# Financial Market Report

# 3 • 2005

- Rapid growth in bank loans to non-financial corporations – more sluggish growth in total stock of corporate credit
- Banks' cost-efficiency improved
- Insurance corporations' profitability and capital adequacy good
- Share prices increasing rapidly in energy and metal industries
- TARGET2 creates challenges for both new and old member states


Bank of Finland

Financial Markets and Statistics

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# 1 Financial intermediation

## 1.1 Rapid growth in non-financial corporations' stock of bank credit

**Pertti Pylkkönen**

**The stock of bank loans obtained by non-financial corporations has been growing at a rate of almost 10%, whereas growth of the total stock of corporate credit is sluggish and the volume of corporate credit from abroad has started to decline. The stock of credit of housing corporations is expanding much faster than that of the rest of the corporate sector.**

At the end of June 2005, the non-financial corporate sectors' stock of domestic credit totalled EUR 57.3 billion[1]. The credit stock grew by just over 3% from the previous year. Private non-financial corporations' domestic credit stock grew less than 5% while that of public non-financial corporations decreased by almost 10%. By contrast, the stock of credit of housing corporations grew rapidly, by nearly 6%. In the course of the year, the stock of corporate credit from abroad declined by 6%, to EUR 33 billion. In June 2005, the corporate stock of foreign and domestic credit (excl. housing corporations) declined slightly.

[1] Outstanding credit 2005, Q2.

Deposit banks' position as lenders to private non-financial corporations has strengthened further. In June 2005, banks' share of private non-financial corporations' domestic borrowing totalled nearly 72%, and the rate of growth of bank loans was nearly 10%. Second quarter growth of bank loans to non-financial corporations was virtually unchanged from the previous quarter[2]. Besides bank loans, only the stock of credit drawn from the private sector (excl. employee pension funds) increased slightly. The stock of credit from the public sector is, however, small, accounting for about 3% of the stock of domestic corporate credit. The stock of lending to private non-financial corporations by other lenders such as insurance corporations and employee pension funds has decreased by about 10% in 12 months and continued to decrease in the second quarter.

In the insurance sector, interest rates on loans are clearly higher than those of floating-rate corporate loans granted by banks. The volume of traditional lending in the insurance sector, based on promissory notes, is currently very modest.

The basis of calculation of employee pension insurers' so-called investment loans was changed as of the beginning of August. In practice this means giving up the 3% lower limit for the reference rate on new investment loans. The change improves the competitive position of investment loans relative to

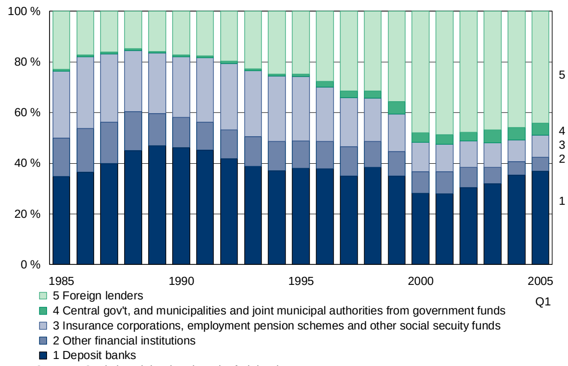
[2] Bank of Finland. Statistical Review 9/2005. Financial Markets.

bank loans. Currently, investment loans are drawn mainly by SMEs, whose financing costs will slightly decrease as a result.

Credit statistics show that the growth rate of the stock of lending to housing corporations (included in the non-financial corporate sector) is currently much higher than that of the stock of lending to the conventional non-financial corporate sector. The current situation in the housing market – strong demand combined with an increasing need to renovate old dwellings – will maintain housing corporations' demand for credit.

Of lending to housing corporations, almost half has been granted by the public sector (excl. employee pension funds), mainly by central government, and also by municipalities. At the end of June 2005, banks accounted for about a third of the stock of lending to housing corporations. The rate of growth of bank lending to housing corporations has, however, increased rapidly due to low interest rates; in June 2005, it was 17%. Moreover, banks' share of lending to housing corporations is increasing.

### Chart 1. Breakdown of corporate debt




Sources: Statistics Finland and Bank of Finland.

# 2 Banks and insurance corporations

## 2.1 Banks' cost-efficiency improved

**Mervi Toivanen**

**Cost-efficiency improved in nearly all banks operating in Finland. Banks' income-expense ratio decreased as a result of increased income and moderate developments in expenses. Banks' operating profits were also improved by the reversal of impairment losses.**

In January–June 2005, the total operating profits of Finnish banking groups[3] grew by 5% (to EUR 510 million) compared to the corresponding period of 2004 (Table 1). Only Evli Group and eQ Bank posted decreases in operating profit. Banks' results were boosted by increased income and the moderate development of expenses. Moreover, banks' impairment losses have remained very low or banks have continued to record reversals of previously booked losses. The results of financial conglomerates operating in Finland[4] have also been boosted by the life and non-life insurance businesses' healthy operating profits. Comparability of financial conglomerates' total operating profits is nevertheless slightly impaired by Sampo Group's structural change.

Of banks' income, particularly net interest income and net fee income have improved. Net interest income has been boosted by an increase in lending stock, which offsets the negative impact of other factors (eg shrinking margins). Banks' net fee income has increased mainly in lending, asset management, mutual funds and investment products-related operations. The increased popularity of mutual funds as investment objects is also reflected in the increase in net subscriptions in mutual funds. In January–August, net subscriptions in domestic funds totalled EUR 6.8 billion[5]. Because the majority of domestic funds belong to banking groups, fees on net subscriptions and other administrative fees are included in fee income of the banking groups.

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[3] Finnish banking groups: savings banks, Aktia Savings Bank Plc Group, local cooperative banks, Bank of Åland plc Group, Evli Group, eQ Online Group, OP Bank Group, and Sampo Group banking and investment services.

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

[5] The Finnish Association of Mutual Funds' Mutual Fund Report (September 2005), Financial Market Report, Annex 3/2005, Chart 33.

Growth of staff expenses increased banks' total expenses. The increase in staff expenses was mainly due to rising wages, costs related to staff incentive schemes, and an increase in the number of staff. Banks' efforts have thus focused on reducing other expenses.

The growth of income and the curbing of expenses have improved the cost-efficiency (measured by the income-expense ratio) of the majority of banks. In addition, banks' capital adequacy ratios remained high on average.

## Table 1. Banks' income statement items and other key data, Jan–June 2005

| | Net interest income, EUR m | | Other income, EUR m | | Total expenses, EUR m | | Operating profit, EUR m | | Expenses, % of income | | Capital adequacy, % 30.6.2005 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1-6 2005 | Change % | 1-6 2005 | Change % | 1-6 2005 | Change % | 1-6 2005 | Change % | 1-6 2005 | 1-6 2004 | Tier 1 capital | Tier 1 + Tier 2 capital |
| Nordea Group | 1 810 | 6.5 % | 1 471 | -9.8 % | 1 816 | 0.3 % | 1 572 | 6.1 % | 55 | 60 | 7.0 | 9.4 |
| *Nordea Group, retail banking | 1 491 | 4.1 % | 761 | 7.3 % | 1 266 | 0.4 % | 1 049 | 20.7 % | 55 | 59 | - | - |
| *Nordea retail banking in Finland | 401 | - | 188 | - | 303 | - | 285 | - | 51 | - | - | - |
| *Nordea Bank Finland Group | 596 | 5.9 % | 343 | 22.1 % | 433 | -1.6 % | 488 | 27.1 % | 47 | 54 | 17.6 | 20.1 |
| Sampo Group | 150 | -3.8 % | 2 837 | 71.9 % | 2 360 | 68.8 % | 630 | 51.1 % | - | - | - | 196.5 |
| *Sampo Group banking and investment services | 165 | 3.1 % | 173 | 2.4 % | 209 | 5.0 % | 136 | -0.7 % | 67 | 64 | - | - |
| *Sampo Group, insurance business | - | - | - | - | - | - | 519 | - | - | - | - | - |
| *SampoBank Group | 165 | 9.3 % | 142 | 4.4 % | 196 | 4.3 % | 119 | 9.2 % | 65 | 67 | 6.7 | 9.9 |
| OP Bank Group | 394 | 5.6 % | 282 | 3.7 % | 382 | 3.0 % | 293 | 6.5 % | 53 | 54 | 14.0 | 15.6 |
| *OKO Bank Consolidated | 78 | 8.3 % | 74 | 10.4 % | 76 | 10.1 % | 75 | 7.1 % | 50 | 51 | 7.8 | 11.0 |
| Savings banks (excl. Aktia) Total | 56 | 4.3 % | 24 | 11.5 % | 52 | 1.0 % | 29 | 20.7 % | 65 | 69 | 16.1 | 18.3 |
| Aktia Savings Bank plc Group | 39 | 9.6 % | 21 | 0.0 % | 38 | -0.8 % | 21 | 22.3 % | 63 | 68 | 9.4 | 14.5 |
| Local cooperative banks | 38 | 4.7 % | 12 | 1.7 % | 34 | 0.6 % | 16 | 14.2 % | 68 | 71 | 19.7 | 19.7 |
| Bank of Åland plc (Group) | 15 | 5.5 % | 11 | 10.2 % | 17 | 6.1 % | 9 | 20.5 % | 66 | 68 | 7.3 | 11.7 |
| Evli Group | 0 | -68.8 % | 28 | -10.9 % | 25 | 5.1 % | 4 | -50.3 % | 91 | 77 | 16.1 | 16.1 |
| eQ Online Group | 2 | 25.4 % | 13 | 38.4 % | 13 | 52.2 % | 2 | -20.3 % | 91 | 83 | 20.2 | 20.2 |
| 1. Finnish banking groups (excl. Nordea) | 708 | 5.0 % | 563 | 3.3 % | 769 | 3.8 % | 510 | 5.1 % | | | | |
| 2. Finnish banking business | 1 109 | - | 751 | - | 1 072 | - | 795 | - | | | | |
| 3. Financial conglomerates operating in Finland | 2 503 | 5.6 % | 4 698 | 28.5 % | 4 736 | 26.3 % | 2 576 | 14.7 % | | | | |

Other income includes net fee income, profit and loss on sales of tangible and intangible assets, and shares of profit/losses of associated companies.
Total expenses include write-downs and depreciations on tangible and intangible assets.
The items of the table do not add up to the operating profit, as not all the banks' income statement items are included.
The change % was calculated on the corresponding figures for 2004.
Sampo Group's capital adequacy ratio has been calculated by the consolidation method. The capital adequacy ratio shows the ratio of the Group's own funds to total claims calculated sector by sector.

Finnish banking business includes the Finnish banking groups, Sammo Group banking and investment services, and Nordea retail banking Finland.
Financial conglomerates operating in Finland include the Finnish banking groups, Sampo group and Nordea group.

Source: Banks' interim reports.

## 2.2 Positive financial performance in the international banking sector

Sampo Alhonsuo – Jyrki Haajanen

**Financial statements for the first half of the year indicate that the outlook for the international banking sector is good. In the Nordic countries and Europe, performance was boosted by the favourable development of returns and an increase in business volumes, combined with low loan losses. Also in the United States, Japan and China banks continue to earn good profits and post rapid growth. The performance level for 2004 should be exceeded clearly if banks' performance continues unchanged for the remainder of the year.**

Banking and financial groups' improved results for 2005 can be explained by three factors: 1) the increase in lending stock has boosted the growth of net interest income, 2) the development of other income has been favourable due to eg banks' good performance in the capital markets, and 3) loan losses have generally been very low. These factors have an impact on the financial performance of banking groups in the Nordic and Baltic countries as well as in euro area countries and other European countries. In the first half of the year, the effect of lower expenses on financial performance was not as pronounced as a year earlier. Nevertheless, the groups are continuously aiming to improve efficiency.

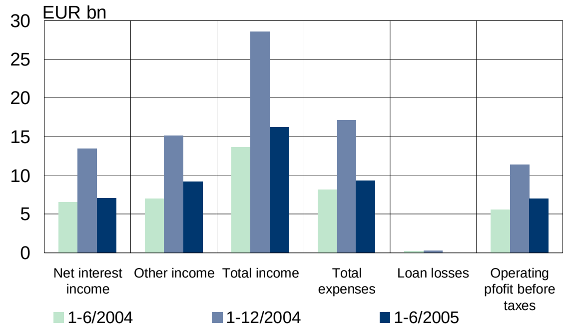
The total pre-tax results of the largest **Nordic and Baltic** banking and financial groups[6] totalled EUR 7.0 billion in January–June 2005. Results improved by 25% on the year-earlier period (Chart 2). Banks' net interest income has increased, due to the fact that the tight pricing competition and the narrowing of interest rate margins were compensated by an increase in business volumes. Banks' other income has also improved as a result of favourable developments in the capital markets and growth of business volumes.

Financial performance, as well as expenses and business volumes, have also been boosted by the expansion of some groups (Danske Bank, Kaupthing Bank and Sampo Group) through acquisitions.

Loan losses were nill in the first half of 2005. In a few groups, the amount of loan loss recoveries was higher than that of new loan losses recorded.

[6] The data covers the 10 largest Nordic banking and financial groups (order of magnitude based on balance sheet totals): Danske Bank, Nordea, SEB Group, Svenska Handelsbanken, DnBNOR Group, FöreningsSparbanken (Swedbank), OP Bank Group, Sampo Group, Kaupthing Bank, and Jyske Bank. The cross-sectional chart also includes Hansabank, Uhispank, and Nordea Bank Finland Plc. All the data is group-level. The figures have been converted into euro at 30 June 2005 exchange rates. The data are derived from interim reports published in August. The new interim results and reference data were prepared in accordance with the new International Financial Reporting Standards (IFRS).

## Chart 2. Main income statement items of large Nordic financial groups

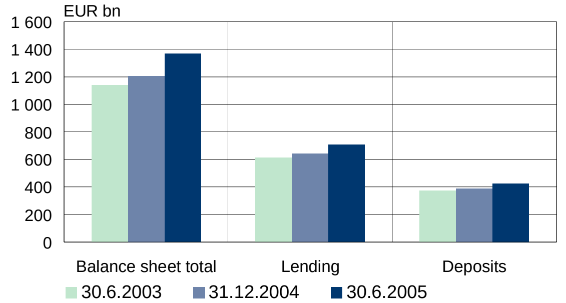



Source: Banks' interim statements.

The balance sheets of all the Nordic and Baltic banking and financial groups have grown rapidly. Growth has been strong particularly in the Baltic countries.

The stock of lending in the balance sheets of large Nordic banking groups currently totals over EUR 700 billion and the stock of deposits is over EUR 420 billion. This higher lending stock is financed ultimately via the international financial markets.

## Chart 3. Balance sheet items of large Nordic financial groups




Source: Banks' interim reports.

The key financial ratios of Nordic (and Baltic) financial groups are good or excellent. Both profitability and efficiency ratios have improved. The capital adequacy of large groups worsened slightly in the first half of 2005 on average (Table 2).

## Table 2. Key figures for Nordic and Baltic financial groups

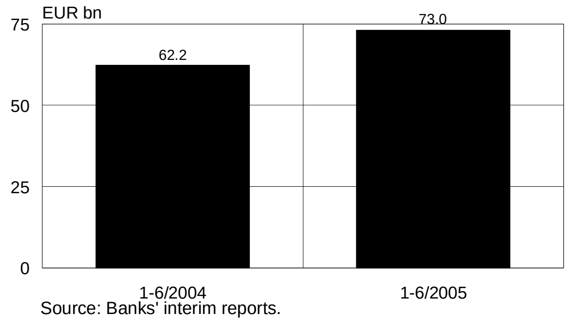
| Averages | 1-6 2004 | 1-12 2004 | 1-6 2005 | Range 1-6/2005 |
|---|---|---|---|---|
| **Profitability: ROE %** | **18.2** | **17.8** | **20.4** | (6.1 - 36.1) |
| **Efficiency: income/expense, %** | **54.2** | **54.1** | **50.4** | (30.3. - 64.2) |
| **Capital adequacy, % Tier 1*** | **10.1** | **10.1** | **9.4** | (5.8 - 17.6) |

***At end of period.**
**Source: Banks' interim reports.**

**Also in the euro area, United Kingdom, and Switzerland,** the results of the largest financial groups grew in the first half of the year. Chart 4 shows combined pre-tax results of 27 European groups[7]. Pre-tax results have grown by 18% year-on-year. The results for 2004 were already good, but if the performance of financial groups stays on its current level, the results will be better in 2005.

[7] Chart 4 and Table 3 includes data on the following European groups (order of magnitude based on balance sheet totals): UBS Group, Barclays, HSBC Group, BNP Paribas Group, RBS Group, ING Group, Credit Agricole S.A., Deutsche Bank, ABN AMRO Group, Credit Suisse Group, HBOS Group, SCH Group, Fortis Group, Societe Generale Group, Rabobank Group, Dresdner Group, HVB Group, lloyds TSB Group, Commerzbank Group, Dexia Bank, BBVA Group, Abbey National Group, Unicredito Group, Banca Intesa Group, Bank Austria Creditanstalt Group, Erste Group, and AIB Group. The data are derived from groups' interim reports published in August–September 2005. The new interim results and reference data were prepared in accordance with the new International Financial Reporting Standards (IFRS). The items compiled from groups' results are as similar as possible, representing pre-tax results.

Chart 4. Combined pre-tax results of large European financial groups



Source: Banks' interim reports.

The table shows clearly that the key figures of large groups are good on average.

Table 3. Key figures for large European financial groups

| | 1-6/2004 | 1-6/2005 | Range 1-6/2005 |
|---|---|---|---|
| Profitability: ROE % | 18.8 | 20.4 | (9.6 - 33.3) |
| Efficiency: income/expense, | 61.3 | 59.8 | (41.8 - 73.0) |
| Capital adequacy, % Tier 1* | 8.3 | 8.2 | (6.5 - 12.2) |

*At end of period.
Source: Banks' interim reports.

**In the United States,** the performance of large banks has remained good throughout 2005. Their income has developed favourably, and they have maintained tight control over expenses, while the number of recorded loan losses has been very low. In relation to the stock of lending, loan loss provisions were at their lowest level since 1986[8].

In the second quarter, other records were also achieved. Growth of lending stock was the second fastest ever in the United States. Variable-rate housing loans of large commercial banks, in particular, have grown rapidly in recent quarters. Banks' lending-to-deposits ratio has increased rapidly. For example, the lending-to-deposits ratio of credit institutions insured by the Federal Deposit Insurance Corporation (FDIC) increased to 92.7% in the second quarter, ie to its highest level since early 2001.

**In the Japanese** banking sector, the start of the financial year (on 1 April 2005) was promising, and the results for the first quarter were good. All the seven major banking groups posted positive results and the combined income of the sector increased by over 60% year-on-year. The increase in productivity was mainly due to lower loan losses and an increase in fee income. The decrease in lending stock seems to be coming to a halt. Raising net interest income will nevertheless be difficult due to tight competition. The decline in loan losses and non-performing loans was mainly due to the improved balance in the economy. In April, bankruptcies of non-financial corporations decreased by nearly 14%. This was the 28th consecutive month of continuous decrease in such bankruptcies. Tight competition in lending has led banks to actively develop their fee income-based products and to focus increasingly on retail banking. The share of fee income in banks' total income is nevertheless still fairly low (15–20%) compared to eg American banks (40%).

The Japanese parliament rejected Prime Minister Koizumi's plan to privatise the Japanese post office system. If Mr Koizumi's plan had materialised it would have created one of the biggest banks in the world, with savings and insurance deposits accrued totalling close to USD 2,900 billion.

**The Chinese** banking sector has recently been very profitable. But the high profits are largely artificial, due to massive government subsidies. The banking sector is not yet expected to be able to operate profitably without government subsidies. The Chinese government has had to subsidise both the Bank of China and the China Construction Bank, by over USD 20 billion each. Also the Industrial and Commercial

[8] Federal Deposit Insurance Corporation, Quarterly Banking Profile, 2005 Q2, and Federal Reserve Report on the condition of the U.S: banking industry, Bulletin, Spring 2005.

Bank of China has received government subsidies worth over USD 15 billion. The objective of these measures is to make the banks competitive by the end of 2006, when the restrictions on foreign banking competition are to be removed.

Many large foreign banks have expressed an interest in the Chinese banking sector. In August, the Royal Bank of Scotland Group PLC announced that it is heading a group that will buy a 10% stake in Bank of China, the largest bank in China, for USD 3 billion. This was the third time within a short period of time when a foreign group of banks has announced that it will buy a share of a Chinese bank. Earlier the Bank of America and Singapore Temasek announced that they will acquire a significant stake in the China Construction Bank. Foreign banks have also established branch offices in China.

## 2.3 Good performance and solid capital adequacy on average in the insurance sector

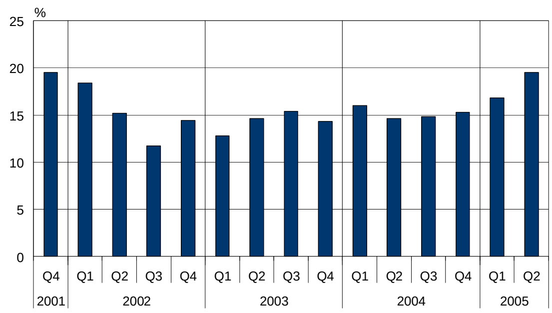
### Pertti Pylkkönen

**The financial performance of most companies in the insurance sector has remained good. Total capital adequacy of the sector has improved in the first half of the year. Pension insurers' overall performance has improved notably.**

Performance in the insurance sector, as in the other parts of the financial sector, was good in the first half of the year. Financial statements show that the results of the majority of insurance corporations have either improved or remained at the same, fairly good, level.

Good financial performance has contributed to the high capital adequacy of insurance corporations, which is high by European standards. The insurance sector's average capital adequacy has improved markedly in the first half of the year[9].

Chart 5. Life insurers' solvency ratio




Source: Insurance Supervisory Authority.

Performance has been boosted mainly by the fairly stable investment environment. Net investment income remained good on average. Performance was supported also by robust growth of premium income. The performance of life insurers however, varies considerably, depending eg on the investment portfolio. The upward trend in the performance of most non-life insurers was slowed by an increase in claims expenditure. On the other hand, non-life insurers have been able to improve the efficiency of operations. Moreover, their expense ratio has improved slightly on average. Growth in the overall result of employee pension insurers has been robust. Their overall result totalled nearly EUR 0.7 billion in the first half of 2004. The result for the corresponding period in 2005 was over EUR 2.3 billion, which exceeds the result of over EUR 2 billion for all of 2004.

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[9] Source: Report by the Insurance Supervisory Authority on the capital adequacy of insurance corporations, pension foundations and pension funds, 30 June 2005.

The growth of employee pension insurers' premium income has been brisk in 2005, totalling some 10% in January–June. The premium income of life insurers grew significantly faster than in the previous year. In 2004, the sales of new life insurance and pension policies to households were hampered by uncertainty surrounding the future taxation of insurance products. Since the new decisions on taxation, the sales of new insurance policies have recovered; sales of endowment insurance policies posted particularly strong growth for the year. The rate of growth of total premium income of life insurers increased to approximately 9% in January–July. Growth in premiums written on personal pension plans was, however, only slightly positive.

The proportion of unit-linked pension insurance in life insurers' total premium income continues to grow. So far in 2005, this proportion in life insurers' premium income has increased to approximately 40%.

Also non-life insurer's premium income grew relatively rapidly in January–July, by some 7%.

Restructuring in the Finnish insurance sector continues. OKO Bank acquired a majority stake in Pohjola Group plc and made a public tender offer for the remaining Pohjola shares. OKO Bank will retain ownership of Pohjola Non-Life Insurance Company Ltd, and Pohjola Life Insurance Company Ltd, which started operations at the beginning of 2005, will be sold to the OP Bank Group Central Cooperative.

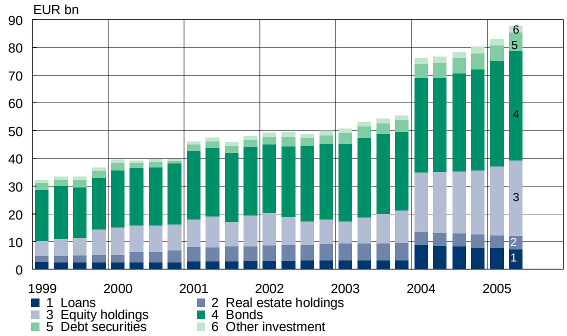
## Employee pension insurers' investment activities

The investment environment has remained stable and there have been no major changes in the past year in the allocation of insurance corporations' investments by instrument or geography.

Differences in the regulation of employee pension insurers' investment framework are clearly reflected in the breakdown of pension insurers' investment portfolios. Of total investments of pension insurers, pension funds and pension foundations, over 60% are in fixed-income instruments. Money market paper accounts for a considerably higher share of fixed-income investments of pension funds and pension foundations than those of other pension insurers.

Equity investment accounts for almost 30% of total investments of pension insurers, pension funds and pension foundations. Of public sector pension insurers' investments, almost half are in equities and less than that in fixed-income instruments. Pension insurers' equity investment strategies have varied over the course of the year. In the first half of the year, employee pension insurers' net investments in Finnish shares totalled over EUR 200 million, whereas other pension insurers have, in net terms, sold Finnish shares from their portfolio.

### Chart 6. Employee pension insurers' investment portfolio



* Since 2004, incl. public sector statutory pension providers.
Source: The Finnish Pension Alliance TELA.

Differences in investment concentrations are also reflected in the geographic distribution of investments. Investments in domestic instruments account for a third of pension insurers' investments, and for only about a fifth of public sector pension insurers' investments, and for less than 60% of pension funds' and pension foundations' investments.

The proportion of non-euro area investments of public sector pension insurers' investments, over a third, is clearly higher than that of other pension insurers' investments. The focus of non-euro area investments is mainly on equities.

The structure of pension insurers' real estate investments is changing. For example, the importance of housing investment is decreasing, and the proportion of investments in real-estate funds is increasing. Employee pension insurers are increasingly using mutual funds to channel investments, particularly in outward investments. Also other insurance corporations are increasingly using investment funds in their foreign investments.

Pension insurers' capital investments amount to over EUR 1 billion. Their investments in hedge funds amount to slightly less.

## 2.4 Distance-to-default indicator applied to Finnish banks

**Jaakko Lehto**

**The distance-to-default indicator is a measure of a company's default risk. The indicator, which captures market outlook, has generated interest in connection with private sector risk management as well as banks' stability analysis. The predictive properties of the indicator are enhanced by the fact that it is based on market prices of shares.**

Recent years have seen increasing interest in the use of equity-price-based indicators in companies' risk analysis and banks' stability analysis. In efficient financial markets equity prices in principle contain all available information on a company's financial condition and developments. As a result, an indicator based on market information would, seemingly, react earlier to changes in the company's financial position than indicators based on traditional financial statement data.

The most common measure of default risk which reflects market outlook is the Distance-to-Default ratio (DD ratio). The DD ratio is based on the options pricing model[10], in which equity is viewed as a call option on total capital. Following this approach, and using equity price data and liability items on the balance sheet, one can define the market's assessment of how far a company is from having its market value drop below the nominal value of its liabilities (default). DD ratio measures distance from default in standard deviations of market value of the company's total assets[11].

When calculating DD ratios, one must define the volatility of equity value. The method of calculating volatility has a significant impact on the behaviour of the DD ratio. Previous studies have usually used the previous six months' moving average of the standard deviation of daily equity returns to calculate volatility[12]. Using a long time period to calculate equity volatility gives a more stable DD ratio, nevertheless one that reacts later than with a short

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[10] Black, F. and M. Scholes (1973), "The Pricing of Options and Corporate Liabilities", Journal of Political Economy, 3, 637-654.

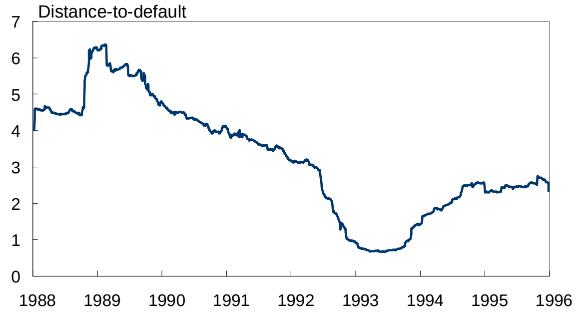
[11] For more information, see eg http://www.moodyskmv.com/research/whitepaper/ModelingDefaultRisk.pdf.

[12] Gropp et al. (2002), "Equity and Bond Market Signals as Leading Indicators of Bank Fragility", ECB Working Paper 150; Marcus, A and I. Shaked (1984) "The Valuation of FDIC Deposit Insurance Using Option-Pricing Estimates", Journal of Money, Credit and Banking, 16, 446-460.

period. The liquidity of equity markets should also be taken into consideration when choosing the time period.

The aggregate DD ratio of Finnish banks, weighted by total assets, shows that the turn predicting the banking crisis took place at the beginning of 1989 (Chart 7)[13]. This was followed by a steady fall in the aggregate DD ratio, followed by a dramatic drop in mid-1992. At first, the drop was accelerated mainly by the fall in Skopbank's DD ratio, which had begun at an early stage. The dramatic fall of DD ratios in 1992 was mainly due to the commercial banks KOP and SYP.

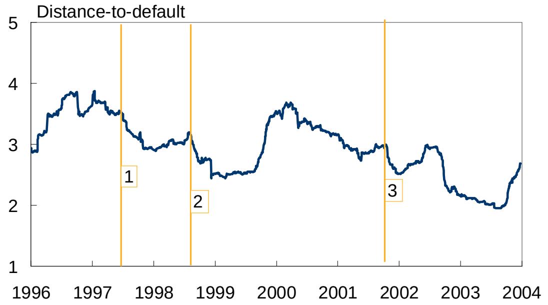
Chart 7. Aggregate DD ratio of Finnish banks, 1 January 1988–1 January 1996



Sources: Helsinki Stock Exchange, banks and Bank of Finland.

International shocks affecting the global economy in the 1990s and later were also reflected in the aggregate DD ratio of Finnish banks, weighted by total assets (Chart 8)[14]. Number 1 refers to the starting point of the Asian crisis, number 2 to the Russian crisis, and number 3 to the terrorist attacks in New York. All these shocks had a direct impact on individual banks' DD ratios and on the aggregate DD ratio. Of these crises, the Russian crisis had the biggest impact on Finnish banks' DD ratios.

Chart 8. Aggregate DD ratio of Finnish banks, 1 January1996–1 January 2004



Sources: Helsinki Stock Exchange, banks and Bank of Finland.

The predictive power of the DD ratio has been studied eg in connection with the drop in credit rating[15] and bankruptcies[16]. An interesting aspect is also whether the DD ratio includes predictive information on financial statement data which is used to assess the financial situation of the banks. Data on Finnish banks during the banking crisis suggests that the DD ratio predicts the ROE ratio by more than 6 months ahead and the proportion of loan losses of total loans by a few months ahead. The connection and predictive power of DD ratio to financial statement data is strongest during periods of robust growth and recession.

The use of DD ratio in banks' stability analysis is supported by the fact that it is, in principle, based on equity market prices, which are forward-looking. Studies so far have also produced encouraging results on the predictive power of the DD ratio. Another positive property of the indicator is that it is available frequently, unlike the key figures based on financial statements.

[13] The examined banks are KOP, SYP, SKOP, OKO Bank, Bank of Åland, Interbank. The DD ratios shown in the above charts are based on the volatility of equity, which was calculated as previous 12 months' moving average of the standard deviation of daily returns.

[14] The examined Finnish banks are OKO Bank, Merita, Nordea, Sampo, Bank of Åland.

[15] Gropp et al. (2004), ”Equity and Bond Market Signals as Leading Indicators of Bank Fragility”, ECB Working Paper 150.

[16] http://www.moodyskmv.com/research/newResearch.html.

# 3 Securities markets

## 3.1 Stock markets recovered after a sluggish performance in early 2005

**Jukka Topi**

**Share prices started to rise in the spring, both in the main global markets and in Finland. Share prices have increased particularly in the energy sector, but also in the other sectors, share prices have well withstood the shocks of recent months. Stock market volatility has remained low.**

After a sluggish early part of the year, share prices recovered in the spring in the main global markets. In January–August, share prices rose by over 11% in the euro area, by just under 8% in Japan, and by just under 3% in the United States[17]. Prices started to increase only in May–June. In January–April, all-share indices fell in the euro area, United States, and Japan. Share price increases in the spring and summer can be explained mainly by the better-than-expected results of companies, and by the improved macroeconomic outlook, particularly in the United States and Japan. The rise in energy prices did not have a noticeable impact on overall share price developments. Instead it boosted share prices in the oil and gas sector. Stock markets did not react strongly to the terrorist attacks in London in July. The first reactions to the impacts of hurricane Katrina in the United States have also been moderate.

In the financial sector, share prices of insurance corporations and banks in the key markets continued to increase for the third consecutive year, with the exception of bank share prices in the United States. Also in the euro area and Japan, insurance corporations' share prices have developed more favourably than those of banks.

Also in Finland, the rate of increase in share prices picked up in the spring. By the end of August, share prices had risen by just under 18%, which is clearly faster than the general trend in the euro area. In Finland, the development of share prices differed only slightly across sectors in the early months of the year. The differences increased, however, considerably in late spring and in the summer. In the energy and construction sectors[18], share prices rose by 50% in January–August. The positive price development in the energy sector, in particular, reflected the strong increase in oil prices. Forest industry is the only sector in which there was a downward trend in share prices in

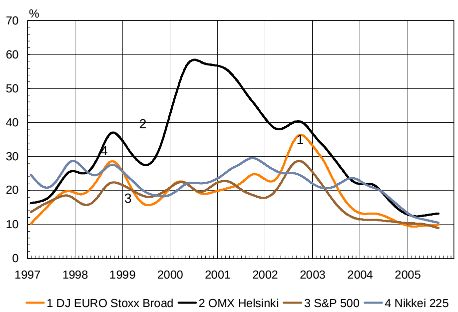
[17] Assessment of share prices is based on the DJ Euro Stoxx broad index (euro area), S&P 500 index (United States), and Nikkei 225 (Japan).

[18] In this Section, sectors are examined based on the industry classification used at the Helsinki Stock Exchange until the end of July. For more information on the changes in industry classification and indices, see Section 3.3.

January–August (prices were down by approximately 2%). Share prices fell mainly in the spring during collective bargaining, before the dispute escalated to a production stoppage. In the other main sectors, share prices rose in the metal industry by approximately 35% in the first eight months. Also in the financial sector, share prices rose faster than in the other sectors in general (in insurance by 35%, in investment and banks by 19% by end of August). In the telecom and electronics sector, the increase in share prices was relatively subdued (approximately 7% by end of August).

Stock market volatility remained relatively low in the key markets, compared to developments in recent years (Chart 9). On the Helsinki Stock Exchange, the historical volatility of the All-Share Index was also clearly lower than in recent years, although volatility started to increase slightly in early 2005.

Chart 9. Historical volatility of share indices*




* Hodrick-Prescott filtered standard deviation (20 days, annualised) of daily returns of stock index.
Sources: Bloomberg, Helsinki Stock Exchanges, Bank of Finland.

Of the major markets, the value of share trading increased in the first half of 2005 in the United States by just under 10% and in the euro area by just under 6%, year-on-year, whereas in Japan, the value of trading decreased by approximately 8%. On the Helsinki Stock Exchange, share trading increased in January–August by just under 16%, year-on-year. In Finland, the rate of increase in trading volumes picked up during the spring and summer.

## 3.2 Bond markets

**Katja Taipalus**

**The future prospects for both corporate and government bonds raise questions. The reasons are narrow interest rate spreads for corporate bonds and low long-term interest rates for government bonds.**

Corporate bond spreads have been narrowing substantially since 2002. This is partly due to increased demand pressure as investors seek higher yields in an environment of low interest rates. The widening of spreads in the spring, which was triggered by the problems of Ford and General Motors, was temporary. In the summer, interest rate spreads began to shrink again, and they have continued to narrow slowly.

The small number of issuances, relative to demand, has in part contributed to the narrowing of spreads. The early summer was an exceptional time in Europe because of a pick-up in issuances, due to a tightening of regulation. Bank competition and the easing of loan terms, together with a low level of interest rates, have elevated companies' interest in traditional bank loans, relative to market financing. On the other hand, issuances by companies with lower credit ratings have increased particularly in the United States, thanks to narrow interest rate spreads. In Europe, issuances by companies with lower credit ratings have decreased slightly compared to 2004. Growth in such issuances is expected to lead to an increase in payment defaults after 2006.

The issuance of bonds by emerging economies has also remained active in the first half of 2005 – the volume of issues is the highest since 2000.

Investors are not interested solely in corporate bonds. Demand pressure is increasing also in the structured assets markets. Investors' interest in securitised assets, in particular, is increasing notably. This is clearly reflected on the US and European markets. In 2004, the volume of issued asset-backed securitisation (ABS) instruments exceeded that of conventional corporate bonds in the United States. The increased interest in investing has also caused some problems. The rating agency Standard and Poor´s reported in August that high demand has led to a situation in which underlying risks are often not analysed thoroughly and investment decisions are made quickly. This may later cause unpleasant surprises in investment values. The drop in credit rating and an increase in financing costs have also led Ford and GM to increasingly resort to securitised financing.

Some investors suffered losses in the credit derivatives markets when Ford's and GM's credit ratings were lowered. Nevertheless, the credit derivatives markets recovered quickly. Demand in the credit derivatives markets has increased not only in the United States and Europe but also in Asia, where investors seek to diversify the risks of locally concentrated positions with the help of eg collateralised debt obligations (CDO).

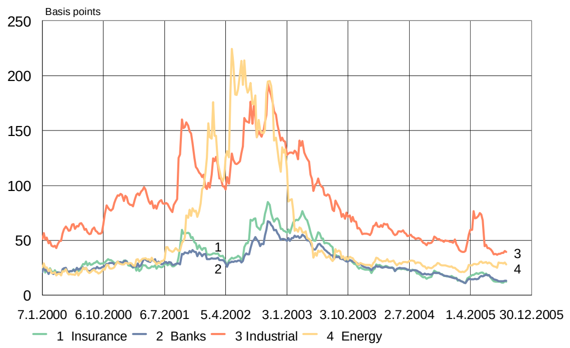
In addition to narrow corporate bond spreads, low interest rates on long-term government bonds in the United States and Europe have been puzzling the markets. At the end of August, the yield curve for US government bonds was reported to be nearly inverted, but in the first week of September, at least the immediate fears of an inversion weakened.

In recent weeks, hurricane Katrina and its possible impact has dominated the discussion. Concerning the bond markets, attention is paid to eg catastrophe bonds, Southern States' municipal bonds, and to commercial mortgage backed securities (CMBS) instruments. If oil prices remain high, this will certainly have a negative impact on the already-weak situation of the auto manufacturers. Close attention is also being paid to the size of claims on insurance corporations and re-insurers. In general it can be said that the damages caused by the hurricane have been spread across financial markets, via different instruments, to a variety of investors.

Another major event in the bond markets was the 18 June expiration of the government guarantee on Landesbank loans in Germany, which is reflected in the increased financing costs of these key institutions.

The major bond issues on the Finnish market were: Citycon Oyj's capital loan (EUR 70 million), Cargotec's domestic bond (EUR100 million) in June, and Nordea Bank AB (EUR 750 million/EMTN) in August. In addition, Sampo Bank plc announced the transfer of a EUR 1.1 billion housing loan portfolio to its subsidiary Sampo Housing Loan Bank. This transfer was covered by a bond issue. There were also changes in the international credit ratings of Finnish companies: Fortum Plc's credit rating was raised to A- in August by Standard & Poor's.

### Chart 10. Spreads between CSFB liquid corporate bond indices and swap rate




Source: Bloomberg.

## 3.3 New sector indices launched on the Helsinki Stock Exchange

**Pertti Pylkkönen**

**The Helsinki Stock Exchange introduced a new industry classification standard at the beginning of July 2005. The new classification improves the international comparability of price developments in different industries.**

Integration of the Nordic and Baltic securities markets took another step when all six OMX exchanges started using the Global Industry Classification Standard (GICS) on 1 July 2005. The GICS was developed by Morgan Stanley Capital International (MSCI) and Standard & Poor's (S&P) and was introduced in 1999. The GICS classification is also used on the Oslo and Icelandic stock exchanges.

The GICS classifies companies on four levels. The highest level is the sector. The 10 sectors are Energy, Materials, Industrials, Consumer Discretionary, Consumer Staples, Healthcare, Financials, Information Technology, Telecommunications Services, and Utilities. The sectors are divided into 24 industry groups, which are divided into 64 industries and further into 139 sub-industries.

The classification is based on the business area in which the majority of the company's turnover is generated. A company is first put in a sub-industry.

On the Helsinki Stock Exchange, GICS indices are calculated on three levels: sector, industry group and industry. Both price and yield indices are calculated.

In addition to the new industry classification, the Helsinki Stock Exchange has started to calculate a new OMX Helsinki Benchmark index (OMXHB). The purpose of the new benchmark index is to serve as an indicator of the overall performance of the Helsinki Stock Exchange. Currently, the index includes 55 of the largest shares in terms of volumes traded and market value. Both price and yield indices are calculated, and a weight-restricted and unrestricted version is calculated for each of these. The weight restriction is based on the UCITS directive, and thus the index is a suitable benchmark index for mutual funds that comply with the UCITS directive.

In the index calculation, the number of a company's shares is the number that is freely floated. For example, state-owned shares or shares owned by insiders are not included.

The OMXHB index corresponds to eg the benchmark indices on the Stock Exchanges of Stockholm, Copenhagen, and Oslo.

The calculation of the Helsinki Stock Exchange yield index has been changed eg in terms of how dividend adjustments are made. Moreover, the number of shares is adjusted daily instead of quarterly, as before.

In addition to introducing the new GICS, OMX harmonised the index names of the OMX exchanges at the beginning of October. For example, the new name of the all-share index of the Helsinki Stock Exchange is OMX Helsinki (earlier HEX).

# 4 Infrastructure

## 4.1 McCreevy: Next six months crucial for integration

**Heli Snellman**

**Integration is on course. The European Commission's recent statement calls for lower costs for cross-border clearing and settlement of securities.**

Charlie McCreevy, the European Commissioner for Internal Market and Services, commented in his speech of 13 September 2005[19] on the high cost of securities' cross-border clearing and settlement. Commissioner McCreevy also mentioned that the creation of a single pan-European Central Counterparty (CCP), as suggested by some market participants, could save costs and improve efficiency in the financial markets of the European Union. The Commission will assess the need for legislative measures on the basis of developments in the next six months.

During the past summer, no major reforms were completed in the securities market infrastructure. Integration is nevertheless progressing in the various sectors of securities and payment systems. For example, according to media reports[20], the Iceland Stock Exchange is considering merging with OMX. The OMX Exchanges have harmonised their operations during the summer by introducing the Global Industry Classification Standard (GICS) and by harmonising their index name structure (see Section 3.3). In early September, OMX Exchanges announced that it had signed a Memorandum of Understanding with Shanghai Stock Exchange on the exchange of information to develop the financial services industry in the Nordic and Baltic region and the People's Republic of China[21]. Moreover, OMX is planning to divest its technology business, which provides services to banks and brokerage firms, and to increasingly focus on marketplaces[22]. In August Nordea and The Bank of New York entered into a strategic agreement to provide global custody services to Nordea's institutional clients in the Nordic and Baltic Sea region. Nordea stated that with this agreement it will become the premier provider of securities services in these regions.[23] Nordea ranks 17th on the

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19 http://europa.eu.int/rapid/pressReleasesAction.do?reference=SPEECH/05/503&format=HTML&aged=0&language=EN&guiLanguage=en

20 The Wall Street Journal Europe, 27 July 2005

21 http://www.hex.com/en/news/index/unnamed_96.html; press release 6 September 2005

22 http://www.omxgroup.com/company/en/showreleases.aspx?id=2005083120130&company=0; press release 31 August 2005

23 http://www.nordea.com/sitemod/nordea_com/modules/PressRelease

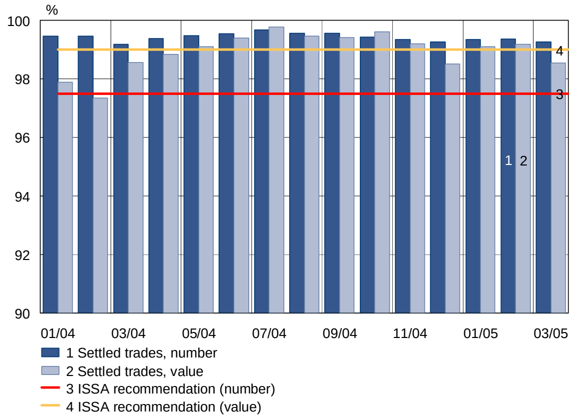
Globalcustody.net's total assets under custody (worldwide) listing[24], which makes it the largest Nordic operator. SEB is 21st.

As integration progresses, an adequate level of competition must be ensured. For example, the Competition Commission of the United Kingdom has announced that it will delay its final report on the possible takeover of LSE by eight weeks.[25]

## Operations of the Finnish Central Security Depository (APK)

On 21 July 2005, the Helsinki Stock Exchange reached an all-time high in daily share turnover, ca EUR 4.3 billion.[26] The number of trades settled in APK's HEXClear system was also high in July; the last time this level was reached was in March 2004. In January–July 2005, an average of 99.3% of exchange trades were settled within the allotted time (T+3) in terms of number, which exceeds ISSA[27] recommendations on settlement (at least 97.5%). In terms of the value of exchange trades settled, the settlement rate was 98.9%, compared to ISSA recommendation of no less than 99% (Chart 11).

### Chart 11. Exchange trades settled in three days (T+3) in HEXClear and ISSA recommendations on minimum level of settlement




Sources: NCSD and ISSA.

The number of account operators in APK's OM system has increased from six to eleven in the past eighteen months. Of the new account operators, two operate from abroad.

The value and number of trades in money market instruments and bonds settled in the APK's relevant settlement system (RM system) have decreased notably since 1998. The settlement rate was 99.6% in January–July 2005, compared to 99.4% in January–July 2004 and 99.7% in 2003.

s/index.asp?pid=51232&strcorecontentarea=194; press release 24 August 2005

[24] http://www.globalcustody.net/fi/custody_assets_worldwide_full/, 8 September 2005

[25] Bloomberg, 18 August 2005

[26] http://www.hex.com/files/58Rhvty5x/linkkifile/OMX_Exchanges_Monthly_Statistics_July_2005.pdf

[27] International Securities Services Association

## 4.2 Challenges for EU payment system initiatives

**Marianne Palva**

**The two key payment system initiatives in the European Union, TARGET2 and SEPA, are not progressing as planned, which poses challenges also to the Baltic countries. Sweden will disconnect from TARGET and acquire a new real-time gross settlement system (RTGS). In Estonia a new retail payment system, ESTA, was introduced. DVP links have been established between the central securities depositories of the Baltic countries. VP Securities Services of Denmark has lengthened its clearing and settlement day. In its assessment based on the Financial Sector Assessment Program (FSAP) for Norway, the IMF recommends that Norway upgrade the risk management of its securities clearing and settlement system.**

### TARGET2

According to the original schedule, TARGET2 should be introduced on 1 January 2007. The project has, however, not progressed as expected, and thus TARGET2 will be introduced in the second half of 2007[28]. The delay means additional investments for those new EU countries that were planning to join TARGET2 upon the adoption of the euro on 1 January 2007. A TARGET interface is a precondition for adopting the euro. Therefore these countries have to build an interface also to the current TARGET system. This temporary interface will result in extra costs also for banks.

Riksbank will close its settlement system for payments in euro at the end of 2006

Sweden will disconnect from the TARGET system already prior to the introduction of TARGET2. In February 2005, the Riksbank, in planning replacement of its RTGS system with a new second generation system and after discussions with Swedish banks, decided that it will not connect to TARGET2. The new system was to be implemented only after the completion of TARGET2. The delay in the introduction of TARGET2 does, however, not affect Riksbank's plans. Instead it plans to transfer to the new system in the first quarter of 2007[29]. The interface to the current TARGET system should be disconnected already at the end of 2006 or upon transfer to the new system at the latest.

### Preparation of SEPA transition plan begins in Finland

SEPA, the initiative for creating a Single European Payments Area, has not progressed as expected. Banks adopted the general plan already 2002, but the parties have still not been able to reach agreement on the details. Creating a new infrastructure calls for an agreement eg on detailed standards. Creating a harmonised direct debit system has proven to be particularly difficult, due in particular to the considerable differences between current national systems in terms of eg the processing of direct debit authorisation and the right to revoke a payment. The New Legal Framework (NLF) for Payments currently

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[28] http://www.ecb.int/paym/pdf/target/future/sibos2005target2presentation.pdf

[29] http://www.riksbank.com/templates/Page.aspx?id=12761 and http://www.riksbank.com/upload/FRIX_hemsida_eng.pdf

being prepared by the European Commission will include regulations also on making payments and the right to revoke payments. The final version of the New Legal Framework should have been published in September, but its publication has been delayed at least until October.

A European Central Bank report[30] calls for each member state to prepare a SEPA transition plan by the end of 2005. The Bank of Finland has started discussions with the Finnish Bankers' Association and its member banks on preparing a transition plan. The challenges posed by the SEPA and NLF will be faced particularly by the new EU countries since they have had only limited opportunities to participate in the preparation of these incentives.

## ESTA modernises the Estonian payment system

In Estonia a new retail payment system, ESTA[31], will be introduced in October. The new system will replace the current DNS system. The business hours of the new system will be from 8.15 am to 5.00 pm, ie almost three hours longer than before. Estonia is also preparing for the introduction of interbank direct debits in 2007. Currently, only intra-bank direct debits can be executed. The planned system corresponds largely to the direct debit system used in the Nordic countries. For example, the payer does not have the right to ask the bank to cancel payment after the payment has been debited from the account. The New Legal Framework for Payments may require that amendments be made in the current plan.

[30] Towards a Single Euro Payments Area – Third Progress Report, December 2004

[31] EeSti panga Tavamaksete Arveldussüsteem

## DVP links established between Baltic central securities depositories

A DVP (delivery versus payment) link between the central securities depositories of Estonia and Latvia was introduced already in 2004. A DVP link between all the Baltic central securities depositories was launched this summer[32].

## VP Securities Services of Denmark extends settlement day

Integration has been hampered by central securities depositories' differing procedures and by differences in legislation. Successful integration requires changes in procedures. Euroclear Bank, an international central securities depository, has developed its clearing and settlement system. As a result, the VP Securities Services of Denmark extended its operative clearing and settlement day in summer 2005 by adding a clearing and settlement run. This enables securities cleared in the Euroclear to be sent to VP Securities Services of Denmark for settlement and the further settlement of these securities in Denmark on the same value date.

## IMF assessment: Norway's financial sector must upgrade risk management measures and formalise payment system oversight

In June 2005, the International Monetary Fund published an assessment[33] of the Financial Sector Assessment Program for Norway. While the overall assessment is positive, the IMF did find that in extreme circumstances certain features of the financial

[32] http://www.ee.omxgroup.com/?id=3951

[33] Norway: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes, June 14, 2005

system could cause contagion and systemic risk. Thus careful monitoring and improved risk reduction measures are required. A priority is to improve risk management of the securities settlement system. Liquidity management in the small value payments system should be upgraded. The IMF also calls on the central bank to formalise payment system oversight and to increase transparency of oversight.

## 4.3 ECB calls for cost recovery

**Heli Snellman**

**The ESCB's assessment of retail payment systems has resulted in improvements in some payment systems. According to the assessment, the Finnish PMJ fulfilled the required Core Principles without changes. The Governing Council of the ECB issued a policy statement on central bank provision of retail payment services.**

In August 2005 the ECB published an assessment of euro area retail payment systems on the basis of the Core Principles.[34] This assessment is part of the ESCB's oversight of payment systems. The assessed retail payment systems were divided into systemically important retail systems (6 systems), prominently important retail payment systems (7 systems), and other retail payment systems (2 systems). Of Finnish payment systems, the inter-bank retail payment system PMJ was assessed in this context. Interbank obligations arising from domestic debit card payments, credit transfers and direct debits are settled through the PMJ system. The system fulfils all the required nine Core Principles. The other domestic payment system, POPS, was assessed already in 2004 in connection with the assessment of large-value payment systems.[35]

In August the Governing Council of the ECB issued a policy statement on central bank provision of retail payment services in euro to credit institutions.[36] In line with the Treaty, national central banks of the Eurosystem may provide processing facilities for retail payments in euro for credit institutions, to contribute to the safety and efficiency of payment systems and access to services. National central banks can either operate their own retail payment systems or participate in private retail payment systems. According to the policy statement, national central banks must, however, take due account of the requirement that services provided by central banks not distort competition or crowd out market initiatives. This line of thinking promotes cost recovery.

[34] European Central Bank (2005) *Assessment of euro retail payment systems against the applicable core principles*

[35] European Central Bank (2004) *Assessment of euro large-value payment systems against the core principles*

[36] http://www.ecb.int/pub/pdf/other/policystatementretailpaymentservicesen.pdf

# 5 Developments in regulation and supervision

**Jyrki Haajanen**

**This year, many significant international legislative projects are in their final stages. Finland has taken an active part in the preparations in recent years.**

One of the major international projects in financial legislation, **Basel II**, has entered its final stage. The European Commission in July 2004 issued a proposal for a directive, in line with the principles of Basel II. The objective of the directive would be to better ensure that investment firms and credit institutions have adequate own funds relative to their risk exposure. The banks' capital requirements will in future be more closely aligned with actual levels of risk exposure. The Directive will encourage banks to improve risk management, enhance capital adequacy monitoring, and increase the transparency of banks' capital adequacy management. The objective of the reform is to promote financial stability.

Discussion of the draft directive by the European Parliament started in spring 2005. According to the Commission's proposal, the new directive will become effective on 31 December 2006. Banks may still apply current regulations until the end of 2007. The most advanced measurement approach for credit risk and operative risk could be introduced only at the end of 2007.

**The International Financial Reporting Standards** (IFRS) were introduced in the EU at the beginning of 2005. The new standards apply to all listed companies. The IAS 39 standard on the recognition and measurement of financial instruments, which is a key standard for the banking sector, entered into force – with some exceptions. The exceptions concerned the application of the fair value option on certain instruments and the application of hedge accounting particularly on bank deposits. The impact of the IFRS reform on key data in European banks' financial statements would seem to be fairly minor. Nevertheless, the reform will clearly have a long-term impact on banks' risk management and business operations.

**The Directive on Markets in Financial Instruments** (MiFID) is one of the most important legislative projects in the European Commission's Financial Services Action Plan. This is an extensive reform of securities market structure, provision of investment services, requirements for service providers, and investor protection. The directive requires the amendment of the Finnish Securities Markets Act, the Act on Trading in Standardised Options and Futures, and the Investment Firms Act.

The Ministry of Finance has set up a working group to draft a proposal for Finnish legislation to implement the directive. The requirement to amend Finnish legislation is based primarily on new EU legislation on investment services. The working group may, however, also address the need to amend legislation in light of domestic developments.

The amendments would eg make the provision of investment advice a service requiring authorisation, improve the possibility of financial intermediaries to provide cross-border services to investors, and increase the importance of co-operation between securities regulators. The amendments must be implemented by 30 October 2006.

The Ministry of Finance set up a working group in 2004 to prepare a proposal, based on the **Prospectus Directive** of the European Union, on the prospectus to be published when securities are offered to the public or admitted to trading. The primary objective of the working group is to define the responsibility of a limited company for the prospectus as referred to in the Securities Markets Act, in which shares issued by the company are offered to investors for subscription or purchase. In addition to the responsibilities of the limited company, the working group discussed the responsibility of the issue organiser and the party selling the shares.

The Prospectus Directive allows member states to define the liability created by an incomplete or incorrect prospectus. Prospectus liability refers to the civil liability of a securities issuer or its agent in connection with incorrect or incomplete information presented in a prospectus prepared in connection with securities issuance. When securities are offered to the public, the investors make investment decisions based primarily on a prospectus drawn up in a specified form. It was thus appropriate to raise this matter for examination in connection with implementation of the Prospectus Directive, even though current Finnish legislation already fulfils the minimum requirements defined in the directive. The working group submitted its first report on implementation of the Prospectus Directive on 7 December 2004. The Government bill on implementation of the directive was submitted to Parliament on 21 April 2005.

In 2004 the Ministry of Finance set up a committee of officials to assess alternative ways to develop the Real Estate Funds Act. The working group's main objective was to 1) study and compare the judicial form, operations and taxation of real estate funds operating in Europe, 2) assess, based on the comparison, how Finnish real estate funds legislation should be developed to improve the functioning of the domestic market, and 3) present proposals for action, based on the assessment of alternatives.

In the interim report published in December 2004, the committee had identified the following key issues: the judicial form of real estate funds, the taxation of real estate funds and their shareholders, and the related question of who would be assumed to have an interest in investing in real estate funds.

According to the committee, the Mutual Funds Act should be amended to enable creation of a real estate mutual fund. In addition, the Real Estate Funds Act should be amended to enable market participants to engage in regulated real estate investment within the framework of a limited partnership. Under both the alternatives, only the investor would have to pay taxes. The committee does not consider it appropriate nor justified, based on EU legislation, that a limited company active in real estate investment would be granted tax advantages. The aim to harmonise tax treatment of direct real estate investment and investments via real estate investment limited companies with that of tax-exempt corporations would result in non-neutral situation as between parties that pay regular taxes and the various industries. Such a solution would in any case be difficult to accept in terms of taxation policy. The committee's final report will be published on 30 November 2005.

The Ministry of Finance set up a working group in 2004 to prepare a proposal in the form of a Government bill, for Finnish legislation implementing the **Directive on Takeover Bids** and the provisions issued by the Commission by virtue of the Directive, taking into consideration market developments. The proposal also had to address the amendments that were proposed in the Companies Act reform on the legislation on takeover bids. The working group also had the opportunity to make a proposal on the further coordination of the Companies Act and the legislation on securities markets.

The working group's report was published in May 2005. The report addenda give background information on the working group's proposals, studies and discussions. However, the working group did not make any proposals on legislation to implement the provisions issued by the Commission because the Commission has not yet initiated the preparatory work. The working group proposes that the directive be implemented on 1 January 2006 if the Companies Act reform takes effect on that date, otherwise on the date defined in the directive (20 May 2006).

The Government bill issued in August 2005 proposes amendments to the law on the on withholding tax. According to the proposals, a 15% tax – or higher tax if required by tax agreement – will in future be withheld from dividends paid on administratively registered shares. The dividend payer would no longer be obliged to disclose identification data to authorities on the dividend recipient, unless specifically requested. Administratively registered shares must, however, be located in such countries with which Finland has signed tax agreements. A standard 28% tax at source would be withheld from the dividend if it is paid to a country with which Finland does not have a tax agreement. The objective of the new regulation is to clarify the contradiction between the wording of the current act and decree and the actual practice. Acquiring full identification data on the dividend recipient prior to dividend payment has proven to be impossible.

# 6 Key corporate arrangements and events in the financial sector

| *Date* | *Event and description* |
|---|---|
| ***Jan 2005*** | *Pohjola Life Insurance Company Ltd started operations. Suomi Mutual Life Assurance Company transferred a EUR 1.2 billion life insurance portfolio to Pohjola Life Insurance Company Ltd. Suomi Mutual stopped selling new life insurance policies.* |
| | *Aon Finland Oy, one of the largest insurance brokers in Finland, sold its life and investment insurance brokerage operations to Bon Life Oy.* |
| | *Standard Chartered Bank acquired Korea First Bank for USD 3.3 billion.* |
| | *Citigroup announced that it will sell its insurance company, Travellers Life & Annuity, to MetLife for USD 11.5 billion.* |
| ***Feb 2005*** | *The government sold 7.1% of its A shares of Sampo plc at EUR 10.75 per share. The State now holds 14% of Sampo's shares and 13.9% of its voting rights.* |
| | *Mitsubishi Tokyo Financial Group, Japan's second largest financial group, announced that it will acquire UFJ Holdingin, the country's fourth largest financial group.* |
| ***Mar 2005*** | *Amendments to the restrictions on the acquisition of own shares included in the Companies Act took effect. Consequently a public limited company can acquire an amount of own shares that does not exceed 10% of its share capital or total voting rights attached to its shares.* |
| | *The Spanish bank Banco Bilbao Vizcaya Argentaria made a EUR 7.6 billion bid for the Italian bank Banca Nazionale del Lavoro.* |
| | *ABN AMRO announced that it will acquire Bank Corluy, a Belgian private bank.* |
| | *Alfred Berg announced it will become a European Company within 2005.* |
| | *ABN Amro Holdings NV made a EUR 6.3 billion offer for majority holding of Banca Antonvenetta SpA, an Italian bank.* |
| | *Société Générale announced it had acquired Promek Bank, a Russian bank.* |

| *Date* | *Event and description* |
|---|---|
| ***Apr 2005*** | *Swedbank announced that it owns 98% of Hansapank's share capital osakekannasta. Hansapank will be withdrawn from the main list of the Tallinn exchange.* |
| | *Fortis AG and FB Insurance will merge. The new company, Fortis Insurance Belgium, will become the largest insurance company in Belgium.* |
| | *Sampo Life Insurance Company Ltd was granted an operating licence for establishing a subsidiary in Sweden. The name of the company will be If Livförsäkring Ab.* |
| | *New York Stock Exchange and Archipelago merged.* |
| | *Nasdaq acquired Instinet.* |
| | *Société Générale acquired Eurobank, a Polish consumer credit company.* |
| | *Kaupthing announced it will acquire British bank Singer & Friedlander Group plc for about GBP 550 million.* |
| ***May 2005*** | *Skandia Life announced that it will stop selling new insurance policies in Finland.* |
| | *E*Trade and Ameritrade to merge.* |
| | *SAXESS trading system was introduced at the Vilna Stock Exchange. The common trading system is now being used at all the exchanges in the OMX Group.* |
| | *Helaba acquires Frankfurter Sparkasse* |
| | *WestLB announces that it will acquire Weber Bank.* |
| ***June 2005*** | *Unicredito Italiano announces that it will acquire the German bank HypoVereinsbank (HVB) and its subsidiaries for EUR 19.2 billion.* |
| | *SEB Unibanka, a subsidiary of SEB, acquires 100% of the shares in the Latvian life insurance company Balta Life from Codan's subsidiary for EUR 7.7 million.* |
| | *BNP Paribas acquires the US bank Commercial Federal Corporation, headquartered in Nebraska.* |
| | *Bank of America Corporation announces that it will purchase 9% of the shares in China Construction Bank. Also Temasek Holdings, a Singaporean state-owned investment company, purchased CCB shares.* |
| | *The Norwegian DnB NOR and the German Norddeutsche Landesbank annouce that they will establish a joint venture bank, operating in the Baltic countries, Poland, Finland, and Denmark.* |
| | *Nordea announces that it will acquire Sampo's Polish life and pension insurance companies for EUR 95 million.* |
| | *Bank of America acquires MBNA Corporation.* |

| Date | Event and description |
|---|---|
| **July 2005** | Helsinki Stock Exchange starts the calculation of new industry indices. |
| | Standard & Poor's upgraded OKO Bank's ratings as follows: short-term rating to A1+ from A1 and long-term rating to AA- from A+ |
| **August 2005** | Sampo Bank announces that it will transfer a EUR 1.1 billion housing loan portfolio to its subsidiary Sampo Housing Loan Bank. |
| | Nordea and The Bank of New York enter into a strategic agreement to provide global custody and clearing services to Nordea's institutional clients in the Nordic and Baltic Sea region. |
| | A group headed by Royal Bank of Scotland acquires a 10% stake in the Bank of China, the second largest bank in China. |
| **September 2005** | OKO Bank acquires a majority stake (58.5%) in Pohjola Group plc. OKO Bank will retain ownership of Pohjola Non-Life Insurance Company Ltd, and Pohjola Life Insurance Company Ltd and Pohjola Fund Management Company Limited will be sold to the OP Bank Group Central Cooperative. |
| | Old Mutual of South Africa makes an offer for Skandia. |
| | Standard & Poor's affirms A1+ and AAA ratings on Finnish government bonds. |
| | Banca Popolare decides to sell a 30% stake in Banca Antonveneta to the Dutch ABN Amro. |
| | Elcoteq Network Corporation converts into a European Company (Societas Europaea). |