, (2) capital grants to financially sound banks, and (3) recapitalisation of banks suffering from capital adequacy problems. EU principles on the single market and state aid are to be followed in implementing the measures, and market driven solutions shall be sought.

EU countries agreed on the possibility of supporting banks' financing by granting government guarantees or corresponding arrangements for financially sound banks' new senior debt instruments with a maximum maturity of five years. To prevent distortion of interbank competition, the guarantees will be priced according to normal market terms and conditions. In addition, governments can set additional requirements for the recipients of government guarantee, eg to safeguard financing of the real economy. The guarantee arrangements are open to financial institutions operating in the country in question (incl. subsidiaries of foreign financial institutions) and fulfilling capital adequacy requirements and other criteria. The commonly agreed guarantee arrangements are limited in amount, temporary and will be subject to close supervision by the authorities. The use of guarantee arrangements is discussed in section 3.2 of this publication.

The EU countries also agreed on the possibility of providing capital to financially sound banks so that they can continue to effectively finance the economy. Despite the opportunity to increase public capital, the aim is to rely on private capital. To prevent government capital injections from distorting competition, banks receiving capital will pay a market price for it and possibly have to agree to additional terms and conditions.

To safeguard the operation of the financial system, the EU countries can also grant capital support to systemically important banks suffering from capital adequacy problems, and thus prevent them from going bankrupt. The primary objective is to look after the interests of taxpayers and ensure that banks' shareholders and management meet their responsibilities. The recapitalisation of problem banks may also include the necessary restructuring measures.

The European Commission is monitoring the compliance of individual EU member states' measures with EU regulations on competition, and the action plans must be approved by the Commission. In October 2008, the Commission issued a communication on the application of state aid rules to measures taken in connection with the financial crisis. The Ecofin Council emphasised in December 2008 the need for country-specific support programmes for the banking sector, and particularly the urgency of capital programmes. Following the request of the Ecofin, the European Commission, in a communication issued in December, provided further guidance for keeping banks' recapitalisation measures consistent with the rules on competition. In its guidance communication, the Commission made a clearer distinction between capital programmes directed at financially sound banks and the recapitalisation of banks suffering from capital adequacy problems. The Finnish government has also

launched measures to implement the aid agreed at the EU level.

## 5.2 EU Commission proposes tightening of regulations on credit rating agencies

### Pertti Pylkkönen

Credit rating agencies assess the probability of the insolvency of governments, non-financial corporations, banks and other financial corporations. Credit ratings are used by several types of entities, eg banks, insurance corporations, and other investors, and they play an important role in the financial market. Credit rating agencies have recently been much criticized for the weaknesses of the rating methods and models. During the current financial market crisis, the quality of ratings of various structured financial instruments, in particular, have turned out to be poor, which has weakened markets' and authorities' confidence in credit ratings and the agencies issuing them.

The role of credit rating agencies and the need for regulatory measures have been discussed widely. On the global level, the issue has been examined by the International Organisation of Securities Commission (IOSCO), the Financial Stability Forum, and the Committee on the Global Financial System (the latter two operate as the Bank for International Settlements-hosted organisations). The European Commission sought the advice of the Committee of European Securities Regulators (CESR) and the European Securities Markets Expert Group (ESME) on the role of credit rating agencies.

The Commission came to the conclusion that self-regulation based on voluntary compliance of the

IOSCO's Code of Conduct is not a reliable way of tackling the problems and structural deficiencies concerning credit rating agencies.

As a result, the Commission adopted in November 2008 a proposal on regulating the operation of credit rating agencies and forming a regulatory framework for the issuing of credit ratings in Europe. The aim of the Commission is to strengthen investors' confidence in the operation of credit rating agencies and to ensure a high level of investor protection. The proposal introduces a legally binding registration and surveillance scheme for credit rating agencies whose ratings are used by eg banks, insurance and reinsurance undertakings, investment funds and pension funds in their investment activities.

The key objectives of the proposal for a regulation are to (a) ensure that credit rating agencies avoid conflicts of interest in their operations or at least manage them appropriately (for example, conflicts of interest concerning advisory services have been an issue in the rating of structured products), (b) improve the quality of rating methodology and ratings, (c) enhance the transparency of credit rating agencies by increasing disclosure requirements, and (d) create a registration and surveillance scheme for credit rating agencies.

The Commission's proposal for a regulation is still being discussed in the EU's expert bodies. The final proposal for a regulation will be presented to the European Parliament and Council in 2009.

Also in the United States, the Securities and Exchange Commission (SEC), a financial market supervisor, has been actively calling for measures to increase the transparency and reliability of credit rating agencies and the quality of rating methodologies. The SEC published its proposal in early December 2008.

## 6 Key corporate arrangements and events in the financial sector

<i>Date</i>	<i>Event and description</i>
<b>September</b>	<p>Norwegian fund management company Odin Forvaltning purchases mutual fund unit brokerage firm Rahastotori and its parent company Fondex.</p> <p>Insurance corporation Sampo Life changes name to Mandatum Life Insurance Company Limited.</p> <p>German insurance corporation Allianz sells Dresdner Bank to Commerzbank.</p> <p>US mortgage banks Fannie Mae and Freddie Mac taken over by federal government.</p> <p>Investment bank Lehman Brothers files for bankruptcy.</p> <p>Nomura Holdings purchases Lehman's Asian operations.</p> <p>Barclays acquires Lehman Brothers' North American investment banking business for USD 1.75 billion.</p> <p>Federal government rescues US insurance giant AIG with a USD 85 billion loan.</p> <p>US Treasury announces USD 50 billion guarantee program for the US money market mutual fund industry.</p> <p>Lloyds TSB announces it will buy HBOS for GBP 12.2 billion.</p> <p>Bank of America announces it will buy Merrill Lynch for USD 50 billion.</p> <p>Danish Ehb Bank runs into liquidity problems. Danish central bank and several commercial banks announce they will guarantee Ehb's liquidity.</p> <p>Mitsubishi UFJ buys a 21% stake in Morgan Stanley.</p> <p>Deutsche Bank acquires a 29.75% stake in the German Postbank for EUR 2.8 billion.</p> <p>FDIC closes down Washington Mutual, the largest savings bank in the USA, and sells its assets and part of its liabilities to JPMorgan Chase for USD 1.9 billion. Washington Mutual was the 13th bank to be closed down in the United States this year.</p> <p>Investment banks Goldman Sachs and Morgan Stanley become commercial banks supervised by the Federal Reserve.</p>

<i>Date</i>	<i>Event and description</i>
<b>September</b>	<p><i>Nationwide takes over two mortgage banks, Derbyshire Building Society and Cheshire Building Society.</i></p> <p><i>British mortgage bank Bradford &amp; Bingley taken over by UK government. Deposit stock and branch network sold to Abbey National, a subsidiary of Banco Santander.</i></p> <p><i>German authorities and financial sector arrange a EUR 35 billion plan to rescue Hypo Real Estate. Rescue was triggered by liquidity problems encountered by Depfa Bank, a subsidiary of Hypo Real Estate.</i></p> <p><i>Belgian, Dutch and Luxembourg authorities invest EUR 11.2 billion in the financial group Fortis. In return, each government will obtain a 49% stake in a Fortis subsidiary in its own country.</i></p> <p><i>Nordea announces it will sell to Municipality Finance Plc a EUR 600-million portfolio of loans granted to municipalities and municipally-owned companies.</i></p> <p><i>Nordea acquires 9 branch offices of the Danish bank Roskilde Bank. Spar Nord purchases 7 branch offices and Arbejdernes Landsbank 5 branch offices.</i></p> <p><i>Ireland's government announces it will guarantee Irish banks' deposits and debts for two years.</i></p> <p><i>Aktia Savings Bank plc's banking operations transferred to Aktia Bank plc. Moody's keeps Aktia's ratings unchanged: short-term P-1, and long-term A1.</i></p> <p><i>Government of Iceland buys Glitnir Bank hf's shares worth EUR 600. In return it acquires a 75% stake in the bank.</i></p> <p><i>Straumur-Burdaras Investment Bank to acquire majority of Landsbanki Island's overseas operations.</i></p>
<b>October</b>	<p><i>Wells Fargo announces it will buy Wachovian.</i></p> <p><i>Kaupthing Bank and Landsbanki Island taken over by the government.</i></p> <p><i>Fitch lowers Iceland's ratings. Short-term: F2 → F3, and long-term A- → BBB-.</i></p> <p><i>The deposits of Kaupthing Bank's Finnish branch saved by Finnish authorities and Nordea Bank Finland, OP Group, and Sampo Bank.</i></p> <p><i>Banco Santander announces it has acquired the remaining 75.7% ownership stake in Sovereign Bancorp for USD 1.9 billion. Santander already held a 24.3% stake.</i></p> <p><i>PNC Financial Services announces it will purchase the troubled National City Corp bank.</i></p> <p><i>Euroclear acquires NCSD and its subsidiaries APK and VPC.</i></p>

<i>Date</i>	<i>Event and description</i>
<b>October</b>	<i>NASDAQOMX announces it has signed a letter of intent to purchase a 22% stake in the Dutch central counterparty clearing house European Multilateral Facility N.V. It also announced that it has chosen EMCF as the central counterparty on the Nordic stock exchange.</i>
<b>November</b>	<p><i>The Sweden-based Carnegie Investment Bank is taken over by the Swedish government.</i></p> <p><i>Latvian government takes over Parex Banka AS.</i></p> <p><i>American Express converts to a bank holding company, subject to supervision by the Federal Reserve System.</i></p> <p><i>Citigroup runs into trouble and receives additional share capital from the US government and a guarantee covering more than USD 300 billion of problem assets.</i></p> <p><i>The listed paperboards company Stromsdal files for bankruptcy.</i></p> <p><i>The Finnish Association of Securities Dealers and the Federation of Finnish Financial Services to merge on 1 January 2009.</i></p> <p><i>Aktia Real Estate Mortgage Bank plc chooses Luxembourg as its' new home Member State, as per the European Transparency Directive.</i></p> <p><i>IMF approves financial rescue package for Iceland.</i></p> <p><i>Standard &amp; Poor's lowers Iceland's long-term rating from BBB to BBB-, outlook negative.</i></p>
<b>December</b>	<p><i>Moody's lowers Iceland's rating. Short-term P-1 → P-2, and long-term A1 → Baa1.</i></p> <p><i>Aktia Bank acquires the asset management unit of Kaupthing's Finnish branch.</i></p> <p><i>Giant pyramid swindle uncovered in US investment market. Securities and Exchange Commission (SEC) estimates that investor losses may reach EUR 38 billion.</i></p>