



Financial Market Report

2 • 2008

- Will structured securities become simpler again?
- Deposits – a safe haven
- Banks' results weaker in the first quarter
- Rising costs eat into listed companies' profitability
- Progress in EU arrangements for financial stability



Bank of Finland

Financial Markets and Statistics

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1 Financial intermediation

1.1 Structured securities: simpler in the future?

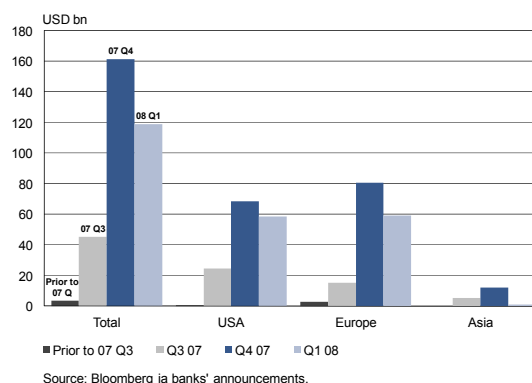
Katja Taipalus

Banks and insurance corporations have been forced into extensive write-downs on structured investments. Why did structured investments cause such huge losses? Is there a future for these instruments?

Banks and insurance corporations have so far recorded nearly USD 400 billion in write-downs in connection with the subprime turbulence¹. By mid-May, write-downs in the US banking sector totalled USD 152 billion; the figure for Europe was USD 158 billion and for Asia USD 18.6 billion. Current evidence suggests that the peak in write-downs occurred in the last quarter of 2007 (Chart 1). Some estimates (eg by IMF) however suggest that major write-downs may still be in the offing.

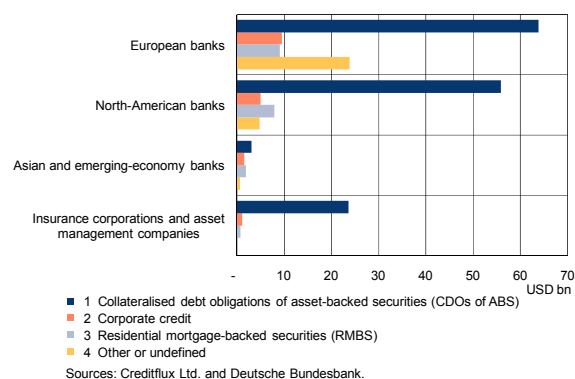
¹ On structured instruments, see 3.2 by J. Vauhkonen.

Chart 1. Write-downs, quarterly data, 2007Q3–2008Q1



The majority of write-downs in the banking and insurance sector were recorded in connection with investments in collateralised debt obligations of asset-backed securities (CDO of ABS) (Chart 2)². The amount of write-downs was considerably lower in connection with residential mortgage-backed securities (RMBS).

Chart 2. Write-downs by product, Q1



² A collateralised debt obligation (CDO) that is collateralized by a pool of securitised asset-backed instruments.

To compensate for write-downs the banking sector has sought new capital. By mid-May, banks had acquired USD 250 billion of new capital.

The recording of such huge losses has raised several questions on structured instruments. There has also been speculation on whether the market for structured instruments will ever return to a state of normality.

Structured assets and their markets developed favourably for quite some time: the assets used to back the structures were stable in terms of risk and the product structures were simple. Trading in these products became easier as market liquidity increased, and the entry of large market participants was expected to promote the functioning of the market also in future. Structured securities generated higher yields than corporate bonds with the same credit rating, which boosted demand markedly.

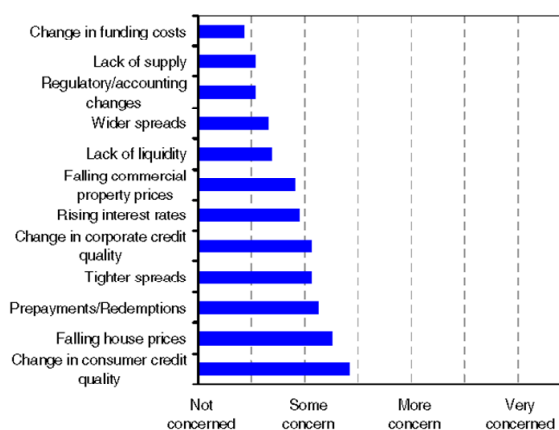
The growth in demand stimulated the supply and development of structured instruments. As increasingly complex securities were launched onto the market, the related risk management became highly challenging to investors. At the same time, the stock of housing loans grew rapidly in the USA. Growth was particularly rapid in housing loans granted by unsupervised entities. In many cases the borrower provided insufficient background information or had low credit scores or problems with credit histories. When these loans with a higher risk were increasingly used as bases for new structured instruments, the seeds of turbulence were sown.

The structures of the newest instruments proved to be much more vulnerable to change than corporate bonds with the same credit rating. In autumn 2007, buyers began to escape from markets that had been considered stable and liquid, and the prices of securities fell as risk-awareness increased. Prices

declined even for instruments backed by collateral which had not yet suffered actual losses.

The strong impact of the turbulence is partly explained by the fact that the majority of realised risks had not been foreseen as major sources of concern. This is evidenced by eg the investor survey conducted by Citibank in late 2006 (Chart 3.). Investors in European structured instruments saw changes in funding costs, wider spreads, and lack of liquidity as the smallest of concerns. In other words, they downplayed all the risks that were later realised. Since these risks were not considered major threats, investors did not protect themselves sufficiently.

Chart 3. Greatest concerns in the market for structured securities



Source: Citigroup Securitized Products Investor Survey.

Some estimates point to a link between volume of structured securities, growth in lending by MFIs, lower pricing of risk, and the rise in housing prices. A recent US study on the subject³ suggests that there is a link between the use of structured instruments, lending growth and rising house prices.

The market for simply structured securities has functioned smoothly for decades, and their positive impact is undeniable: they have eg enhanced lending

³ Mian-Sufi (2007), 'The Consequences of Mortgage Credit Expansion: Evidence from the 2007 Mortgage Default Crises'.

by banks via more efficient use of capital, eliminated large exposures via risk diversification, and provided new funding channels.

Recently there has been very little activity in the market for securitised products. The volume of issues has decreased, and issuers have kept some of the new issues on their balance sheet. Moreover, it has not been possible to transfer all the risks (eg LBO credit⁴). Closing of this market segment has reduced the availability of market financing and weakened, in particular, the liquidity positions of banks that use structured markets as a major source of funding. Only recently have investors shown some renewed interest in structured instruments. This has led to a decrease in risk premia, with consequent price effects. Time will tell whether this is a permanent phenomenon. Many market participants believe that in future structured securities will again be simple and that the market for more complex instruments will shrink permanently.

⁴ Leveraged buy-out.

1.2 Bank deposits a safe haven for households in 2007

Eero Savolainen

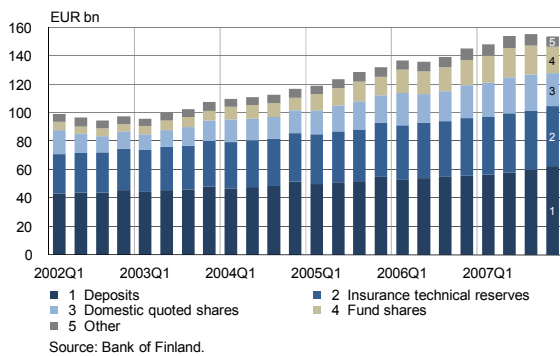
Developments in households' financial assets were mixed in 2007. In the first part of the year, rising share prices boosted the value of equity and fund holdings. In the second part of the year, increased uncertainty in the financial markets and falling share prices induced households to transfer a large amount of funds into deposit accounts.

Households net financial assets (financial assets minus liabilities) decreased slightly in 2007. According to quarterly financial accounts compiled by the Bank of Finland, net financial assets totalled EUR 68 billion at the end of the year, down by 1%, year-on-year. The decrease was due to the fact that the slower growth in financial assets did not offset the rapid increase in liabilities.

The value of households' financial assets increased to EUR 154 billion at the end of 2007, up by EUR 8 billion on the year-earlier figure. Deposits strengthened their position as the largest item, and their share of total financial assets increased by 2.4 percentage points, to 40.6%. One-fifth of the growth was however due to households' asset transfers from savings associations to bank accounts. The popularity of savings was boosted by the tight competition on interest rates, particularly on fixed-term deposits. Moreover, deposits provided a safe haven at the end of the year as households, on net, sold equity and mutual fund holdings.

Households' net sales of quoted shares totalled EUR 1 billion. The value of equity holdings however remained virtually unchanged on the previous year, due to favourable developments in equity prices. Households thus invested 'new money' in the securities markets indirectly via mutual funds and unit-linked insurance, instead of direct equity investments.

Chart 4. Households' financial assets, 2002–2007



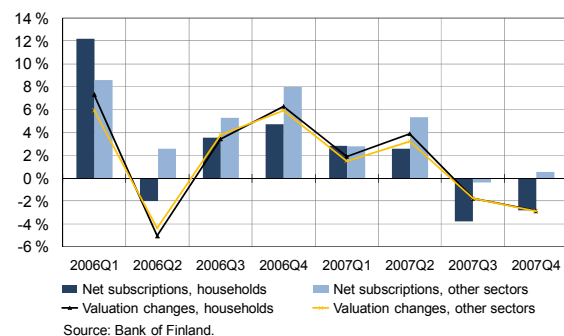
For Finnish mutual funds (incl. money market funds) the year was mixed. In the early part of the year, funds continued to grow rapidly, as in previous years, whereas in the second half, the value of funds turned sharply down, reflecting net redemptions and declining share prices. Fund assets totalled EUR 66 billion at the end of 2007, up by 8% on the previous year, despite the fact that net subscriptions (EUR 4 billion) in 2007 amounted to only just over a third of those in 2006. Fixed-income funds gained in popularity, mostly at the expense of mixed funds, and money market funds overtook equity funds as the most popular fund category.

The imputed valuation change⁵ in investments can be derived from the financial accounts. Chart 2

⁵ Changes in the stock of financial claims are divided into financial transactions (eg difference between purchases and sales of equities) and other, mainly valuation, changes and sometimes changes in classification. Other changes therefore equal the difference between stock changes and financial transactions. If there are no

compares imputed value changes in mutual fund⁶ holdings by households and other sectors. In recent years, the value of households' fund holdings has developed slightly more favourably than the average. The imputed annual return⁷ on households' fund investments held at end-2005 was 6.4% at the end of 2007, ie slightly higher than the annual return on other sectors' investments (5.6%). This is at least partly due to the fact that households' holdings in bond funds are on average smaller than those of the other sectors. As a result, their indirect equity exposure and the premium paid are higher than the average.

Chart 5. Imputed valuation changes in fund investments and relative net subscriptions, 2006–2007



The above analysis is based on the assumption that the proportion of fund holdings purchased and sold by households equals that purchased and sold by the other sectors. This may be a somewhat restrictive assumption because the financial accounts show that households' investment behaviour has differed from that of the other sectors, as a result of the recent market developments. As equity prices declined

classification changes, other changes describe the valuation changes of investments (incl. exchange rate changes of foreign currency-denominated investments).

⁶ Money market funds are excluded from the analysis because their risk and yield profile resembles more that of deposits than other fund shares.

⁷ Annualised geometric mean of quarterly percentage returns.

temporarily in the second quarter of 2006, households sold shares in net terms, while the other sectors were buyers on net. A similar phenomenon took place at the end of 2007. Moreover, as equity prices started to decline in the third quarter of 2007, households were more inclined than other sectors to sell their fund holdings. Factors linked to the timing of purchases and

sales have a major impact on the total return on investments.

The analysis also excludes fund shares held by households indirectly via unit-linked insurance. It is much more difficult to liquidate unit-linked insurance than direct holdings, and thus redemptions have probably been minor.

2 Banks and insurance corporations

2.1 Banks' results deteriorated in Finland in the first quarter 2008

Hanna Putkuri

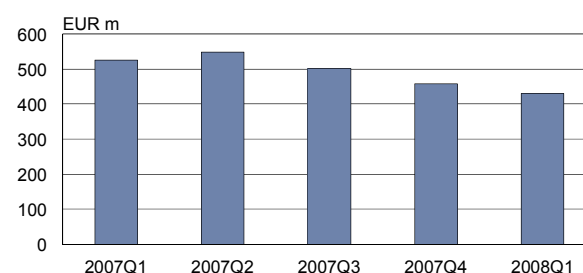
The pre-tax profits on Finnish banking operations for January–March deteriorated on the previous quarter and on the year-earlier period. Credit and deposits grew robustly, whereas demand for other banking products weakened.

Financial market turbulence has had a mixed effect on the income of banks operating in Finland. Rising market interest rates have contributed to the strong growth in net interest income, as interest rates on loans have increased while the demand for credit has remained brisk. Rising interest rates and negative developments in capital markets have also resulted in exceptionally strong growth in fixed-term deposits. At the same time, banks' net fee income from other savings and investment products has shrunk. Banks' own investments in securities have been adversely affected by the rise in risk premia and the decline in share prices, and net income from trading and investment has declined notably on the year-earlier period.

Due to divergent developments in income items, banks' aggregate net income for the first quarter of

2008 remained roughly unchanged on the year-earlier period. In contrast, expenses and loan losses grew. As a result, aggregate pre-tax profits on Finnish banking operations decreased by nearly one-fifth on the corresponding period of 2007. Banks' performance continued to weaken also as compared to the second half of 2007 (Chart 6).

Chart 6. Quarterly pre-tax profits on Finnish banking operations*



* Nordea's Nordic Banking Finland, Danske Bank's banking operations in Finland, OP-Pohjola Group's banking and investment services, Aktia Savings Bank's retail banking, other savings banks, local cooperative banks, Bank of Åland, Evlii Bank and eQ.

Sources: Banks' interim and financial statements.

Weaker financial performance was reflected in banks' cost efficiency and profitability. The expense-to-income ratio for banking operations increased, and the return-on-equity ratio decreased overall (Table 1).

Capital adequacy ratios remained more or less unchanged on year-end 2007.

Table 1. Performance indicators of banking groups operating in Finland

	Return on equity (ROE), %		Expense-to-income, %		Capital adequacy ratio, %		Tier 1 capital adequacy, %	
	08Q1	2007	08Q1	2007	08Q1	2007	08Q1	2007
Nordea Group	15.8	19.1	54	52	9.4	9.1	7.2	7.0
Danske Bank Group	9.8	15.1	62	56	13.6	9.3	9.5	6.4
OP-Pohjola Group	10.3	13.7	56	50	12.8	13.8	12.7	12.6
Savings banks (excl. Aktia)	..	..	63	56	21.9	22.8	20.3	20.4
Aktia Savings bank plc	12.7	17.9	70	67	14.2	15.4	10.5	10.9
Local cooperative banks	..	..	58	55	21.9	22.1	..	..
Bank of Åland plc	12.1	16.4	69	61	12.3	12.8	8.3	8.6
Evli Bank	10.1	18.5	91	77	..	..	15.3	15.3
eQ	..	14.4	..	70	11.3	12.0	11.3	12.0

.. = data not available.

Sources: Banks' interim reports and financial statements.

Banks are cautious in their projections for the remainder of 2008 because the operating environment is characterised by an exceptionally high level of uncertainty. It appears that the highly favourable developments of the last several years are coming to an end. In general, banks' forecasts of results for 2008 are below the record levels of 2007.

Table 2. Key items from income statements, January–March 2008, and changes on year-earlier period

	Net interest income		Other income, net		Total expenses		Loan losses, net		Profit before tax	
	EUR m	Change	EUR m	Change	EUR m	Change	EUR m	Change	EUR m	Change
Nordea Group	1 181	18 %	780	-10 %	1 055	6 %	21	..	885	-1 %
Nordic Banking	971	14 %	540	-4 %	779	7 %	10	..	722	0 %
Nordic Banking Finland	273	9 %	147	-8 %	194	10 %	2	..	224	-12 %
Danske Bank Group	837	9 %	542	-23 %	848	8 %	73	..	458	-36 %
Banking	833	9 %	378	1 %	726	11 %	72	..	413	-19 %
Banking in Finland**	106	54 %	60	58 %	141	76 %	-4	..	29	0 %
OP-Pohjola Group	272	11 %	260	-17 %	333	6 %	2	..	196	-20 %
Banking and investment services	268	10 %	116	-29 %	248	12 %	2	..	134	-27 %
*Pohjola Bank	35	35 %	100	-35 %	115	1 %	2	..	17	-74 %
Savings banks (excl Aktia)	40.1	6 %	8.7	-25 %	30.8	8 %	-0.3	..	18.4	-14 %
Aktia Savings Bank plc (Group)	23.9	17 %	47.0	5 %	56.5	40 %	0.0	..	14.2	-42 %
Retail banking	15.3	1 %	8.1	1 %	20.4	19 %	0.0	..	3.1	-48 %
Local cooperative banks	26.7	3 %	5.8	-15 %	18.4	3 %	-0.5	..	14.6	-5 %
Bank of Åland plc (Group)	10.1	10 %	8.1	-14 %	12.5	20 %	0.0	..	5.7	-30 %
Evli Bank Group	-0.1	..	16.6	-5 %	14.5	2 %	0.0	..	2.1	-34 %
eQ Group	1.9	6 %	5.7	-50 %	8.1	-4 %	0.0	..	-0.6	-113 %
1. Finnish banking	741	13 %	376	-11 %	688	20 %	-1	..	430	-18 %
2. Financial groups operating in Finland	2 392	13 %	1 674	-16 %	2 377	7 %	95	..	1 593	-17 %

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

** Data for the first quarter 2007 is not comparable because Sampo Bank's figures for Finnish banking operations are included only since February 2007.

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

2. Nordea Group, Danske Bank Group and Finnish banking groups (excl. Sampo Bank and Nordea Bank Finland).

Sources: Banks' interim reports.

2.2 Performance of large financial groups has weakened in the Nordic countries

Sampo Alhonsuo

In early 2008, large Nordic financial groups posted weaker results than before. The decline is primarily due to the negative impact on earnings of the disturbances in the international financial markets. However, Icelandic banks' profit performance differed from the rest. Near-term profit performance is marked by uncertainties.

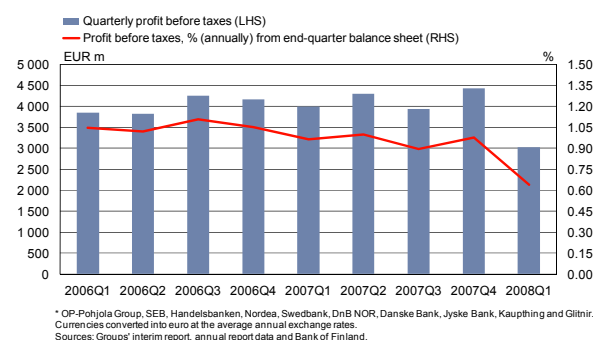
In the first quarter of 2008, performances of large Nordic financial groups weakened considerably compared to the last and first quarters of 2007. In 2006–2007, quarterly profit before taxes for the largest Nordic financial groups⁸ was typically around EUR 4 bn, compared to only EUR 3 bn in the first quarter of 2008. Relative to the total assets and volume of business, the results worsened substantially. This weakening is largely due to the international financial market turbulence, which has had an adverse impact on earnings. Extremely poor and even negative results were posted on securities trading and investment activities; valuation of balance sheet items at fair value lead to write-downs. Fee income also lessened substantially because income from eg asset

⁸ The following 10 financial groups are included to this article: OP-Pohjola Group, SEB, Handelsbanken, Nordea, Swedbank, DnB NOR, Danske Bank, Jyske Bank, Kaupthing and Glitnir.

management, consulting services and transactions has decreased.

In contrast, financial groups' net interest income has continued strong thanks to growth in lending and other funding and borrowing items. Banking operations have also benefited from a rise in short-term market rates compared to the year before or to the previous quarter. Net interest income continues to be the single largest income producing item for financial groups.

Chart 7. Large Nordic financial groups' quarterly profit before taxes



Performances have also been weakened by a continuing rise in costs. As a result of income and expense developments, groups' cost-efficiency has weakened somewhat. If the poor performance is protracted and the international financial market turbulence continues, Nordic financial groups will be pressured to undertake notable performance improving measures. Impairments on receivables (ie credit losses) have also started to increase in many groups, although the aggregate level is still negligible and, relative to the lending stock, impairments are still rare.

Table 3. 10 large Nordic financial groups: quarterly profit before taxes

EUR m	2008 Q1	2007 Q4	2007 Q1	Change, 2008Q1 - 2007Q4, %	Change, 2008Q1 - 2007Q1, %
OP-Pohjola Group	196	247	246	-21	-20
SEB	256	486	441	-47	-42
Handelsbanken	310	781	410	-60	-24
Nordea*	885	1 078	895	-18	-1
Swedbank	395	436	404	-10	-2
DnB NOR	162	662	468	-76	-65
Danske Bank	458	567	710	-19	-36
Jyske Bank	85	68	85	25	0
Kaupthing	200	54	245	268	-19
Glitnir	76	37	83	102	-8
Total	3 022	4 417	3 987	-32	-24

*Nordea's profit before taxes for 2007Q4 includes a EUR 120 million refund from the Finnish Deposit Guarantee Fund. Currencies converted into euro at the average rate for January-March.

Source: Interim reports for April-May.

Despite weakening profits, all large Nordic financial groups posted positive results for the first quarter of 2008. Many group-specific factors are involved: DanskeBank's performance is weakened by merger expenses arising from the acquisition of Sampo Bank. Large one-off income items are related to the performances of Nordea and Handelsbanken for 2007, which weakens comparability with results for 2008.

In contrast, Islandic groups' performance is very much different from that of other conglomerates; their profits increased from the last quarter of 2007. This was due to large open net currency positions and rapidly increased income from foreign exchange operations, following the sizable depreciation of the Islandic krona in the first quarter of 2008. Gains on foreign exchange operations have offset valuation losses arising from share and trading portfolios.

All Nordic financial groups emphasise the ease of funding and their overall good liquidity position. Stock of deposits has continued to increase in the early months of 2008. With the increased cost of funding in the money market, groups have generally sought to increase deposits from the public.

Profit performances by large Nordic financial groups in early 2008 have mimicked European and global patterns; banks' and financial institutions' overall profits have turned downward after a run of good years. Nordic financial groups are cautious in their performance outlook and emphasise dependence on overall developments in international financial markets. Nordic groups' capital adequacy ratios continue to be on a par with previous years, and they have not been compelled to raise additional capital, in contrast to many large global financial conglomerates have.

Table 4. Profitability, cost-efficiency and capital adequacy in 10 Nordic financial groups

	ROE, %		Expenses, % from earnings		Capital adequacy ratio on original own funds	
	1-3/2008	2007	1-3/2008	2007	3/2008	12/2007
OP-Pohjola Group*	10.3	13.7	55	49	12.7	12.6
SEB	9.6	19.3	69	57	8.9	8.6
Handelsbanken	12.3	23.3	55	41	6.8	6.5
Nordea	15.8	19.1	54	52	7.2	7.0
Swedbank	16.8	18.9	53	51	8.2	8.5
DnB NOR	5.7	22.0	74	51	7.0	7.2
Danske Bank	9.8	15.1	62	56	9.5	6.4
Jyske Bank	-	23.5	59	59	8.2	6.9
Kaupthing	23.7	23.5	47	48	9.1	9.6
Glitnir	15.0	19.3	54	57	7.7	8.1

*: OP-Pohjola Group's ROE for 2008Q1 is -3.1% at market values.
Source: Interim reports for April-May.

3 Securities markets

3.1 Rising costs weakening the profitability of listed companies.

Pertti Pylkkönen

Financial results of several listed companies were burdened by rapidly rising costs in the first quarter. Listed companies have also taken out loans at a quickening pace.

Listed companies (excluding financial corporations and real estate companies) have posted varying results for the first quarter. Reflecting general market tendencies, corporate profits weakened because profit after financing items declined for more than half of listed companies compared to the previous year.

The performance of large companies on the Helsinki Stock Exchange was somewhat better than average, while that of average-size companies was somewhat poorer than average. Small companies' performances were mixed, but more than half of them posted poorer first quarter results for this year compared to the previous year.

Apart from the forest industry and some other individual companies, net sales continued to grow moderately. The prices of some production inputs have risen rapidly in recent times. In addition to energy and commodity prices, domestic costs are burdened by markedly increased labour costs. It has not been

possible to raise the prices of end products in line with the rise in costs – hence the weakening in profitability.

Early in the year, just over 20 listed companies (one fifth of the companies) posted losses for the first quarter. Financial losses were primarily posted by small and medium-sized companies. Of the large companies, only a few posted losses for the first quarter.

Despite a slight deterioration of results, listed companies have not reduced dividend payouts. By the end of April, companies had paid out some EUR 6.5 billion in dividends, up a couple of hundred euros on the year-earlier period. In addition, equity buybacks have amounted to a couple of billion euros this year, largely in the shares of a few major companies.

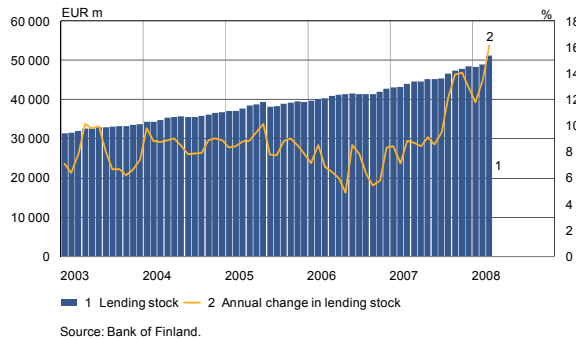
The financial market turbulence has not yet had a major adverse impact on funding for Finnish listed companies. In debt financing, the role of banks has become increasingly important. Before disturbances spread to the financial markets, growth in loans was around 9% pa, but the pace has picked up since last August. By March, growth in euro-denominated loans from monetary financial institutions operating in Finland had reached 16.1%.⁹

According to a survey by the Confederation of Finnish Industries and Ernst & Young, financing problems have affected growth-oriented companies looking to enter the international markets. Companies would welcome improvements in eg tailored funding

⁹ Source: Bank of Finland, Financial Markets–Statistical Review 5/2008.

packages for both initial and growth stages of business.¹⁰

Chart 8. Finnish monetary financial institutions' euro-denominated lending to euro area companies, new business and annual lending stock



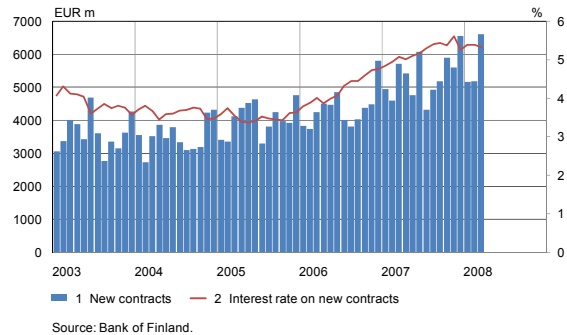
In Finland, loans are almost always obtained from banks. Thus loans from banks operating in Finland have grown rapidly. Bond yields have increased markedly, partly because of expanding risk premia. As a result, Finnish companies have not issued bonds to the general public. Net take-out of other foreign funding, such as syndicated loans, has also been limited during the financial market turbulence.

Bank loans taken out by companies are virtually all tied to floating euribor rates. Interest rates for new loans taken out by companies have been increasing for the past two years, but because of larger risk premia bank loans have been very competitive compared to market-based funding.

The liquidity of banks operating in Finland has remained very good, thanks to exceptionally rapid growth in the stock of deposits, and banks have not had to limit lending due to problems in their own funding. In March, the annual growth rate of bank deposits was more than 16%.

¹⁰ Problems in funding weaken companies' willingness to grow. Confederation of Finnish Industries, Business outlook indicator, May 2008.

Chart 9. Finnish monetary financial institutions' euro-denominated loans to euro area companies, new contracts and interest rates on new contracts



3.2 Closer monitoring of credit rating agencies in the EU

Jukka Vauhkonen

The Committee of European Securities Regulators (CESR) recommends to the European Commission that a new body be formed to develop standards for the operations of credit rating agencies and to monitor compliance with the standards.

Credit rating agencies and the ratings issued by them have been at the centre of the ongoing financial market turmoil that began in 2007. The focus of discussion has been on the role of credit rating agencies in the rating of structured financial instruments.¹¹

The strong growth of structured financial instruments is connected with the securitisation of financial products. Securitisation enables non-liquid assets linked to future cash flows to be transformed as marketable securities. Securitised asset items (eg housing loans) are combined into a pool of collateral. Securitisation enables the selling of the right to the cash flow generated by the pooled items.

In securitisation, the securities issued are divided into tranches so as to create securities that differ in yield and risks. The cash flow and possible losses generated by the pooled assets are allocated to the different tranches so that credit losses impact first the lowest-class tranche and last the securities in the highest-class tranche.

In recent years, securitisation structures have become increasingly complex, and at the same time,

¹¹ Katja Taipalus (section 1.1) examines in more detail the collapse of the market for structured instruments.

the range of asset items to use as collateral has expanded. This has brought up the concept of structured securities.

Assessing the risks of structured securities is difficult due to the multi-level tranche structure, the various methods of transferring risk, and the often highly heterogeneous collateral. The valuation and pricing of these instruments have thus been based mainly on credit rating agencies' ratings of securities in the different tranches. The problems in the market for structured securities have sparked extensive discussion of the quality of these ratings and the rating methodology.

Authorities and credit rating agencies have recently published several reports on the role of credit rating agencies on the market for structured financial instruments. The reports also discuss the need to develop regulation.¹² The focus is on the transparency of the rating process and methodology concerning structured products, the sufficiency of rating agencies' resources, the monitoring of ratings, and the possible conflict of interest involved in ratings.

A credit rating is intended only to reflect an assessment of an institution's or security's credit risk. Credit ratings do not indicate eg the liquidity risk of a security. It is however evident that some investors have misunderstood the purpose of a rating. CESR thus recommends that credit rating agencies clarify the characteristics and purpose of ratings of structured products. CESR also recommends that credit rating agencies provide investors more information on the contents of asset items used as collateral for structured products and on the critical model assumptions,

¹² CESR presents a summary of ongoing studies in its report to the European Commission "CESR Second Report to the European Commission on the compliance of credit rating agencies with the IOSCO Code and the role of credit rating agencies in structured finance", May 2008, www.cesr-eu.org

regarding eg certain parameters and correlations underlying the ratings.

According to the CESR survey, many investors suspect that rating agencies do not have sufficient resources for rating structured products. CESR recommends that rating agencies improve the disclosure of eg indicators of the training, experience and turnover of staff, to improve investors' confidence in the ratings. CESR also recommends that rating agencies ensure that they have adequate resources for monitoring ratings.

Authorities have expressed particular concern about the fact that the nature of the rating process of structured products may compromise the objectivity of ratings. One reason is that issuers of structured products or issue organisers often discuss thoroughly with the credit rating agency which asset items should be securitised. There is a risk that the alleged advisory role of the credit rating agency could conflict with objective rating. To avoid a conflict of interest, CESR recommends that rating agencies increase the transparency of their relationship with issuers and arrangers of structured products.

Thus far the operation of credit rating agencies has not been regulated in the EU. The European Commission however decided in January 2006 that credit rating agencies should comply with the International Organisation of Securities Commissions'

(IOSCO) Code of Conduct and that CESR should report annually to the Commission on the compliance of these recommendations. The recent turbulence in the financial market revealed deficiencies in the rating of structured products. As a result, the Commission requested CESR in September 2007 to examine whether current self-regulation is sufficient.

CESR takes the view that this is not sufficient in the longer term. It urges the Commission to form a new body for monitoring credit rating agencies. The task of the body would be to develop international standards on credit rating agencies in line with IOSCO recommendations and to monitor compliance with the standards. The body would also have 'name and shame' capability, ie the right to disclose possible non-compliance with the standard. The international regulatory community (eg IOSCO, CESR, CEBS and CEIOPS) would appoint the members of the body, who would represent investors, securities issuers and credit rating agencies.

According to CESR, the members of the body should be from different geographic areas. If this cannot be achieved in the short term, the body should be formed on the EU level. In the absence of support from market participants or failure of the body to meet the objectives of ensuring the integrity and transparency of ratings, the Commission should consider direct regulation of credit rating agencies.

4 Infrastructure

4.1 TARGET2-Securities: Decision making time approaches

Kari Korhonen

The Eurosystem's initiative to create a harmonised securities settlement system (TARGET2-Securities, T2S) for the euro area is reaching an important moment of decision. Central securities depositories are expected to express their interest in participating in the development of the project by the beginning of July, after discussions with the key users on their future needs. The Governing Council of the ECB is scheduled decide in summer 2008 whether to proceed to the system specification phase.

The Governing Council of the ECB has invited central securities depositories to express their interest in joining the TARGET2-Securities service when it is launched in 2013. The service concept is based on the Eurosystem providing the central securities depositories with the opportunity to outsource the maintenance of the settlement system to the Eurosystem. The user requirements of the future single settlement system were approved in May, with the support of market participants. The Governing Council will decide whether to proceed to the specification phase, based on market participants' indications of interest.

The aim of the initiative is to promote efficiency and reliability of the securities market of the European Community by providing all central securities depositories a harmonised technical platform and central-bank-money settlement accounts for their customers. The banking sector has already expressed support for the initiative, in the public consultation launched by the ECB in early 2008.¹³ The initiative involves the elimination of many of the national characteristics. The project is managed by a broad-ranging cooperation group (TARGET2-Securities Advisory Group) and its technical groups. National user groups have been established to disseminate information in EU member states and to ensure broader expertise in the development of the system.

The Finnish user group, which consists of a large number of experts from banks, brokerage firms, the central securities depository, authorities and other interest groups, submitted its response on user requirements in April. The response is available on the ECB's website.

In its response, the Finnish user group focused on eg the functionalities required by direct holding of securities, the efficiency of liquidity management, and the importance of pricing. Finnish legislation contains special requirements, which have been discussed on several occasions with the experts of the project team. In practice this involves the specification of user roles and incorporating the corresponding functionalities into the information system, and giving due consideration to the various account restrictions in the

¹³ The consultation documentation and the responses are available on the ECB's website at <http://www.ecb.int/ecb/cons/html/t2s-2.en.html>

functionalities of the information system. Transparent organisation of the project was also considered | important.

5 Key regulatory and supervisory initiatives

5.1 Progress in EU arrangements for promoting financial market stability

Jyrki Haajanen

Rapid developments in financial markets and recent market disturbances have increased pressure to accelerate the development of crisis management tools.

Rapid developments in the financial markets pose many challenges for ensuring financial market stability. Recent market disturbances have shown how difficult it can be to safeguard financial market stability and the multitude of ways market disturbances can arise. Increased integration of financial markets, institutions and infrastructures will also force EU member states to continue developing arrangements for maintaining the stability of financial markets. In fact, we are witnessing a race between financial market development and the instabilities often connected with it.

Several EU initiatives are under way for reducing disturbances in the financial markets. The aim is also to develop tools that will enable member states to more effectively protect themselves against shocks stemming from the financial markets.

The strategic roadmap¹⁴ adopted by the ECOFIN Council in autumn 2007 and the improved utilisation of the Lamfalussy framework are the most important EU initiatives for meeting the challenges of change in the financial markets. Moreover, the ECOFIN Council has introduced some measures for preventing situations like the recent financial market crisis.

Extension of the Lamfalussy framework¹⁵ to the banking and insurance sector in 2004 has created a lot of work for EU institutions. The Lamfalussy framework aims at upgrading the regulatory process also in the banking and insurance sectors. It was found that the aims had been well achieved when the framework was reviewed thoroughly in 2007. Based on the recommendations, the European Commission prepared a communiqué which included practical proposals for further improving regulation and supervision.¹⁶ The key reforms on financial market supervision and regulation include improving the functioning of the Committees of supervisors¹⁷ by clarifying the legal position of the committees and specifying their accountability, and by enhancing the decision making process.

Effective prevention and management of a financial crisis depends mainly on the ability of authorities to exchange information and engage in

¹⁴ Economic and Financial Affairs (ECOFIN) Council adopted in October 2007 a set of proposals on financial market disturbances and crisis management.

¹⁵ The aim of the Lamfalussy process is to facilitate and improve the preparation and implementation of EU regulation.

¹⁶ Review of the Lamfalussy process, November 2007.

¹⁷ CEBS, CEIOPS and CERS.

cross-border cooperation, if necessary. The strategic roadmap presented by the ECOFIN Council includes several measures for improving financial crisis management in the EU. The scope of the roadmap is broad, and it includes many tiers of recommendations. The key recommendations are to prepare a new EU-wide Memorandum of Understanding (MoU)¹⁸, to agree on common crisis management principles and to develop crisis management tools for the EU.

The new MoU extends the scope of the MoU signed in 2005. Moreover, the new MoU is more concrete and detailed. It does not entail changes in national responsibilities or obligations but instead aims to tighten cooperation between authorities in crisis management, based on the existing legal framework. The new MoU is scheduled to enter into force by the end of 2008 at the latest.

The roadmap also includes 9 commonly agreed crisis management principles¹⁹ that all member states aim to follow in the management of a cross-border financial crisis. These principles underline eg that

- managing a cross-border crisis is a matter of common interest for all member states
- crisis management models should be based primarily on private sector solutions
- if public funds have to be used, the costs must be shared on the basis of the economic impact of the crisis in the member states.

The roadmap also encourages member states to develop common crisis management tools for the EU. The MoU includes a set of practical guidelines for dealing with a cross-border financial crisis. The guidelines include detailed recommendations on eg

assessing the systemic importance of a crisis, exchanging information, coordinating decision making, and communications. Member states are also encouraged to sign bilateral agreements in which the possible specific needs of individual countries in a crisis situation can be better taken into account.

In the roadmap, the ECOFIN Council also highlights certain areas of legislation that it hopes the EU Commission will pay attention to and remedy any possible shortcomings. These areas include capital adequacy regulation, the deposit guarantee scheme, the reorganisation and winding up of credit institutions, and cross-border asset transfers.

¹⁸ Memorandum of Understanding on co-operation between the Financial Supervisory Authorities, Central Banks and Finance Ministries of the European Union on Cross-border Financial Stability.

¹⁹ Common principles for cross-border financial crisis management, ECOFIN Council October 2007.

6 Key corporate arrangements and events in the financial sector

<i>Date</i>	<i>Event and description</i>
November 2007	<p><i>Nasdaq to acquire the Philadelphia stock and derivatives exchange.</i></p> <p><i>OMX signs an agreement on acquisition of the Armenian Stock Exchange and the Central Depository of Armenia.</i></p> <p><i>Authorities approve merger between Oslo Stock Exchange and Norwegian Central Securities Depository.</i></p>
December 2007	<p><i>UPM-Kymmene delists from the New York Stock Exchange.</i></p> <p><i>The Deposit Guarantee Fund of Finland approves Kaupthing Bank Oyj as a member of the deposit guarantee fund. Kaupthing Bank Oyj will merge with its parent company Kaupthing Bank hf.</i></p> <p><i>Eirikuva Digital Image Oyj Abp is the first Finnish company listed on the First North marketplace.</i></p> <p><i>Fitch confirms Finland's long-term rating at AAA.</i></p>
January 2008	<p><i>OKO Bank plc acquires K-Finance Ltd share capital from Kesko.</i></p> <p><i>NYSE Euronext announces it will acquire the American Stock Exchange (AMEX).</i></p>
February 2008	<p><i>Kaupthing cancels agreement to acquire Dutch merchant bank NIBC.</i></p> <p><i>Moody's lowers UPM-Kymmene Corporation's long-term debt rating from Baa2 to Baa3. Outlook stable.</i></p> <p><i>Fitch changes rating outlook on Stora-Enso's and UPM-Kymmene's long-term debt from stable to negative. The companies are now rated BBB-.</i></p>

<i>Date</i>	<i>Event and description</i>
February 2008	<p><i>In the United Kingdom, Northern Rock is nationalised.</i></p> <p><i>NASDAQ Stock Market Inc. and OMX AB merge. The name of the new company is The NASDAQ OMX Group Inc.</i></p> <p><i>The Swiss financial supervisory bodies will be integrated into a single organisation (FINMA) on 1 January 2009. Parts of the act on financial supervision took effect already on 1 February 2008.</i></p>
March 2008	<p><i>If P&C Holding Ltd announces it will acquire the Russian insurance company SOAO Region (located in St. Petersburg).</i></p> <p><i>S&P gives Sampo Life Insurance Company Ltd a long-term rating of BBB+.</i></p> <p><i>Barclays Bank plc announces it will acquire the Russian bank Expobank, for USD 745 million.</i></p> <p><i>CME Group announces it will acquire energy-exchange operator NYMEX.</i></p> <p><i>The NASDAQ OMX Group Inc announces it will establish a new pan-European marketplace, the NASDAQ OMX Pan European Market.</i></p> <p><i>JP Morgan Chase acquires investment bank Bear Stearns, which had run into funding problems.</i></p> <p><i>Rautakirja Group announces it will equip each of over 500 R-Kiosks with an ATM.</i></p> <p><i>General Electric sells its commercial card business to American Express. General Electric also sells to Santander, the largest bank in Spain, its finance companies operating in Finland, Germany and Austria. In return, GE Commercial Finance will acquire, inter alia, the Italian bank Interbanca from Santander.</i></p> <p><i>Nordea announces it will sell its institutional global custody portfolio to JP Morgan Worldwide Securities Service.</i></p>
April 2008	<p><i>Aktia Savings Bank plc and Veritas Mutual Non-Life Insurance Company announce plans to merge.</i></p>

<i>Date</i>	<i>Event and description</i>
April 2008	<p><i>The Association of German Banks takes over Düsseldorfer Hypothekenbank.</i></p> <p><i>The German Financial Supervisory Authority (BaFin) orders the closure of Weserbank AG, established in 1912.</i></p> <p><i>Moody's affirms Finland's ratings of P-1 and Aaa. Outlook remains stable.</i></p> <p><i>Standards & Poor's places Iceland's long-term credit rating (A+) on watch for possible downgrading.</i></p> <p><i>Fitch places Iceland's short- and long-term credit rating on watch for possible downgrading. Short-term rating now stands at F1 and long-term at A+.</i></p> <p><i>Fitch places the rating of the Icelandic banks Glitnir Bank, Kaupthing Bank and Landsbanki Islands on watch for possible downgrading. The banks have the same ratings: short-term F1 and long-term A.</i></p> <p><i>S&P lowers Stora Enso's long-term rating from BBB to BBB-.</i></p> <p><i>Moody's lowers Stora Enso's credit ratings as follows: short-term from P-3 to NP, and long-term from Baa3 to Ba1. Rating outlook stable.</i></p> <p><i>Multilateral trading facility Chi-X announces it will start trading the OMX Helsinki 25 component stocks.</i></p>
May 2008	<p><i>Moody's lowers Iceland's long-term rating from Aaa to Aa1.</i></p> <p><i>OMX AB shares delisted.</i></p> <p><i>Fitch affirms Teollisuuden Voima Oyj's ratings; short-term: F2; long-term A-. Rating outlook remains stable.</i></p> <p><i>Fitch affirms Nordea's credit ratings; short-term: F1+; long-term AA-. Rating outlook remains stable.</i></p>