SUOMEN PANKKI • BANK OF FINLAND

Financial Markets Department

Financial Market Report

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- Growth of households' loan stock levelling off.
- Non-financial corporations' financing plans subdued.
- Banks' operating profits increased while net interest income as a proportion of banks' total income declined.
- Speedy reform of China's huge banking sector.
- Electronic invoicing rapidly gaining ground in Finland.
- Formation of the Nordic Central Securities Depository speeds up integration of securities clearing and settlement.

http://www.bof.fi/eng/3_rahoitusmarkkinat/index.stm

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1 Financial intermediation

1.1 Growth of MFI loans to the private sector levelling off

Laura Vajanne

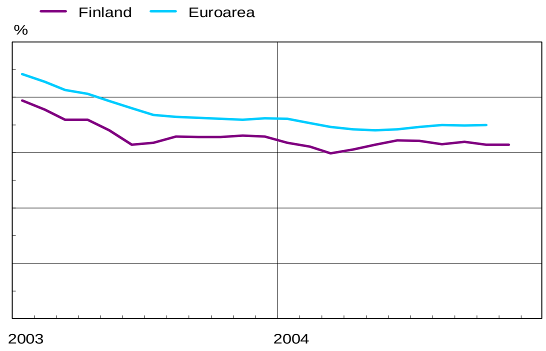
The growth of loans to the private sector by Finnish monetary financial institutions (MFI) is levelling off. The rapid increase in loans, compared to the rest of the euro area, has been due to special factors, whose impact is now waning. The growth rate of loans in Finland is expected to gradually approach the average rate for the euro area.

The financial markets have for long been expecting an interest rate rise. These expectations weakened, however, during the autumn and have now been pushed forward. The changes in expectations were reflected in EURIBOR rate fluctuations. The 12-month EURIBOR has fluctuated, without a clear trend, between 2 and 2.5% since the summer of 2003. The weakening of rate-rise expectations was also reflected in the fall in long-term interest rates. At the end of November, the yield on the Finnish government's 5-year benchmark bond had dropped to 3%.

Changes in market rates have been reflected in MFI interest rates on new business. In Finland, interest rates on new floating-rate loans for house purchase are still among the lowest in the euro area: in October the average was 3.14%, compared to 3.49% in the euro area (Chart 1). In contrast, interest-rate competition on large floating-rate loans to non-financial corporations is significantly tighter in the euro area as a whole and this is reflected in the narrow interest rate differentials between euro area countries. In Finland, the average rate on new large (over EUR 1 million) loans to non-financial corporations was 3.17% in October compared to 2.99% for the euro area (Chart 2).

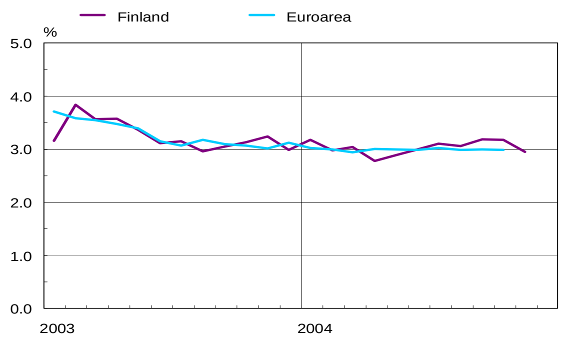
The interest rate margins on new loans for house purchase and large loans to non-financial corporations (loan rate minus 12-month EURIBOR) have narrowed during the autumn to close to 0.8 percentage point. The interest rate margins on small loans to non-financial corporations and other household loans are wider. The narrowing of interest rate margins that has taken place in the course of the year is levelling off.

Chart 1. MFI interest rates on new floating-rate loan agreements for house purchase in Finland and the euro area



Sources: ECB and Bank of Finland.

Chart 2. MFI interest rates on new floating-rate agreements on loans (over EUR 1 million) to non-financial corporations in Finland and the euro area



Sources: ECB and Bank of Finland.

Developments in outstanding amounts of loans

The growth rate of loans to the private sector by Finnish MFIs has for several years been higher than in the euro area on average. The annual growth rate of loans has been higher only in Greece, Spain and Ireland.

In Finland, the annual growth rate of lending for house purchase has stabilised somewhat since spring but is still strong. In other euro area countries, the growth is picking up.

The annual growth rate of loans to non-financial corporations has varied in Finland between 8 and 9%. The assessment of current developments is hampered by wide fluctuations in the loan stock. Mergers and other exceptional arrangements, for example, cause considerable monthly movements in the loans to non-financial corporations.

Based on factors that have impacted recent developments in loans to the private sector, the growth rate of loans is expected to slow down somewhat and the differences compared to the rest of the euro area to diminish.

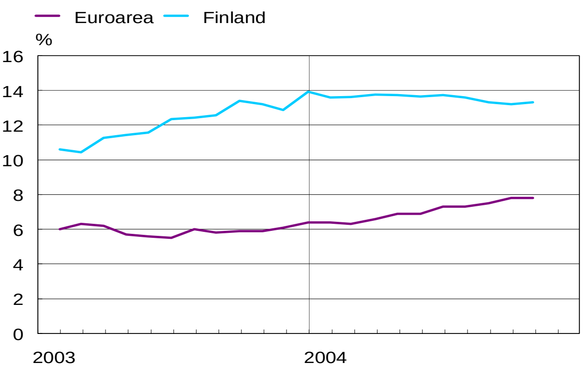
First, the decline in market interest rates that continued for several years has come to a halt. In Finland, the fall in interest rates has been considerable compared to several other euro area countries. A similar boom in loans to the private sector has taken place in those euro area countries in which rates fell with accession to monetary union (Spain, Ireland, Greece). On the other hand, even though interest rates will move up, the level of interest rates is expected to remain so low that the propensity to borrow is not likely to be dampened very much.

The narrowing of banks' interest rate margins is also levelling off. Thus changes in market interest rates will pass thorough directly to loan costs. In Finland, 90% of the loan stock is comprised of floating-rate loans. Therefore a rise in interest rates is quickly reflected in a rise in the interest rates on the entire loan stock.

The new investment plans of domestic non-financial corporations are moderate, and there is no pressing need to increase debt financing in the near future (see Section 1.2).

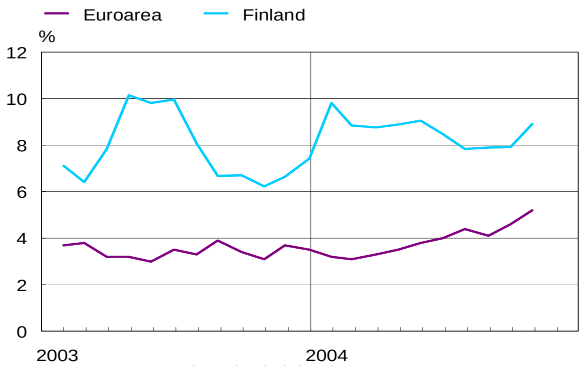
There are some signs that the housing market in the Helsinki area is cooling down: selling times for properties are longer and the rise in prices has – at least for now – slowed down. This is reflected in the slight decrease in the growth of the house-purchase loan stock. On the other hand, longer loan periods enable larger house-purchase loans, which will sustain the growth in the stock of these loans also in the future.
The number of new loan agreements in the private sector is going to be reduced by the fact that a significant portion (about a third of the increase in new lending for house purchase) has resulted from reorganisations of old loans. This part of demand has gradually been met, and there is no longer a need for new loan contracts in connection with narrowing margins.

Chart 3. Annual growth of MFI lending for house purchase in Finland and the euro area



Sources: ECB and Bank of Finland.

Chart 4. Annual growth of MFI loans to non-financial corporations in Finland and the euroa area



Sources: ECB and Bank of Finland.

1.2 Non-financial corporations' financing plans exceptionally subdued

Jukka Vauhkonen

According to the report on the Survey on Business Finances published annually by the Bank of Finland, Confederation of Finnish Industries and Ministry of Trade and Industry, an exceptionally small proportion of non-financial corporations are planning new external financing within the next 12 months.

The Bank of Finland, the Confederation of Finnish Industries (and its predecessor, the Confederation of Finnish Industry and Employers) and the Ministry of Trade and Industry have since 1994 studied the financing, financing plans, and price and availability of financing of industrial and service companies, as well as their use of banking services. The results of the annual survey are presented in detail in the report on the Survey on Business Finances[1].

The most important results of the latest survey deal with the external financing plans of non-financial corporations. The portion of non-financial corporations that are planning financing within the next 12 months is considerably lower than in recent years. The findings of the survey show, in particular, that a significantly smaller portion of large non-financial corporations (over 250 employees) are planning new external financing within the next 12 months (Chart 5). The result is noteworthy because the survey shows that new financing of large non-financial corporations was fairly subdued already during the previous 12 months.

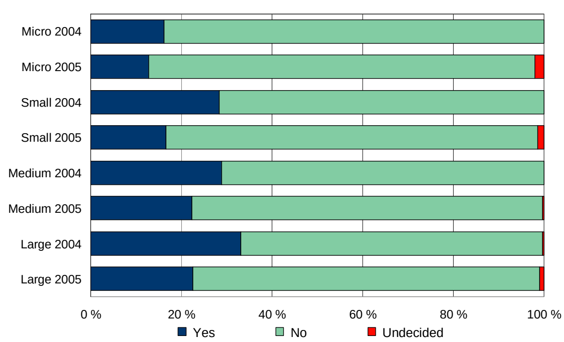
The subdued level of external financing and financing plans of large non-financial corporations is reflected also in their use of public corporate financing. A significantly smaller portion of large non-financial corporations used public corporate financing during the previous 12 months (September 2003 – August 2004) than during the year-earlier period.

This years' survey also includes important results eg on the pricing of bank loans to non-financial corporations and the inviting of bank bids. The survey shows that the interest rate margins on new corporate loans (loan rate minus reference rate) have remained unchanged or continued to narrow. In fact, less than one in every ten non-financial corporations that had acquired financing reported that the interest rate margin on its new loans had widened.

Interest rate margins have remained unchanged or narrowed although the survey shows that non-financial corporations have cut down on bank bidding. The portion of non-financial corporations that invite banks to bid is considerably smaller than at the turn of the century.

In the questions that change annually, non-financial corporations were asked to assess the impact of monetary union on their financial position, imports, and exports. The majority of non-financial corporations are of the opinion that the union has had a neutral or positive impact.

Chart 5. Non-financial corporations' external financing in the previous 12 months (2004 columns) and financing plans for the next 12 months (2005 columns)



Source: Confederation of Finnish Industries, Ministry of Trade Industry and Bank of Finland. Survey on Business Finances 2004.

1 http://www.bof.fi/fin/3_rahoitusmarkkinat/3.6_Raportit/index.stm

2 Banks

2.1 Banks' operating profits increased while net interest income as a proportion of banks' total income declined

Mervi Toivanen

Banks' total operating profits increased in January–September 2004. Lower interest rates and narrower interest rate margins led to a decline in net interest income, in both absolute terms and as a proportion of total income. The concurrent increase in net fee income is thus the main factor behind the improvement in banks' operating profits. Cost control and low loan losses also contributed to an improvement in results.

During the past 12 months, net fee income increased for all banking groups, due to an increase in payment activity and repricing of banking services, as well as higher income from securities intermediation, asset management and mutual fund activity. Thanks to an increase in net fee income, banks' other income has also generally increased.

Net interest income declined from January–September 2003, primarily in response to the lower level of interest rates and narrower interest rate margins. Net interest income as a proportion of banks' total income has declined, while other income has increased. Combined net interest income for Finnish banking groups, for example, accounted for 61% of total income in January–September 2004, compared to 64% in January–September 2003.

The decline in net interest income may have ended, at least momentarily, in the third quarter of this year. According to the reports of some banks, net interest income has either remained unchanged from earlier quarters or increased year-on-year.

The improvement in operating profits was also bolstered by practically unchanged expenses in comparison with January–September 2003, and by low loan losses.

Group operating profits were boosted by an increase in operating profits from life and non-life insurance, and by non-recurring items. Operating profits for the Nordea group improved, but the operating result of Nordea's retail banking in Finland declined by 10%. The performance of the Sampo group improved considerably, although comparability is impaired by the group's structural change, as the group took over the entire share capital of If P&C Insurance Company Ltd this year. The financial result of the OP Bank Group fell as the increase in other income was insufficient to offset the decline in net interest income.

Overall, banks' capital adequacy remained high on average.

Table 1. Banks' financial results, Jan–Sep, 2004

	Net income		Other income		Total expenses		Operating profit	
	EUR m	Change %	EUR m	Change %	EUR m	Change %	EUR m	Change %
Nordea Group	2 598	3.3 %	1 618	-6.1 %	2 679	-5.0 %	1 648	15.3 %
***Nordea Group, banking**	2 611	-5.9 %	1 914	18.7 %	2 702	-3.5 %	1 826	35.0 %
***Nordea retail banking in Finland**	567	-2.6 %	280	-0.7 %	472	2.6 %	372	-9.9 %
Sampo Group	-	-	-	-	-	-	753	112.1 %
***Sampo Group banking and investment services**	294	-3.3 %	206	18.4 %	293	-4.6 %	231	35.9 %
OP Bank Group	580	-3.3 %	340	3.0 %	553	1.1 %	390	-3.2 %
***OKO Bank Consolidated**	121	1.7 %	82	-34.9 %	106	6.0 %	98	-27.1 %
Savings banks (excl. Aktia) Total	81	-6.4 %	34	25.0 %	79	-0.6 %	35	5.0 %
Aktia Savings Bank plc Group	54	-3.2 %	32	9.2 %	57	-4.7 %	28	13.1 %
Local cooperative banks	54	-5.4 %	18	9.2 %	51	2.0 %	22	-10.0 %
Bank of Åland plc (Group)	22	-1.4 %	14	9.3 %	23	-1.3 %	13	3.3 %
Evli Group	1	42.3 %	39	4.9 %	32	2.1 %	8	21.9 %
eQ online Group	2	33.5 %	12	28.8 %	13	10.1 %	1	-
1. Finnish banking groups (excl. Nordea)	1 088	-3.5 %	694	9.2 %	1 100	-0.8 %	727	8.1 %
2. Finnish banking business	1 655	-3.2 %	974	6.2 %	1 572	0.2 %	1 099	1.2 %
3. Financial conglomerates operating in Finland	-	-	-	-	-	-	2 897	26.7 %

Other income includes net fee income but excludes the income statement item "profit/loss of companies consolidated by the equity method".
Total expences include depreciations as well as unrealised losses on tangible and intangible assets.
Nordea's expenses include goodwill depreciation and write-downs.
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 January - June, 2003.

Finnish banking business includes the Finnish banking groups, Sampo 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 Performance of Nordic and Baltic financial groups remains good

Sampo Alhonsuo

In light of recent interim reports, the performance of the large Nordic and Baltic banking and financial groups remains good. Operating profits have improved in response to higher income and lower loan losses.

Banks' income development has not changed much: net interest income has remained unchanged, while other income items have increased. Net interest income has remained the same despite the growth of lending in the balance sheets. This highlights the significance of the low level of interest rates and intense margin competition. The positive trend in other income is due to more favourable developments eg in capital markets.

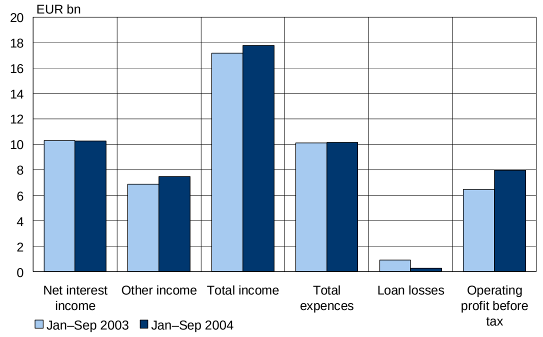
The level of costs has remained in line with the corresponding period of 2003. The various measures introduced by banks to achieve greater operational efficiency have begun to bear fruit. The improvement in operating profits from the year before is attributable to lower loan losses as well as to an increase in other income. In the period January–September 2004, the combined loan losses for the ten largest Nordic financial groups were as low as EUR 0.2 billion.

As a consequence of these developments, the key business indicators for efficiency, profitability and capital adequacy are good, or even excellent. For example, expenses accounted for just 57% of income.

The balance sheets of the large Nordic financial groups have grown rapidly, reflecting a robust expansion of lending and business volumes over the past few years. At the end of September 2004, the stock of lending, EUR 691 billion, exceeded the stock of deposits by more than 80%. However, lending and deposits have posted balanced growth in the past year. The rate of lending growth is slowing in the Nordic countries.

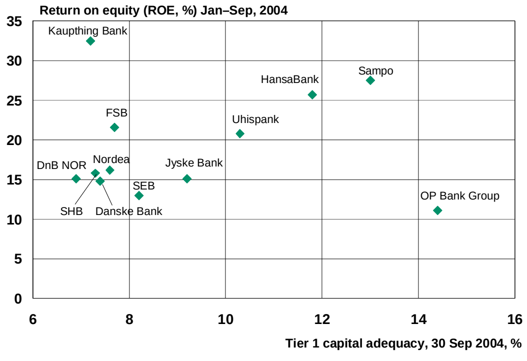
Banks are currently preparing for the introduction of a new accounting framework based on International Financial Reporting Standards (IFRS), at the start of 2005. The adoption of a new regulatory framework will have consequences for banks' presentation of results, and higher volatility of results is anticipated for the future. But now at the changeover the performance level of the large Nordic banking and financial groups is very good.

Chart 6. Main income statement items, Jan–Sep 2004 and 2003, EUR bn



Sources: Interim reports of banking and financial groups, Jan–Sep 2004.

Chart 7. Tier 1 and ROE for selected banking and financial groups



The charts are derived from interim reports for January–September 2004 of the following banking groups: Nordea, Sampo, OP Bank Group, SEB, Handelsbanken (SHB), Svenska FöreningsSparBanken (SFB), Danske Bank, Jyske Bank, DnB NOR and Kaupthing Bank. The latter chart also includes HansaBank and Uhispank.

2.3 Speedy reform of China's huge banking sector

Tuuli Koivu, Institute for Economies in Transition

China's huge banking sector accounts for the bulk of China's financial market. Much of the sector is still government owned, and not all banks are operating yet on market terms. Banks are currently undergoing rapid reform, as opening of the sector is expected to tighten competition.

China's financial sector is dominated by banks. At the end of 2003, bank loans amounted to 150% of GDP, while the shares of bond markets and listed shares were about 30% and less than 40%, respectively. By international standards, the banking sector is huge and the ratio of debt to the size of the economy is exceptionally high. A major reason for the huge size of the sector is households' high savings ratio.

The Chinese banking sector is characterised by very different types of operators, but a common feature of most of them is government ownership. The dominant role of central and local government is reflected in banks' credit decisions, as a large part of that credit still goes to state-owned companies. Despite the vast banking sector, small and middle-sized private companies continue to suffer from insufficient external financing.

Four large state-owned commercial banks account for more than half of total bank credit. These banks are massive even by international standards; they employ up to 1.4 million people. Central and local governments also have holdings in nearly all of the other (about 100) commercial banks. In the countryside in particular, there are more than 30,000 credit cooperatives. China also has three large development banks, investment companies and other smaller financial institutions. Foreign banks' operations are still tightly regulated in China, and their role in the market is small.

The banking sector has grown rapidly in recent years. At the end of June 2004, total outstanding deposits and credit were, respectively, 18% and 14% higher than a year earlier. At the same time, credit maturities have lengthened. Although short-term loans still account for approximately half of total credit, in 1998 its share was nearly 70%. The majority of both credit and deposits are denominated in the home currency.

Bank reform started as early as 1979. The pace has accelerated in recent years, because China made a commitment, as part of WTO membership negotiations, to open its banking sector to foreign banks in December 2006. From then on, competition is expected to be considerably tighter, and China is in a hurry to strengthen its banking sector beforehand. Foreign banks are showing a great deal of interest in the Chinese banking sector, and some have already acquired minority holdings in Chinese banks. However, a number of experts have warned foreign banks against too-high expectations for deregulation, because China has set strict requirements on foreign banks entering the Chinese market.

China has been revamping its banking sector in many ways in recent years. An independent supervisory authority was established in spring 2003. China has also strengthened banks' balance sheets by giving them more capital. Bank management has been improved, operations have been made more efficient and transparency has been increased. Interest rate deregulation on credit has been implemented in stages and legislation has been updated. Reform of the four major banks has started with two of the most efficient banks, ie Bank of China and Construction Bank of China. They are currently seeking foreign investors interested in acquiring minority stakes in Chinese banks, and they are expected to be listed on the stock exchange in 2005.

Chinese banks will face a number of challenges in the coming years. Although the amount of nonperforming loans has declined over the last year, a study by the central bank shows that they continued to account for more than 13% of total outstanding credit of the 14 major banks as at the end of September 2004. Moreover, nonperforming assets are substantial in the smaller financial institutions. In fact, the true number of nonperforming assets is probably considerably higher than what the statistics show, as official figures are believed to underestimate the true magnitude of the problem. This is partly due to the calculation method, which differs from international practice. Estimates by international experts and credit institutions of the total amount of nonperforming loans vary between 30% and 40% of GDP.

In addition, banks' capital adequacy is poor, and many banks are inefficient because of dense branch networks and large staffs. By international standards, return on own capital has been relatively low in recent years, particularly for large government-owned banks and development banks, even though the margin between deposit and lending rates has been relatively wide. Since inflation accelerated in 2004, real deposit rates, which are still tightly controlled, have turned negative. This has probably induced some households to channel their deposits to black market operators, who provide higher returns than commercial banks. The black market provides financing to private companies that find it hard to obtain financing from official banks. The size of this unlawful financial market is impossible to estimate, but it is expected to be significant for China's economic development.

The area where improvements are most urgently needed is probably in bank management. Previously, loan decisions were always made under government supervision, and public administration still seems to intervene very often. Furthermore, soft budget constraints are still common in many state-owned companies, and government-owned banks are obliged to finance these unprofitable companies. It is alarming that a considerable part of nonperforming loans are loans that were granted only a couple of years ago. Authorities have warned that the rapid growth of lending over the last year or so could lead to a new wave of nonperforming loans within a couple of years. It is essential to improve the skill and expertise of banking officials and to give banks incentives for more market-driven behaviour.

2.4 Year of big bank mergers and acquisitions

Jukka Vauhkonen

JPMorgan Chase and Bank One merged. Mitsubishi Tokyo Financial Group and UFJ announced their intention to merge in 2005. Banco Santander Central Hispano acquired Abbey National. In Europe, banks' mergers and acquisitions have generally declined since the peak years of 1998-2000.

Major bank mergers and acquisitions were completed or initiated in 2004 in the USA, Japan and Europe.

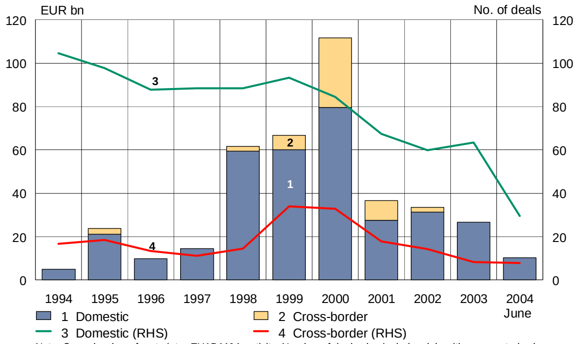
In July, US authorities approved the merger of the third and sixth largest US banks, JPMorgan Chase and Bank One. Named JPMorgan Chase & Co, the new bank is now the second largest bank in the country. This was the second merger of major US banks within a short period of time. In October 2003, Bank of America had jumped to second place among US banks by merging with Fleet Boston.

Japan's second and fourth largest banks, Mitsubishi Tokyo Financial Group and UFJ, announced merger plans in July 2004. If realised, the new bank will be the world's largest bank in terms of balance sheet total. Completion of the merger is unsure, however, as Japan's third largest bank, Sumitomo Mitsui Financial Group, made a competing offer to UFJ shareholders, also in July.

Europe's largest cross-border acquisition was finalised in November 2004, when Spain's largest bank, Banco Santander Central Hispano, acquired UK's sixth largest bank, Abbey National. Following the acquisition, Banco Santander announced its entry into the world's top ten banks in terms of market value.

Nevertheless, the number and total value of national and cross-border bank mergers and acquisitions in EU15 countries were considerably lower in 2001-2004 than in the peak years of 1998-2000 (Chart 8).

Chart 8. Bank mergers and acquisitions in EU15 countries



Note: Cross-border refers to inter-EU15 M&A activity. Number of deals also includes dels with no reported value.
Source: ECB; original source Thomson Financial (SDC Platinum).

There are a number of factors that spur cross-border M&A activity in the EU15 countries in the future. These include fierce competition over market shares, banks' strong liquidity position, EU's new take-over directive and the extensive centralisation of national banking sectors in a number of European countries.[1]

Among the new EU member states, M&A activity in the banking sector began to pick up in 1998 and peaked in 2000–2002. The number and value of mergers and acquisitions declined notably in 2003 and early 2004. Mergers and acquisitions in the new member states have been mainly cross-border operations, contrary to the EU15 countries.

It is worth noting that Icelandic banks, especially Kaupthing Bank and Islandsbank, have recently expanded their operations into other Nordic countries. The most significant Nordic acquisition by an Icelandic bank was carried out in June 2004, when Kaupthing Bank doubled its size by acquiring the Danish FIH Ehrvervsbank.

[1,2] ECB (2004). Report on EU Banking Structure.

3 Securities markets

3.1 Less variation in equity returns

Jukka Topi

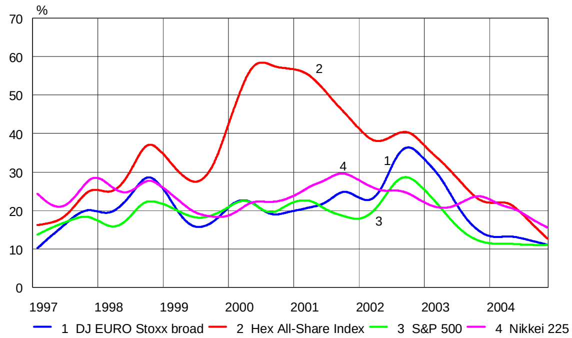
Share prices increased in several key markets in the autumn of 2004, but market volatility continued to decrease. The value of share trading declined in the third quarter. The dispersion of equity returns between different countries has declined in recent years.

Share prices rose in autumn 2004 in several key markets, including Finland. Because of a general decline in prices in the spring and summer, changes from the beginning of the year have been relatively minor. The share price increase has been felt in many key sectors, particularly ICT, where prices turned upward again in the autumn, after falling in the early part of the year. Bank shares also performed well in both Europe and the USA. Of the major markets, share price performance was weaker in Japan than in the USA and Europe.

Stock market volatility has diminished globally since 2002 (Chart 9). Although volatility is at its lowest since 1997, the level is not exceptionally low from a long-term perspective. Recent years' above-average volatility is a reflection of many exceptional factors such as several financial market and financial statement related scandals as well as geopolitical tensions.

In January-September 2004, the value of share trading on the major markets was higher than in the year-earlier period. During spring and summer, however, share turnover started to decline, due partly to a fall in share prices. In the third quarter of 2004, respective values of shares traded in the euro area, USA and Japan were lower than in 2003 Q3 by 8%, 6% and 2%.[1] The trend in Finland was similar, as share turnover fell by 7% in the same period. The increase in share prices in the autumn seems to have prompted an upturn in share trading in recent months, at least in Finland.

Chart 9. Historical volatilities of share indices*



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

Lower dispersion of equity returns in the euro area

The dispersion of equity returns across countries has declined since 2001, ie equity returns are now more closely aligned than before (Chart 10). This trend has continued in 2004, even as equity returns have turned positive after several years of negative performance.

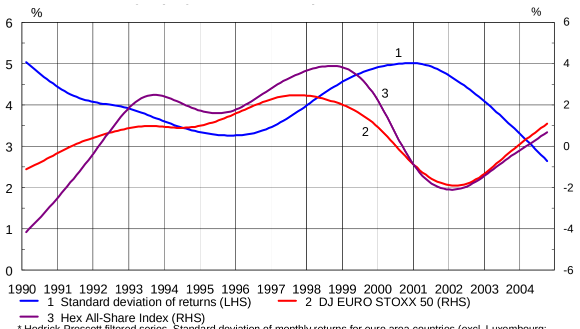
The decrease in equity return dispersion is one sign of share market integration[2] in the euro area. Another indication of integration is that the dispersion of equity returns between euro area countries has shown signs of declining more in recent years than the dispersion of equity returns between differ-

[1] For the USA, total share turnover on the New York Stock Exchange and Nasdaq; for the euro area, total share turnover on key euro area stock exchanges; and for Japan, share turnover on the Tokyo Stock Exchange.

[2] For more information on securities markets integration, see Pylkkönen, P. (2004). Securities Markets Integration. In Financial Markets Integration, Bank of Finland Studies A:107, Koskenkylä, H. (ed.) (2004).

ent sectors.[3] The decline in the dispersion of equity returns also implies that the benefits of investment diversification across euro area countries are diminishing and investors need to look for new ways of diversifying eg across sectors within or beyond the euro area.

Chart 10. Monthly equity returns and dispersion in the euro area*



* Hodrick-Prescott filtered series. Standard deviation of monthly returns for euro area countries (excl. Luxembourg; Portugal since Aug 1995). Returns measured as log differences of monthly value of Morgan Stanley Capital International Index.

Sources: Bloomberg, Morgan Stanley Capital International, Helsinki Stock Exchange, own calculations.

It should be noted that in addition to structural factors, such as those relating to EU integration, the dispersion of equity returns between euro area countries may be affected by other factors, such as cyclical movements. For example, at the end of the 1990s, dispersion increased despite the introduction of the euro and other factors relating to EU integration. The increase reflected a pronounced simultaneous rise in share prices, which was felt unevenly in the different euro area countries. The recent turn to positive equity returns does not yet seem to have prevented the reduction in dispersion of returns.

[3] See, for example, Baele, L. – Ferrando, A. – Hördahl, P. – Krylova, E. – Monnet C. (2004) Measuring financial integration in the euro area, European Central Bank, Occasional papers no 14, May.

3.2 Clear downturn in stock of domestic corporate bonds in Finland

Pertti Pylkkönen

Favourable market conditions notwithstanding, the growth of corporate bond issuance in the euro area has been modest. In Finland, the stock of corporate bonds has contracted this year.

Bond markets calmed in the summer, with long-term interest rates turning down again in June. In the euro area countries, 10-year bond rates continued to fall up until the beginning of December. US long-term interest rates trended upward in late October and the US 10-year bond yield differential vis-à-vis the euro area countries has widened to just over a half percentage point.

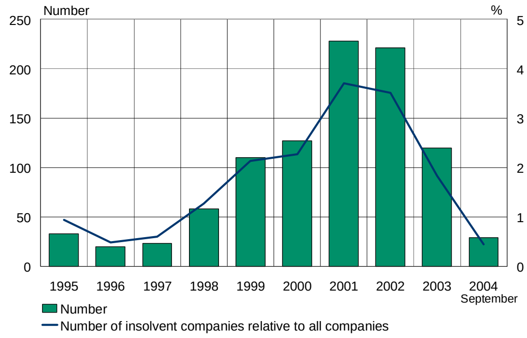
Volatility in the markets for fixed income instruments, as in the stock markets, has been muted for a long time now. The Federal Reserve's interest rate hikes have been expected and have not had much effect on bond markets since the spring. Volatility of US long-term rates has also been dampened by reduced needs of financial institutions specialising in housing finance to resort to portfolio hedging to protect against potential interest rate rises.

Because of the low interest rates, investor interest has increasingly shifted towards corporate bond markets and the market for various structured bonds.

Interest rate spreads between corporate bonds and government bonds have remained narrow, partly because of the continued good profitability of the corporate sector and declining indebtedness. At the same time, corporate creditworthiness has improved.

Bankruptcies of rated companies have been on the decline for a couple of years already (Chart 1). For example, none of the companies assigned Standard & Poor's investment grade[1] have been driven into insolvency this year. Default experience of companies of S&P speculative grade [2] has also declined notably[3].

Chart 11. Default experience of rated companies



Source: Standard & Poor's.

Over the period January–September 2004, 29 companies with S&P ratings were driven into insolvency, among them two European and 25 US companies. Companies of emerging economies have done exceptionally well in this regard.

The growth rate of bond issuance slowed in international markets in the third quarter as compared to the early part of the year. New bond issuance, however, clearly exceeds that of the corresponding period of last year.

The slowing growth rate of bond issuance primarily reflects lower public sector demand for loans. In the euro area, corporate bond issuance has also declined considerably despite the low level of interest rates and narrow interest rate differentials.

Bond issuance in Finland has remained subdued despite the low level of long-term rates. By October 2004, the stock of domes-

[1] Short-term rating at least A-3 and long-term rating at least BBB-.

[2] Short-term rating B or lower and long-term rating BB+ or lower.

[3] Standard & Poor's. S&P Quarterly Default Update & Rating Transitions. October 2004.

tic bond issuance had increased by just over 2 percentage points, ie by around EUR 1 billion.

The stock of euro-denominated government bonds has increased by just over 3%. Financial institutions, primarily banks, have also raised more funds through bond issuance, but this increase is not yet very significant in terms of fund raising.

The stock of corporate bonds has contracted by nearly 10% this year. Within the international capital markets, Finnish companies have raised funding in the market for syndicated loans, as well as via a few bond issues. In the autumn, new bond agreements worth more than EUR 1 billion were concluded.

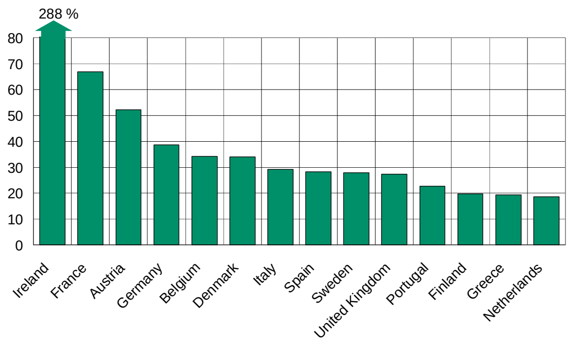
3.3 Continued robust growth of money market and equity funds

Pertti Pylkkönen

Finnish mutual funds have posted the strongest growth this year of all EU 15 countries. Money market funds continued to expand, in contrast to other countries.

The strong growth of mutual funds registered in Finland continued throughout the autumn, with total fund assets crossing the limit of EUR 30 billion in October. The majority of new investment has been channelled into money market and equity funds. Growth prospects for Finnish mutual funds continue to be good. Fund sizes, eg relative to GDP, remain small by European standards. Because of the low level of interest rates, households are increasingly shifting their financial wealth from deposits to mutual fund markets. Mutual fund holdings of Finnish households amounted to approximately EUR 10 billion in October, which accounts for just over a fifth of household bank deposits.

Chart 12. Mutual funds' investment capital for selected EU countries, % of GDP, 30 Sep 2004*



* GDP figures are European Commission estimates for 2004.
Sources: FEFSI and European Commission.

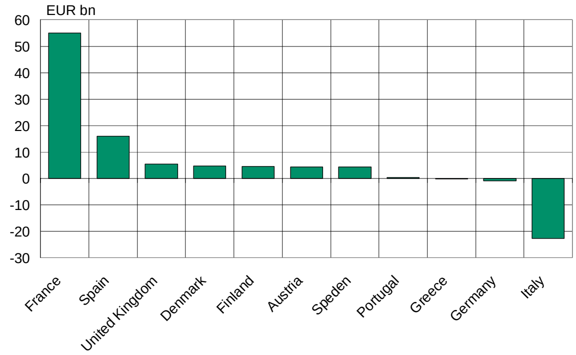
Growth figures for mutual fund markets are somewhat distorted, as the total amount of investment capital is not adjusted for assets in funds of funds, which amount to just over EUR 3 billion and account for 10% of total fund assets. A considerable part of these assets are reinvested in domestic mutual funds, and so the statistics do not accurately reflect the investment capital of domestic mutual funds.

Among the EU 15 countries, Finnish mutual funds posted the highest growth rate in the third quarter of this year. In absolute euro terms, the growth ranked third after Luxembourg and Spain. The growth rate of Finnish mutual funds was also highest among the EU 15 countries for the period January–September 2004.

Developments in Finnish mutual fund markets diverged in the autumn from developments in other European funds in that money market funds in Finland have continued to grow at a rapid pace. In most other EU countries, investment capitals of money market funds have declined or increased only marginally. The slowdown in the share price rise in the spring ended the growth of equity funds in several countries. Finland was an exception in that the net expansion of equity funds has remained almost as strong as the increase in money market funds.

Amendments to the Finnish Mutual Funds Act were introduced in the spring. Following the regulatory changes in mutual fund investing, an opportunity arose for several domestic special mutual funds to become restructured as UCITS funds[1]. Some special mutual funds have subsequently been restructured as UCITS funds and thus can be marketed in other EU countries as well as in Finland.

Chart 13. Net sales of mutual fund units for selected EU countries, Jan–Sep 2004



Source: FEFSI.

[1] Mutual fund within the meaning of the EU UCITS Directive, units of which can be marketed in countries of the European Economic Area as well as in the home state.

4 Infrastructure

4.1 Electronic invoicing is quickly gaining ground in Finland

Timo Iivarinen

The Finnish Parliament chose to rely on tight monitoring instead of imposing a euro limit on banks' service charges, in order to reduce abuse of market power. There will be changes in the division of responsibilities concerning the misuse of payment cards. Electronic invoicing is quickly gaining ground in Finland. The number of interbank payments in the euro area has decreased slightly.

A proposal to set a euro-denominated limit on banks' service charges was rejected by the Finnish Parliament before year-end. Nevertheless the Parliament amended section 4 of the Act on the Financial Supervision Authority so that the Financial Supervision Authority will be responsible for monitoring the availability and pricing of banking services. The amendment will take effect on 1 January 2005.

The cash card, which was intended to replace cash, has not attracted consumers, since the minimum amount for a debit or credit card purchase was abolished. In Sweden, use of the corresponding product will be halted due to the lack of popularity. For this purpose banks now offer customers mobile solutions (involving at least two competing service concepts).

There will be changes in card payments in the next few years because Finnish banks will stop issuing debit cards based on magnetic stripe technology. The aim is to replace these cards with international cards that offer the same service and are equipped with EMV chip technology[1], which more effectively guards against misuse. The transfer to this new technology requires the updating of EFTPOS terminals. Shopkeepers and other retailers should update their payment terminals and card readers rapidly because as of 1 January 2005, the liability for losses caused by possible misuse fall on the party that does not have the equipment required for EMV chip card payments.

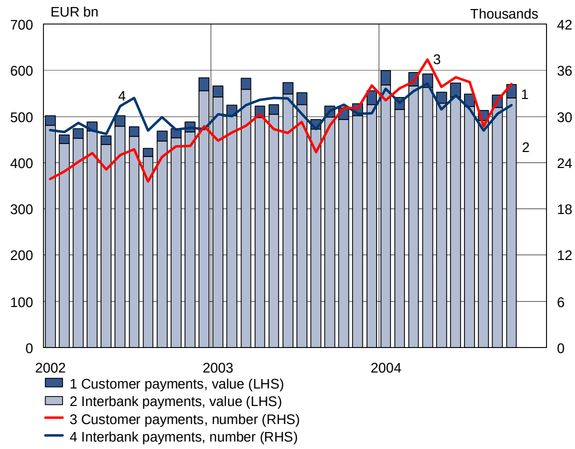
[1] Standard for chip payment used by Europay, Mastercard and Visa.

Electronic invoicing is quickly gaining ground in Finland. This is due to the fact that Finnish banks have been able to agree on a common standard for electronic invoices (Finvoice). Finvoice enables a company to send an e-invoice to a corporate customer directly through its own bank. In 2005, the system will be extended to encompass also private citizens. The standard has also sparked broader interest. The same service is gaining popularity in Sweden, Norway and Denmark, where major banks operating in Finland are also active. The service offer is also being studied in Austria. Finvoice applies the ePI (electronic payment initiator) standard, which means that e-invoices are transmitted through banks' SWIFT systems (Swift Fileact). Finvoice uses the SWIFT system for transferring messages. Thus the standard could also be used for simplifying international payment traffic.

The statistics for 2004 show that the number of euro payments transferred in major interbank payment systems has dropped slightly. Developments in the value of payments are not yet as marked. Much the same can be said for the domestic POPS system for large-value payments but not for the domestic retail payment system PMJ.

In early 2004, the number of cross-border customer payments transferred within TARGET exceeded for the first time the number of interbank payments in nearly every old EU country (EU15). The latest monthly data, however, show that the number of customer payments has decreased substantially from the first quarter of 2004. The share of low-value payments is quite high also in Finnish TARGET payments: about half of the outgoing and incoming TARGET payments are for less than EUR 50,000.

Chart 14. Monthly value and number of cross-border TARGET payments within EU15, daily average



Source: European Central Bank.

4.2 Nordic Central Securities Depository to improve interoperability in the Nordic market

Kirsi Ripatti

The Nordic Central Securities Depository (NCSD) formed by the Finnish Securities Depository APK and VPC, the Swedish equivalent, is a major step forward in the Nordic securities infrastructure.

The letter of intent signed last spring between OMX and the Swedish Securities Depository (VPC) on the merger between APK and VPC was confirmed in the early autumn and the merger was completed at the end of November.

Based on the terms and conditions of the merger, VPC will acquire APK's entire share capital. The principal owners of VPC – large Swedish banks – and OMX will hold equal stakes in NCSD. APK was separated from OMX to create a stand-alone company that will continue operating as an independent legal unit – as a subsidiary of VPC – under Finnish law. The Baltic central securities depositories will remain under OMX ownership via local stock exchanges.

The aim of creating a Nordic – or initially a Swedish-Finnish – central securities depository is to facilitate the harmonisation of rules and clearing and settlement practices in the Nordic market area and to promote the development of a platform based on a common technology. This would in turn speed up the cross-border integration of securities clearing and settlement. The aim is to increase the efficiency, interoperability and competitiveness of Nordic financial markets, which will also benefit issuers, market participants and investors.

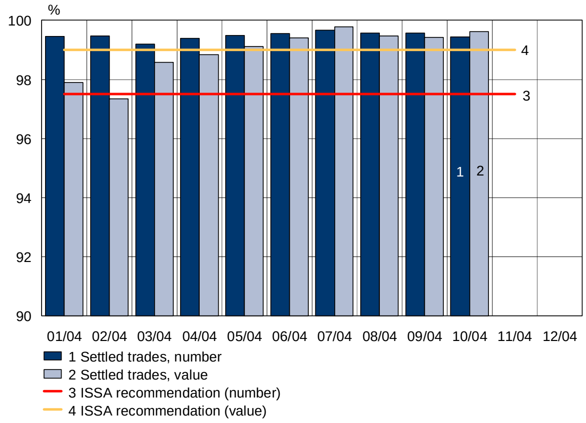
A recent example of interoperability upgrading is automation of the 'bridge' between two international central securities depositories – Clearstream Banking and Euroclear Bank. The recommendations of the various joint fora of market participants are also aimed at improving interoperability. APK is committed to the ECSDA[1] recommendations and is striving to have the recommendations on operational times and finality of cross-border settlement implemented in the domestic market by April 2005. ISSA[2] recom-

[1] European Central Securities Depositories Association.

[2] International Securities Services Association, international joint forum of securities depositories.

mendations provide a benchmark for evaluating exchange trade settlement.

Chart 15. Exchange trades settled in three days (T+3) in HexClear and ISSA recommendations on the minimum level of settlement



Sources: Helsinki Stock Exchange and ISSA.

Exchange trades settled in APK's HEXClear system meet ISSA recommendations on settlement (> 97.5%) based on the average number of trades settled since HEXClear started operating. Between January and October 2004, 99.5% of exchange trades on average have been settled within the allotted time. Measured by the value of settled trades, the average success rate is 98.9%. The settlement rate of MMP trades, which has remained close to 100% for some time, has recently dropped slightly. On average 99.5% of these transactions were settled successfully according to market conventions in January – October 2004. In 2003, the corresponding rate was 99.7%.

5 Key corporate arrangements and events in the financial sector

Date	Event and description
Mar 2004	Nordea Bank Sverige merged with Nordea Bank AB.
	Yrityspankki SKOP Oyj was removed from the Main List of the Helsinki Exchanges at the beginning of March.
	BNP Paribas acquired the American retail bank Community First for USD 1.2 billion.
	Extraordinary General Meeting of Suomi Mutual Life Assurance Company approved the reorganisation of life insurance business with Pohjola Group plc.
	Helsinki Exchanges and Stockholmsbörsen to harmonise equity and derivative markets' trading hours. New trading hours in Finland are 10.00–18.30. The harmonised trading hours are scheduled to come into effect in the autumn, and they will also be applied to the Tallinn and Riga Stock Exchanges.
Apr 2004	HEX Integrated Markets (HEXIM), Copenhagen Stock Exchange, Oslo Børs and Iceland Stock Exchange agreed on a new NOREX cooperation agreement. HEXIM is to represent Helsinki Exchanges, Stockholmsbörsen, Tallinn Stock Exchange and Riga Stock Exchange in the NOREX stock exchange alliance. After signing the agreement, the Alliance comprises 7 stock exchanges and 4 clearinghouses.
	OMHEX-owned Finnish Central Securities Depository (APK) and VPC, the Swedish equivalent owned by 4 Swedish banks, signed a Letter of Intent concerning a possible merger.
May 2004	Royal Bank of Scotland acquired the US bank Charter One Financial, Inc.
	Standard & Poor's lowered Sampo ratings by one grade. The new rating for short-term loans is A-2 and for long-term loans A-. At the same time S&P removed the Credit Watch placement on Sampo. It had placed Sampo on Credit Watch, reflecting possible downgrade, in February.
	Property and Casualty Insurance Company If became a subsidiary of Sampo plc.
	Ministry of Social Affairs and Health granted a business licence to Pohjola Life Insurance Company Ltd. The new company is a subsidiary of the Pohjola Group plc.
	OMHEX and the State of Lithuania signed a Letter of Intent concerning the National Stock Exchange (NSEL) and the Central Securities Depository (CSDL) of Lithuania. According to the agreement, OMHEX will acquire 44.3% and 32% of the shares of NSEL and CSDL, respectively. Following the transaction OMHEX holds 85% of NSEL's share capital.
	Danish Jyske Bank acquired 60% of the share capital of the Dutch stockbroking firm Berben's Effectenkatoor B.V.
	Wiener Börse announced it had acquired a 14% stake in the Budapest Stock Exchange. At the same time, HVB Bank Hungary, owned by the Bank Austria Credianstalt, increased its stake in the Budapest Stock Exchange to 25.2%, and Erste Bank to 12.2%. The new owners included the Austrian banks OeKB (11%) and RZB (6.4%).

Date	Event and description
Jun 2004	Nordea announced the acquisition of the Lithuanian operations of Kredyt Bank SA (KBC) of Poland.
	Nordea sold 17% of its shares in BGC Holding (Bankgirocentralen). Nordea still holds a 10% stake in BGC.
	Commerzbank intends to acquire ING-BHK Bank from ING Groep NV
	Finnvera announced merger of Fide and Finnish Export Credit with their parent company at the end of the year.
	Trading of Finnish derivatives was transferred to Stockholm.
	Iceland's largest bank, Kaupthing Bank, announced its intention to acquire the Danish bank FIH from Föreningsbanken in Sweden for the total sum of DKK 7.1 billion.
	FED approved merger of J.P. Morgan Chase & Co (New York) and Bank One Corporation (Illinois).
	OM HEX sells XACT Fonder AB to Handelsbanken. XCAT manages Sweden's first listed mutual funds (EFTs) XCAT OM and XACT SBX.
	The government sold 60 million Sampo Oyj shares at EUR 7.97 per share. State holding in Sampo Oyj subsequently fell from 32.4% to 21.3%.
	The fourth largest US bank Wachovia Corp. announced its intention to acquire SouthTrust Corp for the sum of USD 14.3 billion.
	SEB announced its intention to acquire the Danish insurance company Codan Liv & Pension for the sum of DDD 2.7 billion. The seller was the British insurance concern Royal & Sun Alliance.
Jul 2004	Handelsbanken Liv announced its intention to acquire SPP Fondförsäkrings AB from SPP Liv AB.
	Mitsubishi Tokyo Financial Group and UFJ announced merger plans. Sumitomo Mitsui Financial Group announced its intention to submit a competing offer for UFJ.
	Santander Central Hispano SA and Abbey National Plc announced they are discussing a merger.
	Rabobank announced its intention to acquire Farm Credit Services of America (FCS America). FSC America is part of the US Farm Credit System.
	Citigroup intends to acquire First American Bank.
	All the Finnish banks operating automatic cash dispensers joined the Ottopiste ATM network.
Aug 2004	Nordea outsourced their Nordic corporate analysis services to Standard & Poor's.
	Fennograting's BBB rating for Myllykoski Oy came to an end.
Sep 2004	eQ Bank Ltd starts operating as an account operator.
	Nordea sells Helsingin Pantti Oy, a Finnish pawnbroker.

Date	**Event and description**
	The trading platform SAXESS, already in use at the Stockholm Stock Exchange, is launched at Helsinki, Tallinn and Riga stock exchanges.
	Pohjola insurance company announces its plan to sell the business operations of its subsidiary, Conventum Securities Limited, to eQ Bank Limited, a subsidiary of eQ Online Corporation for EUR 2 million.
	S&P revises its outlook on Sampo Bank plc's rating from negative to stable.
	Sampo Credit plc merges with Sampo plc and Sampo Finance with Sampo Bank plc.
Oct 2004	Danish life and pension companies Codan Liv & Pension sold to SEB Tryg Liv Holding AB.
	SEB's Lithuanian subsidiary, Vilniaus Bankas, acquires more than 90% of the share capital of the Ukranian bank, Bank Agio.
	Sampo plc acquires Varma Mutual Pension Insurance Company's shareholding in the Property and Casualty Insurance Company If (10.1% of the share capital). After the transaction, Sampo plc holds If's entire share capital.
	The Finnish state sells14.6% of Sponda Plc's share capital. The state's stake in Sponda remains at 34.5%.
Nov 2004	OMX and Copenhagen Stock Exchange sign Letter of Intent on the combination of OMX and CSE.
	Islansbanki hf makes an offer to purchase all outstanding shares in the Norwegian bank BNbank.
	Sampo Bank plc acquires Maras Banka of Latvia.
	Citigroup Global Markets Ltd starts as a remote member at the Helsinki Stock Exchange.
	OMX and VPC announce that the Finnish Central Securities Depository and VPC have fulfilled the terms and conditions of their merger. Following the merger, the business area Settlement & Depositary will be separated from OMX.
	Swedish investment bank Öhman Fondkommission announces that it will commence share trading and investment banking operations in Helsinki at the beginning of January.