Financial Market Report

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1 Financial intermediation

1.1 Households invest abroad via mutual funds and unit-linked insurance

Eero Savolainen

Households' investments in personal pension and life insurance and in fund units have been increasing in the current decade. These investments, effected via financial intermediaries, can be allocated by security type, which facilitates the assessment of risk and return. A breakdown of fund investments and unit-linked insurance investments into shares and debt securities results in much larger holdings of foreign securities for households in particular. These indirect holdings nevertheless still account for only a small proportion of households' total financial assets.

Households can invest in securities either directly or indirectly. They can eg purchase quoted shares or subscribe for mutual fund units via a management company or an insurance corporation. Households' indirect investments can be broken down by underlying securities, based on the structure of mutual fund assets. This type of wider analysis augments the picture of the structure and the risks of households' investments (Table 1).

Finnish households' financial assets totalled EUR 141 billion on 30 September 2006.[1] Two-thirds of this is in deposits and insurance technical reserves, and the rest is mainly in quoted shares and mutual fund units. Below, we examine households' investments in mutual funds (EUR 14.2 bn) and unit-linked insurance (EUR 7.2 bn), which together account for 15% of households' total financial assets.

The most important items in indirect holdings are quoted shares and bonds, which account for over 70% of total indirect investments (EUR 21.4 bn). The proportion in short-term debt securities is 10%, and the majority of the rest is in indirect mutual fund investments[2]. This item can however not be broken down due to a lack of information on the structure of foreign funds' portfolio.

[1] Quarterly data published by the Bank of Finland do not include unquoted shares and other equity or other accounts receivable, due to a lack of data sources.

[2] Investments in foreign mutual funds by domestic mutual funds owned by households.

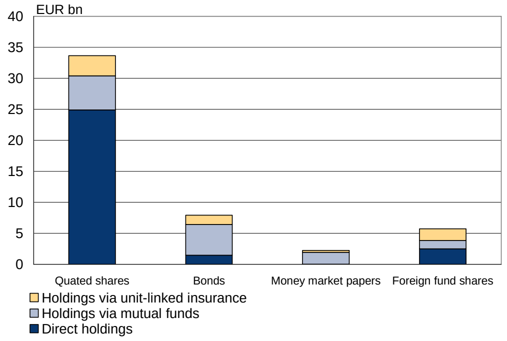
Table 1. Households' financial assets, 30 September 2006, EUR bn

	Direct holdings	Holdings via mutual funds	Holdings via unit-linked insurance	Total
Quated shares	24.9	5.5	3.2	33.6
Domestic	21.2	1.3	0.8	23.3
Foreign	3.7	4.2	2.5	10.4
Bonds	1.5	4.9	1.5	7.9
Domestic	0.4	0.7	0.2	1.3
Foreign	1.0	4.2	1.3	6.6
Money market papers	0.0	1.9	0.3	2.2
Domestic	0.0	1.3	0.2	1.5
Foreign	0.0	0.6	0.1	0.7
Foreign fund shares	2.5	1.3	1.9	5.7
Other items (eg deposits, majority of insurance technical reserves)	90.7	0.5	0.2	91.5
Total	119.6	14.2	7.2	141.0

Source: Bank of Finland calculations.

The breaking down of indirect holdings raises households' investments in debt securities almost sevenfold. Households' direct investments in short-term debt securities are minor, whereas indirect investments via mutual funds total over EUR 2 billion. In euro terms, the majority of households' indirect holdings are in quoted shares, but due to the dominance of direct investments, indirect investments raise the total position by only a third. The role of indirect investments is highlighted in households' holdings of foreign securities, of which less than a fourth are directly held (Chart 1).

Chart 1. Households' direct and indirect holdings of securities, 30 September 2006, EUR bn



Source: Bank of Finland calculations.

The large share of indirect holdings suggests that households lack the ability or willingness to make direct investments in debt securities or foreign securities. Short-term debt securities are traded in the wholesale market, which explains the small amount of households' direct holdings. In addition, bond offerings to households have been fairly minor.[3] Investing in foreign securities is considered difficult and expensive. Moreover, the issuers are less well known than domestic ones. In these cases, easily-available investments in mutual funds become an attractive alternative to direct investments, especially as mutual funds are heavily marketed to private investors. In analysing indirect investments in foreign securities, one should however take into consideration that not all households necessarily perceive themselves as investing abroad when they buy units in euro-denominated fixed-income funds, marketed more on the basis of currency than geographic diversification of the portfolio.

In principle, employee pension fund assets could also be counted as household assets, even though this is not done in the national accounts. However, in Finland's defined benefit pension scheme, an individual household does not carry investment risk. Therefore the above analysis is not applied to employee pension fund assets. Guaranteed-return life insurance and pension insurance policies, which are included in insurance technical reserves, and provision for unearned premiums and provision for claims outstanding are also excluded from the analysis.

[3] Uncertainties involve also statistics on domestic debt securities held by households, and thus the holdings may be underestimated. For example, growth in recent years of structured products is not clearly reflected in financial accounts.

1.2 Financial markets moving into virtual reality – should the authorities follow?

Emilia Koivuniemi

Own currency, monetary policy, active business life and a population of over 5 million; this is the virtual world established in the Internet – which is looking more and more like the real world. As banks move into to these virtual communities, one might ask whether financial supervision and regulation should also move in.

One of the virtual communities that have recently been written on extensively is Second Life, which was established in 2003. The Finnish company Sulake had already much earlier established Habbo Hotel, a virtual hotel for young people, which is now global and twice the size of Second Life, in terms of number of visitors. Similar virtual realities include the Swedish Entropia Universe and the game worlds of Disney and MTV Network.

But Second Life is the first virtual game world that will be linked to the real world. The company behind Second Life, Linden Lab (located in San Francisco) aims to turn the community into a real virtual economy in which the logics of business and economics apply. The community has its own currency, the Linden dollar, which is quoted against the US dollar and traded on the LindeX currency exchange.

Linden Lab assumes three roles in the game. It aims to make a profit by attracting as many users and as much advertising money as possible; it supervises the compliance of rules, and acts as a central bank. The virtual central bank conducts monetary policy based on the same principles as a real central bank.

Linden Lab's business is renting 'land' and providing avatars[4] with services ranging from clothing to jazz clubs. In addition, players can establish their own companies in Second Life. These avatars' companies do business with each other using Linden dollars. The tradable virtual currency enables players to earn a real-life living via a virtual-world company.

Like the real world, the virtual world cannot operate without a banking sector if companies and individual players want to do business. Thus far, the market potential of parallel realities has been exploited mainly by consumer brands, but the range of services is increasing. The news agency Reuters has assigned a reporter to cover events in Second Life, and now the Swedish Institute (SI) will be opening the first embassy in Second Life[5]. In the longer term, SI plans to acquire an island in the virtual world and to open a business park there for Swedish companies.

Denmark's Saxo Bank is planning to offer Second Life residents the possibility to manage their real-life financial portfolios from within the virtual world and eventually create a market to trade the Linden dollar against real-world currencies[6]. ABN Amro has opened a branch office in Second Life. The office now offers

[4] In virtual reality, players represent themselves as avatars.

[5] 'Virtual world of 'Second Life' is starting to look a lot like Sweden', San Francisco Business Times, 2 February 2007. http://sanfrancisco.bizjournals.com/sanfrancisco/stories/2007/02/05/tidbits1.html

[6] Reuters/Second Life. 'Danish bank moves to offer trading in Second Life', 2 March 2007, http://secondlife.reuters.com.

only financial advice, but in future it will provide also banking services[7].

We are starting to talk about large money flows, because in Second Life, ca. 1.5 million real dollars are traded daily. What makes Second Life such a phenomenon is the rapid growth in participants. For example, renting virtual land is so profitable for Linden Lab that it is the company's main source of revenue[8]. Once the banking sector enters the game, only the imagination and advertisers' willingness to make money will limit the ways of integrating the real with the unreal.

Clearly, it is especially consumer authorities and parents of minors that will need to ensure that players do not become alienated from reality. But can the merging of real and the virtual worlds have other consequences? Tax issues have already become topical. Some players' avatars have succeeded in getting rich in Second Life, and once they repatriate their profits, they catch the attention of real-world tax authorities. Tax authorities in some countries are preparing legislation to prevent tax evasion when virtual profits are converted into real money[9].

Payments made in virtual business actually take place within the systems of a company, so that the company will eventually be responsible for exchanging real US dollars for Linden dollar proceeds. Could banks create liquidity in bit space and transfer it to real-life use? If will thus be interesting to see whether trading with a virtual financial instrument can one day become a part of real life. How fictitious is a debt instrument if the debt is located in a virtual community while the money is located in the real world?

The problems of a virtual bank might well spread to the real world if the bank operates in both the worlds and money flows to both directions.

Linden Lab's possible problems as a central bank could for the time being harm only those few who earn a living in the virtual world. Banking supervisors may however be forced to take a stand on the operations of Second Life, based on the concepts of payment transfer and e-money. PayPal, which utilises email, is used for paying eBay auction purchases, and Linden dollars are used to pay for recreational services on the Internet. In both cases, real money flows in and out of the system.

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[7] 'ABN Amro Bank opens in Second Life', 3 December 2006, www.nevillehobson.com

[8] Kirkpatrick, David, 'It's not a game', Fortune, 5 February 2007.

[9] 'Virtuaalivoitoista maksettava todelliset verot – tietysti'. 21.11.2006. http://optimax.blogit.kauppalehti.fi/?s=second+life (in Finnish only).

2 Banks and insurance corporations

2.1 Banks' business expanded and operating profits improved in 2006

Mervi Toivanen

Finnish banks' business continued to grow in 2006. Lending grew rapidly and banks extended their range of other services and products. Banks also expanded their operations abroad and in other business lines. Growth in business operations was accompanied by improved operating profits. This was due to growth in income, which exceeded that of expenses, as well as one-off capital gains and virtually zero net loan losses.

In 2006, Finnish banks expanded their business operations. Lending continued to grow rapidly, and banks focused on developing and selling other services and products. Favourable stock market developments have increased the demand particularly for fund and asset management services and stock market-related products. In addition, eg local cooperative banks and savings banks started selling Aktia Real Estate Mortgage Bank's products.

Banks also expanded their operations abroad and in other business sectors. Sampo Bank increased its operations in the Baltic countries, and Evli Bank opened new branches in Sweden and Poland. Banks also continued to expand their operations in the insurance sector. Year 2006 was the first year in which Pohjola's total non-life insurance operations were included in OP Bank Group. The latest example of alliances between banks and insurance corporations is Aktia, which acquired Veritas Life Insurance Company Ltd. In addition, Aktia moved into real estate brokerage in 2006, while Ålandsbanken continued to expand the operations of its subsidiary, which offers IT services, and eQ acquired the investment firm Fides.

Besides growth and expansion of business operations, 2006 was an excellent year for Finnish banks in terms of financial results. Growth in operating profits was boosted by an increase in net interest income and net fee income and positive developments in net income on items measured at fair value. The rise in net interest income was driven by an increase in the stock of lending and a higher level of interest rates, only partially offset by shrinking margins on lending. Net interest income was also supported by deposit margins because increases in interest rates on deposits lag behind market interest rates. Banks gained net fee income particularly from funds, asset management and securities brokerage. Some banks also received one-off capital gains from sales of shares and investment properties.

At the same time, banks' expenses continued to increase. Higher staff expenses are due to growth of performance-linked bonuses and wage increases, as well as to recruiting. The growth in other expenses was mainly due to expansion of business operations, commencement of new activities, and increased focus on sales and marketing. Net loan losses were generally low or banks recorded net recoveries. Overall, Finnish banks' total operating profits improved markedly.

Table 2. Key items from banks' income statements in 2006 (EUR m) and changes on 2005

	Net interest income, EUR m		Other income, EUR m		Total expenses, EUR m		Operating profit, EUR m	
	1-12 2006	Change %	1-12 2006	Change %	1-12 2006	Change %	1-12 2006	Change %
Nordea Group	3 869	5.6 %	3 516	20.6 %	3 822	4.2 %	3 820	25.3 %
Retail banking	3 185	4.7 %	1 827	12.0 %	2 667	2.4 %	2 565	18.4 %
Insurance services	-	-	300	5.3 %	174	26.1 %	126	-14.3 %
Nordea retail banking in Finland	873	8.0 %	464	16.9 %	656	2.5 %	694	21.8 %
Nordea Bank Finland group	1 415	16.9 %	1 044	60.1 %	881	-2.3 %	1 639	79.1 %
Sampo Group	343	8.9 %	5 850	1.1 %	4 840	0.6 %	1 353	4.5 %
Banking and investment services	374	8.1 %	443	13.0 %	459	8.3 %	355	12.3 %
Insurance services	-	-	5 399	-0.5 %	4 375	-0.4 %	1 025	-0.9 %
OP Bank Group *	883	11.2 %	1 072	69.6 %	1 148	36.2 %	800	38.2 %
Banking and investment services	899	12.0 %	596	16.6 %	844	6.7 %	643	24.4 %
Insurance services	-	-	487	-	340	-	146	170.4 %
OKO Bank Group *	96	-33.3 %	537	143.0 %	409	92.9 %	223	48.7 %
Savings banks (excl. Aktia), total	134	15.5 %	50	11.2 %	110	3.2 %	73	37.1 %
Aktia Savings Bank plc (Group)	84	5.6 %	55	1.7 %	84	11.0 %	56	14.9 %
Local cooperative banks, total	93	17.9 %	25	13.1 %	71	4.3 %	47	43.1 %
Bank of Åland plc (Group)	33	4.1 %	29	41.1 %	41	23.2 %	21	12.8 %
Evli Group	1	-14.3 %	55	2.0 %	51	6.7 %	5	-33.8 %
eQ Group	5	67.5 %	42	51.9 %	30	19.8 %	19	195.7 %
1. Finnish banking business	2 496	10.1 %	1 759	15.5 %	2 345	6.1 %	1 913	21.8 %
(incl. Nordea retail banking Finland)								
2. Finnish banking and financial groups	2 480	9.8 %	2 235	35.9 %	2 649	17.1 %	2 070	26.8 %
(incl. Nordea retail banking Finland)								
3. Financial conglomerates operating in Finland	5 445	7.1 %	10 694	11.9 %	10 196	5.4 %	6 194	21.7 %

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

1. Includes savings banks, Aktia Savings Bank plc Group, local cooperative banks, Bank of Åland plc Group, Evli Group, eQ Group, OP Bank Group's retail and corporate banking services, Sampo's banking and investment services and Nordea's retail banking activities in Finland.
2. Includes savings banks, Aktia Savings Bank plc Group, local cooperative banks, Bank of Åland plc Group, Evli Group, eQ Group, OP Bank Group, Sampo's banking and investment services and Nordea's retail banking activities in Finland.
3. Includes Finnish banking anf financial groups, Sampo Group and Nordea Group.

* Pohjola Group plc is included in OP Bank Group's (and OKO Bank Group) income statement for 2006. Pohjola's figures are included in comparative data only as of November 2005. As a result, 2006 and 2005 figures for OP Bank Group and OKO Bank Group are not highly comparable.
In addition, the structure of OKO Bank Group has changed substantially as a consequence of the Pohjola deal.

Source: Banks' financial statements; press releases.

2.2 Continued good performance in the US banking sector

Jyrki Haajanen

Performance of the largest US banks continues to improve. Banks' income has remained good and the number of non-performing loans remains exceptionally low. Banks' capital adequacy is also good.

The largest banks have for the most part managed to maintain good profitability, despite tight competition (Table 3). Profitability has however not been as good in all areas of banking. The best performers have been banks with diverse income structures, and those that have spread their risks.

Low interest rates and tight competition have squeezed lending margins. In addition, increasing numbers of customers are putting their money into high-yielding fixed-term accounts rather than low-yield transactions accounts. As a result, banks' interest rate margins have been shrinking already for a number of years. The increased volume of credit and growth in other income have nevertheless maintained banks' high level of total income. In 2006, the proportion of other income in total income grew as a result of fee income particularly from asset management and from income on investment banking. The exceptionally low level of loan losses and controlled growth of expenses also boosted banks' results.

Despite the good level of profitability, banks are facing a number of challenges. Demand for credit is not on a solid footing and growth of other income is slowing. In recent years, many households have financed consumption spending with using real-estate as collateral. This has been enabled by the rise in housing prices, which has continued for several years. The housing market has however shown clear signs of cooling, and average prices of old dwellings fell last autumn for the first time in 11 years. Growth in households' demand for loans has already eased as a result. On the other hand, the growth rate of loans to non-financial corporations has increased in some regions. As a result, growth in lending stock will not necessarily decline markedly in the short term. The cooling housing market may nevertheless have a significant impact on the US economy, and in the medium term, banks may face significantly tougher times.

A good example of the sensitivity of the housing loan market are the problems that merged in the subprime loan market in late 2006. The sustained growth in the housing market and narrowing interest rate margins have induced banks to grant credit fairly generously also to households with low credit ratings. In many cases, the amount of credit granted has been too large, and banks have also compromised on their collateral requirements. In late 2006, delinquency rates increased considerably for households with low credit ratings, causing turbulence across the market for mortgage-backed securities (MSB). The fall in prices was particularly pronounced for securities backed by subprime loans. These subprime securities account for ca 14% (USD 824 billion) of the total MBS market. Large banks have however announced that subprime loans and securities will not pose a threat to their capital adequacy. According to the Federal Reserve, the situation is under control and there have been no signs of spillovers to other market segments. The supervisory authorities nevertheless consider the situation so serious, that they are revising the instructions to banks on granting credit.

Banks' strong profitability over a period of several years has created a situation in which banks have abundant 'excess' capital. Some of this capital has been distributed to shareholders in the form of dividends, and many banks have repurchased their own shares. As growth in income slows, repurchasing shares is a way of keeping the return-on-equity ratio high. Banks good capital adequacy was also reflected in the large number of corporate restructurings. Large banks were particularly active in corporate restructurings to diversify income structures and/or risks.

The US banking sector also seems fairy well equipped to face a possible economic downturn. Banks' income structures are diverse and their balance sheets do not (at least not currently) have major structural weaknesses. Major developments in risk management methods in recent years leads us to believe that banks are currently better equipped to price their risks and monitor their large risk exposures.

Table 3. Key figures for 15 large US financial groups

	Operating profit 1-12/2006 EUR m	Operating profit 1-12/2005 EUR m	Balance sheet 31.12.2006 EUR m	ROE % 2006	Costs per income % 2006	Capital adequacy Tier 1, % 31.12.2006
Citigroup	23 605	23 658	1 499 329	18.7	59.1	8.6
Bank of America	25 464	20 220	1 162 582	16.3	48.2	8.6
JPMorgan Chase & Co.	15 838	9 818	1 076 395	13.0	62.1	8.7
Wachovia Corporation	9 465	7 606	563 174	14.4	58.4	7.5
Wells Fargo & Company	10 151	9 282	383 877	19.6	57.9	9.0
Washington Mutual	3 883	4 371	275 795	13.6	60.7	8.3
U.S. Bancorp	5 466	5 282	174 604	23.6	45.3	8.8
Countrywide Financial Corporation*	3 452	3 334	159 244	19.0	60.8	10.6
Sun Trust Banks, Inc	2 410	2 298	145 112	12.3	59.4	7.7
Capital One Financial Corporation*	2 909	2 274	119 462	14.9	57.6	13.2
Regions Financial Corporation	1 560	1 143	114 184	10.9	59.9	8.1
National City Corporation	2 726	2 380	111 653	18.0	54.5	8.9
BB&T Corporation	1 970	1 983	96 648	13.4	55.7	9.0
Bank of New York	1 728	1 903	82 405	29.1	68.3	7.8
PNC Financial Services Group	3 190	1 590	81 093	28.0	51.7	10.4
Total	113 817	97 142	6 045 555			
Weighted average (balance sheet)				16.6	57.0	8.7

Source: Fitch Ratings Ltd.

* Tier 1 figure based on situation at end–2005 since the 2006 figure was not available.

2.3 Iceland's financial sector expanding robustly

Toni Honkaniemi[10] and Pertti Pylkkönen

Icelandic banks have in the past few years rapidly expanded their operations to the other Nordic countries and the United Kingdom. Overseas operations account for half of commercial banks' aggregated balance sheet.

Iceland's financial sector has over the past few years experienced major structural changes and exceptionally rapid growth. Liberalisation of the Icelandic financial sector started in the mid-1990s when Iceland signed the EEA agreement.

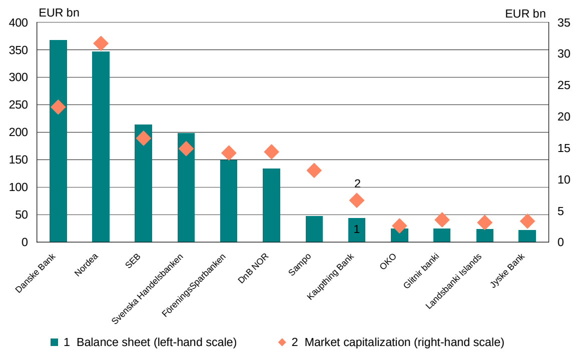
Liberalisation of the financial market marked the start of a process of concentration in the banking sector. Glitnir banki (former Islandsbanki) was established in 2000 with the merger of Islandsbanki and Icelandic Investment Bank - FBA. The current Kaupthing Bank was formed in 2003 as a result of a merger between Kaupthing and the formerly state-owned Bunadarbanki.

The state sold another commercial bank, Landsbanki Islands, in 2003. Privatisation of state-owned banks fundamentally changed the banks' strategies, and they began to expand rapidly. The privatised banks also entered the housing finance market in summer 2004 when the monopoly of the state-owned housing board was dismantled.

After the liberalisation of financial markets and capital movements, Icelandic banks and investment firms started to expand and acquire banks and other operators in the financial sector in both the Nordic countries and the United Kingdom.

Investments abroad led to rapid growth of Icelandic banks' balance sheets. Icelandic banks' and other credit institutions' balance sheet totals amounted to ca EUR 17 billion in 2001. At year-end 2005, the banks' and other credit institutions' combined balance sheet total had risen to nearly EUR 83 billion, which is about six times the GDP of Iceland. The largest commercial banks continued to grow rapidly in 2006. The combined balance sheet total of the three largest commercial banks grew by ca 25%. Despite the rapid growth, the banks are still small by Nordic standards (Chart 2).

Chart 2. Nordic financial groups' balance sheet totals and market capitalization, 31 December 2006



Sources: Interim reports and Bloomberg.

The Icelandic banking market is highly concentrated. The three largest banks, Glitnir banki, Kaupthing Bank and Landsbanki Islands, account for ca 90% of the banking sector's balance sheet total. Of the balance sheets of these three banks, about half reflects overseas operations. Savings banks and Iceland's fourth commercial bank, Icebank – owned by the savings banks, have thus far focused on the domestic market.

Icelandic banks' indicators of profitability and cost-efficiency are high. In 2006, return on equity (ROE %) for the three largest banks was ca 40% and the

[10] Financial Supervision Authority, FIN-FSA

indicator of efficiency, ie the cost-to-income ratio, was less than 0.4. The capital adequacy ratios were also clearly higher than the required minimum level. At the turn of the year, the total capital adequacy of the three largest commercial banks was ca 15% and Tier 1 capital adequacy, calculated on the basis of original own funds, was at least 10.5%.

As a result of the robust growth of the largest commercial banks, the structure of banks' financing has changed so that banks increasingly resort to debt financing from the international capital markets, instead to deposits. The deposits-to-lending ratio of the three largest commercial banks varies from less than 30% to over 40%. Banks funding risk has consequently increased significantly in recent years.

The risk ratings of debt instruments issued by Icelandic banks differ considerably between rating agencies (Table 4).

Moody's revised it bank rating methodology. As a result, it upgraded in February the long-term credit ratings of the above-mentioned banks by four or five grades to the highest grade, Aaa. The upgrading has prompted lively debate, both internationally and in the Nordic countries. In April, Moody's lowered three Icelandic banks' long-term senior bond ratings from Aaa to Aa3.

Table 4. Credit ratings of Icelandic banks (23 April 2007)

	Moody's	S&P	Fitch
Glitnir Bank	P-1/Aa3/C	A-2/A-	F1/A
Kaupthing Bank	P-1/Aa3/C	...	F1/A
Landsbanki Islands	P-1/Aa3/C	…	F1/A

On the other hand, Moody's has lowered Kaupthing Bank's financial strength rating to C. The rationale for the downgrading included concentration of ownership, weakened corporate governance, and increased credit risks.

The Icelandic insurance sector is small compared to the country's banking sector. The combined balance sheet total of insurance corporations was less than EUR 2 billion in 2005. One reason for the small size of the life insurance market is the significant role of pension funds. Over 40 pension funds operate in Iceland, and their assets are ca 1.3 times the national GDP. The amount of funded pensions, relative to the size of the economy, is among the highest in the world.

The Icelandic banking and financial sector is characterised by cross ownership. The main shareholders of the three largest commercial banks include other domestic banks, investment companies, life and pension insurance corporations, and a variety of holding companies.

Icelandic banks have expanded their operations also in Finland over the past few years. Kautphing Bank has a license to operate in Finland as a credit institution, as a subsidiary of a foreign credit institution. It has already acquired Sofi Oy, a small brokerage company. The publicly listed investment company Norvestia plc is also part of the Kaupthing group, which owns ca 30% of the share capital and over half of the voting rights in the company. In early February 2007, Glitnir banki made an offer for the FIM Group, and it holds about two-thirds of the group's share capital. Exista increased its shareholding in Sampo plc in February to just over 15%. Exista's holdings in Sampo plc are divided into three parts, with the largest part (ca 9.5%) held by Exafin B.V, a subsidiary registered in Luxembourg. In addition, Icelandic investment companies with links to banks have made major investments in eg Finnish listed companies, the most highly publicised being FL Group's investments in Finnair.

2.4 Are there barriers to competition in the EU retail banking market?

Laura Vajanne

Findings of a European Commission study show that in the European retail banking market, several barriers to competition exist, which raise retail banking costs to companies and consumers. High profitability of banking, concentrated markets and evidence of entry barriers give reason to suspect that in some EU countries, banks are able maintain a fairly high level of fees charged to consumers and small firms.

The Finnish banking sector is highly concentrated compared to the other European banking sectors.[11] Three bank groups (Nordea, Sampo, OP Bank Group) account for 90% of retail banking, in terms of balance sheet total, whereas in the EU, the comparable average is 50%. The banking markets in Sweden, Lithuania, the Netherlands, and Belgium are also highly concentrated, while the German banking market is highly fragmented.

Profitability of banking has remained good in the EU. In a comparison of profitability by the Commission, Finnish banks ranked third, after Irish and Spanish, followed closely by Swedish and Danish banks. Profitability of banking is weak in Germany, Austria and Belgium.

The EU survey shows that there is a clear positive dependency between profitability and cost-efficiency. In this comparison, Finland ranks slightly below the EU average. Despite high profitability, costs of business operations in Finland were higher than the EU average.[12]

The Commission report cites the use of credit registers in lending activities by banks and other lenders as one of several possible barriers to competition. Credit registers are considered a particular problem for new banks entering a market. Credit registers may impede competition via asymmetric information if access to data is denied or expensive. Access to credit registers may also be denied to foreign banks or access may be restricted by regulatory measures, in addition to discrimination for purely commercial reasons.

Does co-operation between banks reduce competition?

Banks cooperate with each other in many ways. Cooperation is typical in payment systems and credit registers and in constructing and utilising infrastructure that require information technology. Bank groups also engage in deeper forms of cooperation.

Cooperation between banks can result in economic benefits to consumers. This is the case particularly if the banks are small and do not have a significant combined market share. But cooperation between

[11] The data are based on a report by the European Commission, available at: http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/

[12] Eg in the Nordic Banking Structures report published by Nordic central banks on 28 August 2006 Finnish banks' costs-to-income ratio was clearly better than in the Commission's report.

banks can also limit competition and exclude new entrants.

The Commission report identifies savings and cooperative banks in some EU countries as an example of cooperation that may restrict competition or hamper market entry by new operators. Some EU member states still have legislative or other administrative provisions that support the position of savings and cooperative banks. For example, some savings and cooperative banks may have the right to tax-exempt deposits. In some countries, standard competition laws are not applied to various forms of cooperation, and in some member states the role of the state as owner or guarantor may distort competition. Banks also have agreements on reserving a defined geographic area for the activities of an individual retail bank.

Cooperative banks have a major market share in France, the Netherlands, Italy, Austria, and Finland,[13] whereas savings banks have a significant role in eg the German and Spanish banking markets.

Due to the diversity and complexity of issue, the Commission cites the need for further studies on the various forms of cooperation between banks, with a focus on competition. If such studies were to provide evidence of cartels, the Commission would raise the issue at the Community level.

Tie-in sale and services tying

European banks typically engage in product tying eg by obliging a loan customer to take out extra loan insurance policy or to open a current account. Banks may also tie services, which makes it difficult to compare prices. Package pricing may also force consumers to pay for services they do not need.

Product tying limits customer mobility and thus weakens the competition position of market participants and new entrants. In Finland, banks usually require that a mortgage holder have a current account at the bank.[14] For example in Germany, Sweden and the United Kingdom this is not common practice. Tying other services to the main product – particularly to mortgages – is widespread in Finland.

The Commission study shows that in product pricing, Finnish banks stand out. Prices of several products and services, such as account fees and closing charges, default charges and loan transfer fees are fairly low in Finland, compared to many other countries.

Limited customer mobility

About 5 to 6% of current account holders in the EU switch banks annually. Finnish households and companies switch banks much less frequently than the EU average. In addition, the average time of use for active accounts seems to be clearly the longest in Finland. The inquiry however shows that the number of customers not satisfied with their bank is significantly higher than that of customers that switch banks. Switching costs are considered to be the key barrier to switching banks.

Banks' profit margins are lowest in countries in which customers switch banks more frequently. Promoting customer mobility is thus considered a welcome means of increasing competition. Based on the findings of the inquiry, the Commission set up a

[13] In Finland, co-operative banks' share of deposit banks' total euro-denominated deposits of households and non-financial corporations was 34% and savings banks' 9.5 % in 2006.

[14] Of mortgage holders, 75% had a current account in the same bank, and for those with consumer loans the figure was 85 %. Banks' practices have become more flexible in recent years, and banks do not always require that customers hold eg a wage account at the bank. By contrast, banks usually require that loan repayments be made from an account in the lending bank.

working group to examine customer mobility. In addition, the Commission is currently preparing a report on pricing transparency in the mortgage market and the link between pricing and customer mobility.

2.5 Favourable situation in the insurance sector

Pertti Pylkkönen

Profitability and capital adequacy of Finnish insurance corporations remained good in 2006. The rise in long-term interest rates resulted in a decline in investment income compared to 2005.

Developments in the domestic insurance sector continued to be favourable in 2006. The profitability of insurance activities remained broadly unchanged compared to the previous year. Investment income of a number of companies did however decline. The rise in long-term interest rates reduced the investment income of insurance corporations investing heavily in fixed-income instruments. The highest incomes came from unlisted shares, ie mainly venture capital and private equity investments.

Growth in premium income varied considerably between types of insurance corporations. Employee pension insurers' premium income grew by slightly over 8%, boosted by the improved employment situation and wage growth. Non-life insurance corporations' premium income grew by a couple of percent, and life insurance corporations' premium income declined in 2006 by ca 4%, year-on-year.

The structure of life insurance corporations' premium income changed in 2006. Premium income from guaranteed-return policies declined by more than a fifth, whereas premium income from unit-linked policies grew by nearly a fifth. The share of unit-linked policies in life-insurance corporations' total premium income was in 2006 for the first time higher than for guaranteed-return policies.

Despite the growth in unit-linked insurance policies, insurance corporations' insurance portfolio is still heavily focused on guaranteed-return policies. At the end of 2006, they accounted for more than 70% of life insurance corporations' total insurance portfolio.

Total premium income from pure risk policies and endowment insurance grew by over 2%. By contrast, premium income from personal pension plans declined by nearly 10%, year-on-year. Premium income from group life insurance also declined considerably, after robust growth in 2005. Despite the slower growth of premium income, life insurance savings increased by over 7%.

The structure of life insurers' investment portfolio (over EUR 28 bn) remained broadly unchanged in 2006. The proportion in bonds decreased and that in various types of mutual funds increased. The proportion in mutual fund investments increased also in non-life insurers' investment portfolio (over EUR 10 bn). Equity investments grew, but still account for only just over 10% of non-life insurers' total investments.

Average capital adequacy of the insurance sector remained fairly good in 2006. The average capital adequacy ratio fell, due eg to the fact that Suomi Mutual Life Assurance Company paid over EUR 300 million in supplementary benefits to its policyholders for the year 2006. The average capital adequacy of non-life insurers also fell slightly due eg to increased dividends. Employee pension insurers' average capital adequacy, by contrast, improved in 2006.[15]

The total results of employee pension insurers, ie result at fair values, fell to slightly over EUR 2.5 billion, from EUR 4.3 billion in 2005. Net investment income declined, due in particular to the rise in long-term interest rates. The decline in total results was also due to the rise in interest paid on technical provisions.

The operating environment of employee pension insurers changed on 1 January 2007 when the new Employees Pensions Act (TyEL) entered into force.

In the same context, legislation on employee pension insurers' assets vis-à-vis technical provisions and minimum capital adequacy calculations was revised. For example, classification of assets is now more clearly based on investment risks. In addition, minimum capital adequacy calculations and the covering of technical provisions will more effectively take account of the risks related to investments.

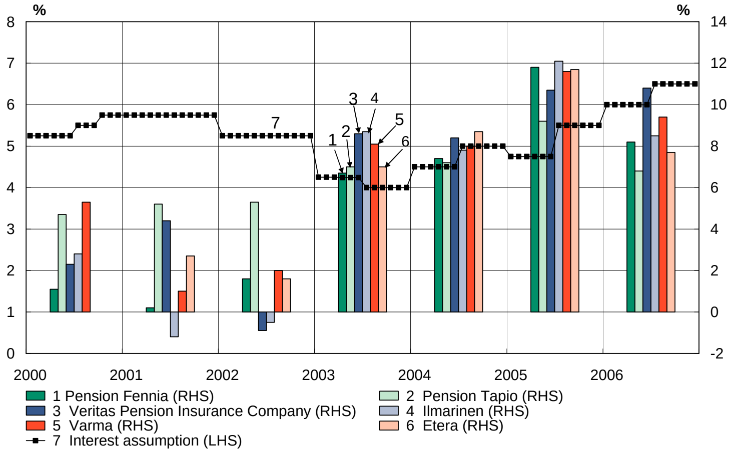
The new regulations on employee pension insurers' solvency margin and technical provisions are aimed at changing the funding principles and capital adequacy mechanism to enable employee pension insurers to increase the proportion of equity investments and seek higher returns on investment.

The focus of investment activities shifted already in 2006 to equity investments and various types of alternative investment outlets, such as hedge funds and venture capital and private equity investments.

Employee pension insurers' return on capital invested has in the long run exceeded the return requirements imposed by interest assumptions. Despite the brief dip a few years ago, employee pension insurers' average return on investment was in 1998–2006 over 7%. Return on investment differs across companies, mainly due to the weight of equity investment (Chart 3).

[15] Capital adequacy of insurance corporations and pension funds as at 31 December 2006. Insurance Supervisory Authority. Press release 1/2007.

Chart 3. Employee pension insurers' return on invested capital, %



Sources: Companies' annual reports and Finnish Centre for Pensions.

Employee pension insurers' stock of capital investments totalled EUR 2 billion at end-2006. A large proportion (over 70%) of the total was in outward (non-euro area) investments.

Investments in hedge funds have increased; the stock totalled EUR 3.5 billion at end-2006 and accounted for ca 3% of employee pension insurers' total investments

3 Securities markets

3.1 Nordic banks' ratings

Pertti Pylkkönen

Moody's revised its bank rating system, and the new ratings were issued in February. The reform engendered mixed reactions, and Moody's clarified the new rating system at the end of March.

One of the major credit rating agencies, Moody's, announced in February 2007 that it will introduce a new bank rating system, which it had been preparing for quite a long time. The new methodology combines the new bank financial strength rating (BFSR) method and the joint default analysis (JDA). Moody's introduced its previous bank financial strength rating system in 1995.

Moody's analysis is based on the BFSR rating. This involves evaluation of a bank's financial strength and risk-bearing capacity excluding outside support. The BFSR rating applies to a bank, not to the debt instruments that it issues or to its deposits. The BFSR does not directly measure the credit risk involved in a deposit or debt instrument. The grades (from best to worst) are A, B, C, D and E.

The joint default analysis involves the assessment of the probability that a bank will be able to timely repay its commitments, ie deposits and debt instruments. Domestic currency and foreign currency-denominated debt instruments are issued separate ratings. One key factor affecting the rating, in addition to the position of the bank, is the probability that it can obtain outside support to overcome its commitments.

In February, Moody's issued the first ratings based on the new system. Changes were made mainly in ratings based on the joint default analysis – essentially the ratings of debt instruments. The financial strength ratings (BFSR) of some banks were also reviewed. Nordic banks were included in the first group of new ratings issued. At the same time, new ratings were also issued for banks in the Benelux countries, Baltic countries and some Eastern-Central European countries.

In accordance with the new rating methodology, several Nordic banks' long-term senior bonds were given the best risk rating, Aaa. Nordea was the only Swedish bank whose rating was raised to the best category, whereas three Icelandic banks, Glitnir banki, Kautphing Bank and Landsbanki Islands were upgraded to the best category, Aaa. Of the Icelandic banks, the ratings of Glitnir bank and Kaupthing Bank were raised by four grades and that of Landsbanki Islands by a full five grades.

OKO, Nordea and Sampo Bank were also upgraded to the best category. Of the other Nordic banks, Danske Bank and DnB Nor Bank were also upgraded to the best category.

Moody's also downgraded the financial strength rating (BFSR) of some banks by one or two grades. In these revisions, attention is drawn also to the fact that eg the ratings of Nordea's subsidiaries vary across countries. Nordea Bank Finland's and Nordea Bank Sweden's ratings remained unchanged, at B, whereas the ratings of Nordea Bank Norge and Nordea Bank Danmark were lowered by one grade, to B-.

OKO's rating was lowered by two grades, to C+. The corresponding rating of OP Bank Goup is B. Sampo Bank's rating remained unchanged, at B- and Aktia's at C.

Icelandic banks' financial strength ratings were not lowered in this context. Moody's had already earlier revised Glitnir bank's and Kaupthing Bank's rating to C.

At the end of March, Moody's revised its joint default analysis, ie the system for issuing JDA ratings on deposits and senior bonds. Moody's reduced the weight of outside support and increased the weight of a bank's own financial position in the rating. Both factors affect the rating on a bank's deposits or senior bonds.

In April, Moody's lowered the debt ratings of several Nordic banks following the refinement of its bank rating methodology, which incorporates the JDA ratings. OKO, Nordea and Sampo Bank were downgraded from Aaa to Aa1. Also Danske Bank and DnB NOR Bank were downgraded from Aaa to Aa1. Skandinaviska Enskilda Banken's rating was lowered by one grade, to Aa2. Three Icelandic banks, Glitnir banki, Kaupthing Bank and Landsbanki Islands were downgraded to Aa3. Finnish Aktia Savings Bank was downgraded from Aa2 to A1.

3.2 STEP-by-STEP: transparency is improving in the European money market

Kristina Rantalainen

As from 2 April 2007, the ECB will publish on its website yield and market statistics on STEP-labelled short-term European paper. This in effect creates a new market.

The integration of markets for short-term debt securities with original maturity of up to one year has been lagging behind the integration of financial markets and capital markets in the euro area. Cross-border trading is hampered by country-specific settlement and market practices.

The Eurosystem aims to promote market transparency by publishing on the ECB website[16] daily data on short-term securities issued under STEP programmes[17]. The data include

- yields
- trading volumes
- pricing of new issues.

As of April, STEP notes will also be accepted as collateral for Eurosystem money market operations if they comply with all the eligibility criteria[18].

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[16] http://www.ecb.int/home/html/index.en.html

[17] Short Term European Paper.

[18] See 'The implementation of monetary policy in the euro area: general documentation on Eurosystem monetary policy instruments and procedures', Chapter 6: Eligible Assets. The European Investment Bank (EIB) will be the first to the take advantage of the eligibility of STEP issues. The bank announced a euro-denominated STEP programme (value EUR 15 bn) as at the start of April.

STEP markets refer to the trading of short-term debt securities in non-regulated markets in the European Union. The Eurosystem aims to foster the integration of European short-term money markets. The objective is to standardise market practices and increase market liquidity and transparency.

A STEP label can be applied for and obtained for programmes that comply with the requirements listed in the Convention drawn up by the European Banking Federation (EBF) and ACI - The Financial Markets Association[19]. The STEP Market Convention[20] lays down requirements for short-term paper programmes concerning eg:

- disclosure of information
- settlement of trades and settlement systems
- provision of data to the ECB for the production of statistics.

However, the Convention does not set requirements eg on issuer's credit rating or accuracy of information provided. STEP programmes are managed by the STEP Market Committee, comprising ten members appointed by representatives of ACI and EBF.

The day-to-day operations are handled by the STEP Secretariat, which grants the STEP label to money market programmes that comply with the requirements of the Convention. To obtain a STEP label, also the settlement procedures of a money market programme must fulfil certain criteria. The Finnish Central Securities Depository (APK) has been granted the status of STEP settlement system, along with nine other central securities depositories.

The STEP initiative[21] was launched by the ECB in 2001. Its development has been handled by the above-mentioned organisations, ACI and EBF.

The ECB and nine national central banks, including the Bank of Finland, support the STEP initiative by providing (until July 2008) technical assistance to the Secretariat regarding the STEP labelling process.

Table 5. STEP monthly outstanding amounts July-November 2006

EUR m

Currency	July	August	September	October	November
EUR	69 643	75 755	77 928	82 244	84 423
USD	170	445	2 436	2 985	2 896
GBP	86	58	458	642	971
JPY				49	48
CHF	288	344	200	214	291
Other			659	629	761
Total	70 187	76 602	81 682	86 763	89 390

Source: ECB securities issues statistics.

The first STEP notes were issued in July 2006. In practice, they can be issued under the legislation of any EU country and in any convertible currency. In November 2006, the outstanding amount of STEP notes was EUR 89.4 billion for 16 STEP-compliant programmes[22]. The majority of issues are euro-denominated, and the issuers are financial institutions[23]. Finnish issuers have not yet applied for a STEP label.

[19] The Financial Markets Association; an association for banks' foreign exchange and money market operations.

[20] For information on the STEP, see the STEP market website (www.stepmarket.org).

[21] See Harri Lahdenperä: 'Euroalueen rahamarkkinat kehittyvät – lyhytaikaisten arvopapereiden markkinat käynnistyvät', Euro & talous 4/2006 (in Finnish only).

[22] Euro Money Market Study 2006, February 2007.

[23] http://www.stepmarket.org/eca1.html

3.3 Streamlined processes provide competitive advantage in e-trading

Kristina Rantalainen

Systems development facilitates electronic trading of securities. Integration of post-trading services with the trading process will give a competitive edge to providers of trading platforms.

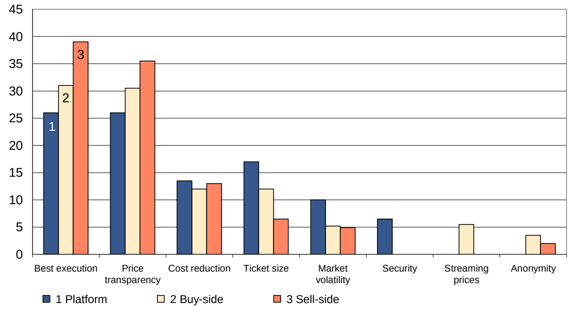
In connection with a conference arranged by SIFMA[24] in February 2007, a study[25] was published on the growth of electronic trading of debt securities. Intermediaries report a 32% increase in e-trading of debt securities in 2006. Trading volumes are anticipated to continue to increase, by 38% in 2007. The study also shows that just over half of European institutional investors currently execute over 60% of bond trades electronically. Only about 1% of investors reported that they do not trade electronically.

Data published by the ECB[26] on the development of euro area money markets in 2006 tell a similar story. Of repo transactions in the euro market, 49% were executed electronically, an increase of 6% on 2005. Growth is bolstered by the fact that repos are standardised products that can readily be traded electronically.

According to the ECB study, the leading platforms in Europe are BrokerTec[27], Eurex Repo and MTS. They all have invested in systems development and consider ease of integration with the customers' system environment to be a critical factor. According to estimates by the American research institute Tabb Group, intermediaries operating in the global financial markets will invest USD 970 million in 2007 in the development of electronic trading services[28] (compared to USD 350 million in 2003).

Electronic trading has increased at the expense of telephone trading. Studies show that 75 providers of electronic platforms are currently operating in the market. Market transparency and provision of best execution[29] were cited as the primary motivations for moving from telephone trading to electronic trading (Chart 4), followed by trading costs and ticket size.

Chart 4. Motivations of sell-side firms for choosing electronic trading instead of telephone trading



Source: SIFMA.

The development of systems and interfaces increase market participants' interest in electronic trading. We are moving towards an integrated trading process which includes investment decision, confirmation of trade, collateral management, settlement of trade, and

[24] Securities Industry and Financial Markets Association.

[25] 2nd Annual European Fixed Income e-Trading Survey (6 February 2007/James George, Director, Concise). For more information, see SIFMA website www.sifma.org

[26] Euro Money Market Study 2006, February 2007.

[27] BrokerTech merged with ICAP in May 2006.

[28] www.icap.com/pdf/e-trading: 'E-trading, the advantage, David Rutter, Deputy Chief Executive, ICAP Electronic Trading.

[29] The term 'best execution' was introduced in the Directive on Markets in Financial Instruments (MiFID). 'Best execution' can be considered to include the requirement for best market price, speed of execution of orders, and back office processing of trades.

risk management. In addition, the systems have properties that facilitate the work of investors and intermediaries. The properties include automatic messages in the event of changes in the market situation, alarms, and pop-up functions.

Depth of liquidity offered by the securities trading place is, as expected, the key reason for choosing a market place. Depth of liquidity was more important for intermediaries than for institutional investors (Table 6). Investors paid attention to costs and user-friendliness of the system. For intermediaries, the other main reason for choosing an electronic platform was the STP feature,[30] ie an automated trading process, from investment decision to settlement of trade and risk management, in which participants' positions are updated in real time. Electronic trading also provides a continuous audit trail, which benefits all participants.

Table 6. Reasons for choosing an electronic platform

Weighted reason	Platforms	Buy-side	Sell-side
Depth of liquidity	46.7	27.9	45.5
Ease of integration	10.0	5.7	4.6
STP functionality	6.7	7.1	15.2
Range of products	13.3	12.2	9.0
User friendly	6.7	16.7	10.6
Robust technology	3.3	9.0	4.6
Speed of execution	10.0	0.0	0.0
Market data provision	3.3	3.5	3.0
Trading fees	0.0	15.0	7.5
Research and analytics	0.0	1.4	0.0
Use of central counterparty	0.0	1.5	0.0

Source: SIFMA.

According to a survey published a year ago, robust technology and depth of liquidity were considered key reasons for choosing an electronic platform[31]. In the latest survey, respondents cited user-friendliness, trading fees and range of products as reasons for choosing an electronic platform.

The challenge for growth in electronic trading is the compatibility of external system platforms and internal risk management and back-office systems. The investment costs are high and the management of counterparty risk is more difficult[32].

The benefits of electronic trading are market transparency and quick execution time of orders. These benefits, however, cannot be achieved if the overall process is not functioning.

[30] Straight-Through Processing is the automated processing of transactions, with few manual stages as possible, from investment decision to settlement and accounting. Automation speeds up the execution of transactions and reduces operative risk.

[31] 2nd Annual European Fixed Income e-Trading Survey, Paragraph 3.6 'Reasons for choosing an electronic platform'.

[32] BIS: 'New developments in clearing and settlement arrangements for OTC derivatives', March 2007.

4 Infrastructure

4.1 Non-financial corporations lack knowledge of the Single Euro Payments Area

Jukka Vauhkonen

Finnish non-financial corporations are still not well informed about the Single Euro Payments Area, and most of them need more information. Those with knowledge of the Single Euro Payments Area reckon that it will have a positive impact on the quality of cross-border payment services that they use.

A report on the 2006 Survey on Business Finances by the Bank of Finland, Confederation of Finnish Industries and Ministry of Trade and Industry examines Finnish industrial and service businesses' knowledge of the Single Euro Payments Area (SEPA) and their preparations for the necessary system changes. The survey was conducted in September–October 2006.

The European Commission's objective is to create a Europe-wide domestic market for payments in which banks provide consumers and companies with uniform payment services and in which the execution time for payment transfers is the same throughout the area. European banks have been developing uniform payment services, ie SEPA services, the first of which will be introduced in 2008. SEPA services to be available in the first phase of the project are credit transfer, direct debit and card payments[33]. SEPA services differ slightly from Finnish banks' current payment services. But the banks intend to extend the range of SEPA services to maintain the current level of services. SEPA services will mainly affect consumers' and companies' cross-border payments.

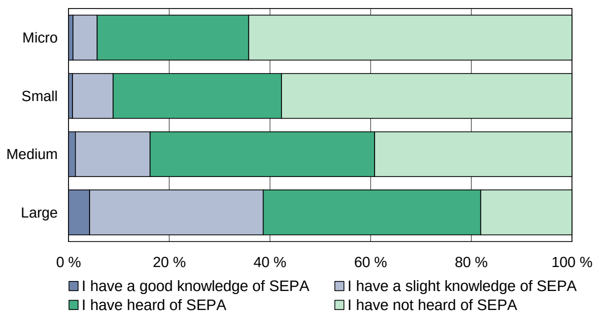
The report on the 2006 Survey on Business Finances examines separately the responses of industrial and service companies. In addition, the companies are divided into micro, small, medium and large companies, based on the number of staff. Industrial and service companies' responses to questions concerning the Single Euro Payments Area differ only slightly, and therefore the companies are examined as a single group. By contrast, the responses of different-sized companies differ considerably.

The survey shows that companies' knowledge of the Single Euro Payments Area is fairly limited. Less than 20% of respondents stated that they have at least a fair knowledge of the Single Euro Payments Area. Less than 40% of the companies had heard of it. Over 40% of all the companies and over 60% of the micro

[33] For more information, see eg the Federation of Finnish Financial Services' website http://www.fkl.fi/asp/system/empty.asp?P=2607&VID=default&SID=519148748246874&S=2&A=closeall&C=27616

and small companies had not even heard of the Single Euro Payments Area (Chart 5). Nearly half of the companies hoped for more information. Over a third of the companies desired for more information on banks' SEPA services and on system amendments required by the Single Euro Payments Area. About a fourth of the companies hoped for more information on the SEPA migration timetable. Companies would want particularly banks and authorities to provide additional information.

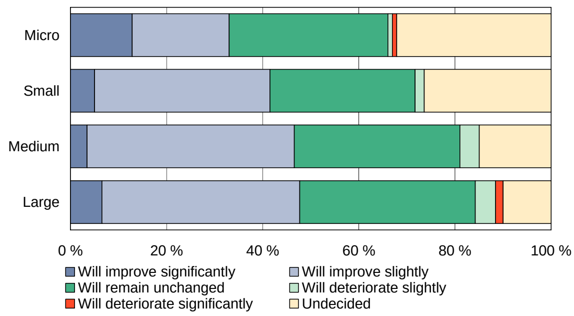
Chart 5. Which of the following statements best describes your knowledge of the Single Euro Payments Area?



Source: 2006 Survey on Business Finances.

The majority of companies with knowledge of the Single Euro Payments Area assessed that it will have a positive impact on the quality of the cross-border payment services that they use (Chart 6). About half of the respondents believe that the quality of cross-border payment services will improve either significantly or at least slightly. Only a negligible percentage of companies estimated that the quality of services will deteriorate.

Chart 6. How will the quality of payment services used by your company change as a result of SEPA?



Source: 2006 Survey on Business Finances.

Only a small proportion of the companies have started preparing for the system changes required by the Single Euro Payments Area. Over a fifth of the large companies and over 5% of the other companies had started preparations in September–October 2006, at the time of the survey. Less than 30% of the companies stated that they will start preparations in 2007 and ca 10% later. Nearly 60% of the companies could not say when they would start preparing for SEPA.

4.2 TARGET2-Securities project moves ahead

Kristina Rantalainen

The Eurosystem's initiative for improving the efficiency of settlement services for securities transactions is moving to the next phase – the specification of user requirements. The common technical platform will be based on the TARGET2 payment system solution.

TARGET2-Securities (T2S) is a Eurosystem initiative for harmonising the post-trading functions of securities transactions and for building a common platform for central banks, financial institutions and central securities depositories to settle securities transactions in central bank money. Custody services and other related tasks will continue to be provided by central securities depositories.

In March 2007, the Governing Council of the ECB took a decision[34] to go ahead with the next phase of the T2S project and to utilise in its implementation the technical platform of the TARGET2 payment system. The Governing Council's decision is based on feasibility studies[35] and consultations with authorities and market participants (central securities depositories, banks, intermediaries).

The main reason for using the TARGET2 platform is cost savings. The Governing Council has decided to exploit the existing technical solutions and experience gained in the development of the TARGET2 payment system. Constructing the T2S on an existing platform will bring synergies. Payments in connection with securities transactions, liquidity management, collateral management, and transfer of ownership will take place on a common platform.

The objective of the T2S initiative is to promote harmonisation of securities settlement and cost-effectiveness in the Eurosystem. The securities market is fragmented and inefficient, which is reflected in the costliness and slowness of post-trading functions, compared to the United States.

Fragmentation and inefficiency are due to several factors. Fees levied for settlement of securities transactions differ considerably across countries and pricing is not transparent. Market practices and legislation are largely local. The settlement of cross-border securities transactions is complicated and settlement costs rise with every intermediary: for example, a bank settling a cross-border securities transaction has to be a member of the central securities depository of the country in which the security was issued, or pay another operator for the service.

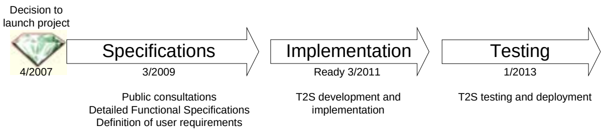
The scope and contents of the T2S project have not yet been defined; this is to be done in 2007, in cooperation with market participants. The aim is to

- find a solution for governance and organisation of the implementation project
- define user requirements
- prepare business specifications.

The ECB estimates that T2S will be fully operational in 2013 (Chart 7). The development phase is likely to start in early 2008.

[34] http://www.ecb.int/press/pr/date/2007/html/pr070308_2.en.html
[35] Studies that formed the basis for the decision are available on the ECB's website (http://www.ecb.int/paym/market/secmar/integr/html/nextphase.en.html)

Chart 7. Target2-Securities project timeframe



In addition to the ECB, also other EU authorities[36] are supporting the T2S project.

Market participants – mainly large banks – are cautiously positive about the project. Central securities depositories and intermediaries have been the most critical. ECB has been criticised for monopolising the securities settlement business.

Open issues remain to be solved before a final decision can be taken and the implementation phase can begin. For example, the following issues have been raised:

- acceptance of currencies other than the euro as settlement currency
- the role of clearing houses located outside the Eurosystem and their possibilities to settle securities transactions in central bank money.

With the aim of resolving these issues in 2007, consultations are to be held with the market participants.

[36] Draft Council conclusion on clearing and settlement (TARGET2-Securities project).

5 Key regulatory and supervisory initiatives

5.1 ECOFIN Council adopts Payment Services Directive

Risto Koponen

The Payment Services Directive harmonises EU legislation on payments and eg creates a new category of payment services provider, ie the payment institution. Due to its wide scope, the Directive will affect nearly all forms of payment and thus also consumers, companies, and providers of payment services. The ECOFIN Council adopted the Directive at the end of March, and the European Parliament will vote on it in April.

In December 2005, the European Commission issued a proposal for a Directive on payment services in the internal market.[37] The main objective of the Directive is to create a common legislative framework for the payments market and so to promote the creation of a Single Euro Payments Area (SEPA) and competition by offering more choices for users of payment services and by improving the safety and efficiency of payment services.

The Directive will apply to nearly all types of payments and payment instruments, and to both domestic and cross-border payments in the EU. It will not cover eg certain paper-based means of payment such as cash or cheques or certain special payment services (eg some payment services offered by telecommunications operators). The Directive also specifies the entities that have the right to provide EU-wide payment services. These include traditional credit institutions, electronic money institutions, payment institutions (new category), and post office giro institutions that are entitled under national law to provide payment services.

The main contents of the Directive can be divided into three parts: i) information requirements for payers and providers of payment services; ii) rights and obligations of payers, payees and providers of payment services; and iiii) regulatory framework for payment institutions.

[37] Implementing the Community Lisbon programme: Proposal for a Directive of the European Parliament and of the Council on payment services in the internal market and amending Directives 97/7/EC, 2000/12/EC and 2002/65/EC {SEK(2005) 1535} /* COM/2005/603 final - COD 2005/0245 */

Information requirements specify the information that must be provided with payments. This includes a unique identifier (eg account number), payment transaction fee, and maximum execution time. Regulations on rights and obligations define the liability of the payment service provider in the event of inaccurate execution of a payment order. Under the regulations, the maximum execution time for a payment in the EU (including cross-border payments) is one day. However, up to 2012, a payer and his payment service provider may agree on an execution time of up to three days. The regulatory framework for payment institutions includes eg regulations on capital requirements and types of services they can provide (they may not eg take deposits).

The Economic and Financial Affairs Council (ECOFIN) of EU finance ministers adopted a general approach on the proposal for a directive on payment services in its meeting on 27 March 2007. The European Parliament will vote the proposal for a directive in its plenary session on 22 to 26 April. If the Parliament adopts the proposal for a directive, the directive is in practice adopted. ECOFIN must nevertheless still officially adopt the technically revised Directive. The Directive shall be transposed into national legislation by 1 November 2009.

6 Key corporate arrangements and events in the financial sector

Date	***Event and description***
June 2006	*OMX launches the First North marketplace in Stockholm.*
	The French group Axa announces it will acquire Winterthur, an insurance corporation owned by Credit Suisse.
	OP Bank Group and Kesko Corporation start cooperation in the development of payment cards.
	Nordea sells its stake in the Russian bank International Moscow Bank to HypoVereinsbank, a German subsidiary of Unicredit.
July 2006	*Spanish stock exchanges listed on the Madrid Stock Exchange.*
August 2006	*Sampo Bank plc concludes acquisition of Profibank, a bank based in St. Petersburg.*
	Banca Intesa announces it will acquire Sanpaolo IMI.
	The Finnish Bankers' Association and the Federation of Finnish Insurance Companies to merge at the start of the year 2007.
September 2006	*Nationwide Building Society and Portman Building Society announce their decision to merge.*
	OMX and the Icelandic stock exchanges announce the signing of a letter of intent on the acquisition of the Icelandic Stock Exchange by OMX.
	Helsinki Stock Exchange adopts round lot 1 trading.
	S&P's revises its outlook on OKO Bank plc from negative to stable. Short-term rating is A1+ and long-term AA-.
	Fitch Ratings rates Teollisuuden Voima Oyj for the first time. Ratings: short-term F2 and long-term A-.
	Moody's upgrades Metso's long-term rating from Ba1 to Baa3.

Date	*Event and description*
	Nordea will apply for a banking licence in China to open a branch in Shanghai.
October 2006	*OMX launches Nordic List.*
	Chicago Mercantile Exchange Holdings Inc. and CBOT Holdings Inc. announce agreement to merge.
	French company AXA announces agreement with the Greek Alpha Bank, to acquire its insurance subsidiary Alpha Insurance.
	Banca Popolare di Verona e Novara announces it will acquire Banca Popolare Italiana for EUR 8.2 billion, to create the fourth largest bank in Italy.
	Tapiola Bank and Bank of Åland announce they will establish a new payment card company.
November 2006	*Sampo Group announces it will sell all the companies that are part of Sampo Bank Group to Danske Bank, for EUR 4.05 billion.*
	Aktia annouces it will acquire Veritas Life Insurance Company Ltd and an 80% stake in Oy Fondex AB (Rahastotori Oy).
	Nordea announces it will acquire a 75% stake in the Russian bank JSB Orgresbanki, for USD 313.7 million.
	Icelandic Stock Exchange and Icelandic Securities Depository (ISD) are sold to OMX.
	Bank of America announces agreement to acquire U.S Trust Corporation from The Charles Schwab Corporation for USD 3.3 billion.
	Fitch and S&P confirm ratings for Finnish government bonds: Fitch: F1+ and AAA; S&P: A-1+/AAA.
	S&P upgrades Elisa Plc's short-term rating from A-3 to A-2.
	Moody's downgrades Stora Enso's ratings: short-term from P2 to P3 and long-term from Baa2 to Baa3.
	OMX finalises acquisition of Icelandic Stock Exchange (ICEX) and Icelandic Securities Depository (ISD).
December 2006	*NYSE Group and Euronext shareholders approve merger agreement.*
	Iceland's alternative marketplace ISEC to merge with First North in April 2007.

Date	***Event and description***
	eQ Corporation and owners of investment firm Fides agree on a transaction in which eQ Bank purchases Fides' share capital for EUR 6.4 million.
	If P&C Insurance Holdings Ltd is granted a licence to start non-life insurance operations in Russia. If has had a representative office in St Petersburg since 1995.
	Confederation of Finnish Industries, Helsinki Stock Exchange and the Central Chamber of Commerce of Finland establish the Securities Market Association.
	Pohjola Group Ltd merges with its parent company OKO Bank plc at the end of the year. Pohjola Non-Life Insurance Company Ltd, A-Insurance Ltd, Eurooppalainen Insurance Company Ltd, and the Sesam non-life insurance companies operating in the Baltic states continue operations as subsidiaries of OKO Bank.
January 2007	*Pohjola Non-Life Insurance Company Ltd merges with OP Life Assurance Company Ltd at the start of 2007.*
	Sampo Life merged its subsidiaries operating in the Baltic states into one company, SE Sampo Life Insurance Baltic. The company's domicile is Estonia.
	FIM Group announces plans to start retail banking operations.
February 2007	*The Swedish bank Swedbank announces it will acquire the Ukrainian bank TAS-Kommerzbank for slightly over USD 700 million.*
	FIM Group Corporation's main shareholders announce they will sell their 68.1% holding of the share capital to the Icelandic bank Glitnir banki hf. The transaction was finalised in March.
	Acquisition of Sampo Bank by Danske Bank Group was completed at the beginning of the month. S&P raises the bank's short-term issuer rating from A-1 to A-1+, and long-term issuer rating from A to *AA-. Moody's raises the bank's long-term issuer rating from A1* to *Aa2.*
	Moody's revises its bank rating methodology. As a result, Moody's upgrades OKO Bank's and Sampo Bank's long-term credit rating from Aa2 to Aaa. Nordea's (incl. Nordea Bank Finland) long-term credit rating is raised from Aa3 to Aaa. Aktia's short-term credit rating is upgraded from P-2 to P-1 and long-term rating from A3 to Aa2.
March 2007	*The Oslo Stock Exchange and the Norwegian central securities depository VPS plan to merge.*
	Policyholder's of Kansa life insurance corporation to receive full compensation plus interest for their insurance premiums in 2007.

Date	***Event and description***
	Barclays and ABN Amro confirm that they are negotiating on a merger. *Moody's downgrades M-Real's long-term credit rating from B2* to *B3, rating outlook stable. Also S&P lowers M-Real's long-term credit rating, from B+* to *B, rating outlook remains negative.*