Financial Market Report

3 • 2006

- Banks taking on a bigger role in corporate lending
- Bank profits good, but costs are rising
- Nordic-country differentials in retail lending rates narrowing
- Mutual funds still growing fast
- Reforms in European securities settlement

Bank of Finland

Financial Markets and Statistics

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1 Financial intermediation

1.1 Corporate sector debt growth still moderate

Hanna Putkuri

The stock of corporate credit relative to GDP has remained on the same level for the past five years. The role of banks as the most important lenders to non-financial corporations has increased, at the expense of other financial and insurance corporations and employee pension insurers.

This article examines the indebtedness of the corporate sector, based mainly on the outstanding credit statistics issued by Statistics Finland and financial accounts prepared by the Bank of Finland. The financial accounts are more comprehensive than the statistics on outstanding credit, as they include non-financial corporations' equity financing and loans between companies. Moreover, the statistics on outstanding credit include only a part of loans by central and local government entities.

Bank loans ever more important

The outstanding credit statistics show that the non-financial corporate sector's (incl. housing corporations) stock of credit from domestic financial and insurance corporations totalled EUR 43 billion at the end of June 2006. The sector also had EUR 17 billion in credit from government and social security funds, mainly employee pension insurers[1]. This includes EUR 1.5 billion in bonds issued by non-financial corporations.

Domestic deposit banks' position as the most important lenders to non-financial corporations has strengthened in the past five years. Banks' share of lending to non-financial corporations by financial and insurance corporations has increased to 84%, from 72% at the end of 2001. At the same time, the proportion of lending by the whole financial and insurance sector in the stock of domestic corporate credit has increased from 67 to 72%.

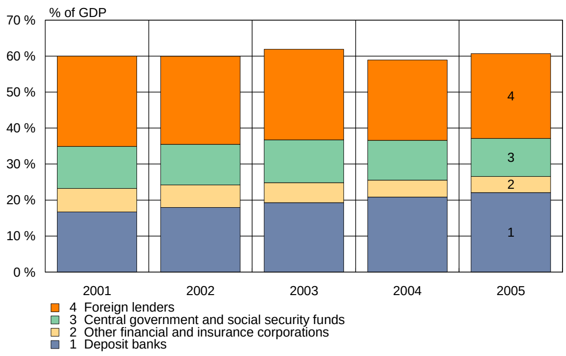
The outstanding credit statistics show that non-financial corporations' foreign debt totalled EUR 37 billion at the end of June 2006. Foreign debt includes: loans (EUR 9.9 bn), trade credit (EUR 4.4 bn), non-residents' holdings of bonds (EUR 12 bn) and money market instruments (EUR 0.4 bn) issued by Finnish non-financial corporations, and shareholder loans

[1] Outstanding credit statistics include loans *distributed* by local government from central government funds, but not credit *granted* by local government, nor credit flows between non-financial corporations. Some credit granted by central government is also excluded.

(ie direct investments in capital other than equity capital, EUR 9.9 bn).[2]

In the current decade, corporate debt has grown in line with nominal GDP (Chart 1). At the end of 2005, the corporate debt-to-GDP ratio was 61%, up from 60% in 2001. Non-financial corporations' domestic debt has increased steadily, by almost 5% per year, whereas the development of foreign debt has not been as steady.

Chart 1. Corporate debt; domestic (1-3) and foreign (4), 2001–2005



Sources: Statistics Finland and Bank of Finland.

Shares account for half of total liabilities

According to financial accounts, at the end of March 2006 the corporate sector's (incl. housing corporations) liabilities amounted to EUR 350 billion, of which 53% was in quoted shares[3]. Actual financial liabilities (excl. market value of share capital) totalled EUR 164 billion (see Annex Chart 4). Of the total, loans accounted for 84%, bonds for 11%, money market instruments for 4%, and derivatives for slightly over 1%.[4]

According to the financial accounts, loans granted by financial and insurance corporations totalled EUR 44 billion at the end of March 2006 (same magnitude as in the statistics on outstanding credit). The financial accounts also include non-financial corporations' loans obtained from central and local government, employee pension insurers and other social security funds (EUR 19 bn), other domestic sectors (mainly other non-financial corporations; gross EUR 57 bn) and non-residents (EUR 18 bn).

Manufacturing industry indebtedness has decreased

According to financial statement statistics issued by Statistics Finland, the corporate sector's total liabilities[5] have developed in line with the volume of business activity. Preliminary data indicate that in 2005 the ratio of liabilities to turnover was about 61%, ie up slightly (less than 1%) from four years ago. The indebtedness of manufacturing companies declined in 2005 by 7 percentage points, but the industry is still the most indebted industry. The corresponding ratios of the other main industries have remained relatively stable in recent years (Chart 2).[6]

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[2] In the Bank of Finland's balance of payment statistics, non-financial corporations' foreign debt also includes investments in shares and direct investments in equity capital. These items, including gross corporate foreign liabilities, totalled EUR 154 billion at the end of June 2006.

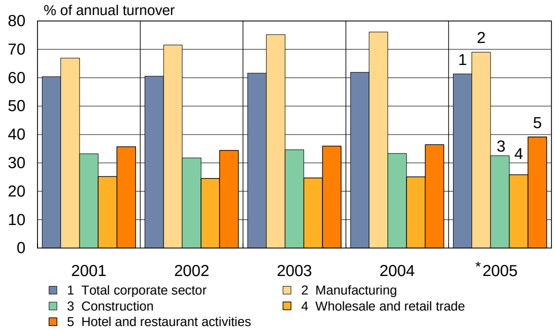
[3] Quoted shares account for a considerable proportion of the corporate sector's aggregate debt, which is mainly due to Nokia's market capitalisation.

[4] See also Financial Market Report 4/2005 Section 1.1 'Non-financial corporations' financial assets and liabilities'.

[5] In the financial statement statistics: liabilities = liabilities - advances received.

[6] Industry-specific data are also available in the statistics on outstanding credit.

Chart 2. Liabilities, by industry, 2001–2005



Source: Statistics Finland.
* Preliminary data.

1.2 Ageing and financial markets

Pertti Pylkkönen

Population ageing brings financial innovation and heightened competition among banks and other financial services providers.

In the past 50 years, life expectancy in Europe has increased by approximately 7 years, from 65 to 72 years, and in Asia by 15 years, from 50 to 65. According to the latest Word Population Prospects of the United Nations, the median age of the population will increase between 2000 and 2050 by about three months per year, ie by almost 10 years by 2050[7].

Ageing and real interest rates

As the population ages, the labour supply contracts and the conditions for economic growth weaken. Consumer behaviour is expected to change, and population ageing will also be reflected in investments, productivity growth, and economic growth[8]. Moreover, population ageing reshapes the financial markets in many ways. Several studies show that ageing has an impact on eg saving, prices of financial assets, financial innovations, and international capital flows.

Savings growth is expected to result in a decline in global equilibrium real interest rates over the next two decades[9]. The magnitude of the decline depends not only on ageing but also on other factors such as pension system reforms. If pension benefits are cut in order to ease the pension-cost burden, we should see a bigger decline in the global equilibrium real interest rate than if pension benefits are maintained at the current level. On the other hand, a rise in the retirement age and longer working lives would reduce the decline in the real interest rate.

Saarenheimo's study shows that the real interest rate would decline by about 0.7 percentage points with no significant change in pension benefits. If pension benefits are reduced to alleviate the cost pressure of pensions, the decline in global equilibrium interest rates could even be doubled, to about 150 basis points, whereas a rise in the retirement age would dampen the prospects for a decline in the real interest rate.

Making provisions for retirement expenditure is one of the key motives for saving, which has often been cited as the main reason behind the rapid growth of pension funds in the past decade and their current key role in the financial markets. At the same time, household savings are increasingly channelled to entities with a financial deficit, through various institutions such as pension funds and mutual funds. The institutionalisation of household saving has

[7] United Nations (2004), World Population Prospects: The 2004 Revisions.

[8] OECD (2005), Ageing and Pension Systen Reform. Implications for Financial Markets and Economic Policies.

[9] Saarenheimo Tuomas (2004), Ageing, interest rates and financial flows. Bank of Finland Research Discussion Papers 2:2005.

lengthened the maturity of saving. Institutions are able to eg spread their risks more efficiently and are thus better able to invest in long-term instruments or equities. Provisioning for retirement spending has already rechannelled savings out of banking sector and into other financial intermediaries. This trend is expected to continue.

Ageing induces people to reallocate their savings. Working-age people invest primarily in the equity markets, and after retirement, they switch from equities to fixed-income instruments. Estimates already show that this transfer of investments, together with low inflation, has helped to lower the level of long-term interest rates. Changes in pension fund and accounting regulations have also been a factor in the reallocation of retirement savings from equities to long-term and index-linked bonds.

It has also been suggested that population ageing causes prices of financial assets to plummet[10]. Studies and actual developments do not however, support the view that baby-boomers will soon after retirement sell their portfolio holdings to smaller cohorts and thereby cause a crash in prices of financial assets.

Impact of ageing on the banking sector

As the population ages, a growing proportion of financial intermediation may be transferred from banks to other financial agents, such as mutual funds and insurance corporations. Banks' funding will thus shift from deposits to more market-based funding. This will increase competition for deposits, so that new deposit instruments are likely to appear. As the population ages, banks will develop new products and improve operations aimed at retail customers, which will change the structure of banks' income.

Population ageing may reduce households' demand for credit. The declining demand for credit can be compensated by eg the expansion of markets for reverse housing loans[11]. Particularly in those European countries in which housing is primarily urban owner-occupied housing, the market for reverse housing loans may expand considerably from the current modest level. Active markets for reverse housing loans currently exist mainly in the United Kingdom. In Spain, France, Sweden and Finland, these markets are in the start-up phase.

In future, banks will need to strike a balance between services required by even wealthier and more demanding pensioners and the opportunities provided by technological advance in retail banking. Banks must develop new products that compete with those of the other financial service providers. At the same time, banks must generate cash flow to support their decreasing net interest income.

In Europe, banks have prepared for population ageing in the sense that they are able to provide, at group level, not only banking services but also other savings products such as mutual funds and life and pension insurance products. As the population ages, the focus of financial groups' operations and income will increasingly shift from provision of banking services to provision of other products.

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[10] Siegel J (1998), Stocks for the long run: The definitive guide to financial market returns and long-term investment strategies, and Goldman Sachs (2004), Global Ageing and Bond Yields. Global Interest Strategy, 04/10.

[11] In a reverse housing loan, the customer draws a fixed-period loan that is a certain proportion of the value of the dwelling used as collateral. The loan is not amortised but is repaid when the dwelling is sold – as in bullet loans. The loan period is predefined and the customer carries the risk that the dwelling may have to be sold during his lifetime.

2 Banks and insurance corporations

2.1 Banks' expenses on the rise

Mervi Toivanen

Banks' aggregate expenses rose in the first half of 2006. This development is currently disguised by banks' high income, as a result of favourable developments in net fee income and net interest income. Overall, banks' operating profits continued to increase in January–June 2006.

Banks' staff expenses and other expenses have grown on January–June 2005. Higher staff expenses are due to wage increases and the growth of performance-linked bonuses, as well as to recruiting. In January-June 2006, the number of banks'[12] clerical employees increased by about 700, year-on-year. The structure of personnel is also gradually changing, with banks recruiting new customer service and sales personnel and cutting the number of personnel in support services.

[12] Nordea Bank Finland Group, OP Bank Group, Aktia Savings Bank plc Group, Sampo Bank Group, local cooperative banks, Bank of Åland plc Group, Evli Group and eQ Group.

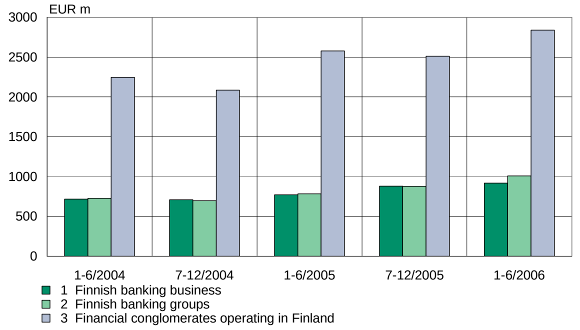
The growth in other expenses is mainly due to bank-specific factors – most commonly higher business volumes, increased focus on sales and marketing, mergers, and expansion of operations to new areas.

Banks' income has increased more rapidly than expenses. An increasingly higher proportion of net fee income comes from asset management and mutual funds. Moreover, income items measured at fair value in accordance with the International Financial Reporting Standards (IFRS) have developed favourably. Banks' net interest income has also grown, due to the fact that the narrowing of interest rate margins has been offset by the increase in lending stock. Since the majority of loans in Finland are linked to floating interest rates, the net interest income has also been boosted by the rise in market interest rates.

The income statement item 'impairment losses' has become a contributor to banks' improved performance as loan loss recoveries exceeded new loan losses in January–June 2006.

Banks' operating profits were higher in January–June 2006 than in the first half of 2005. The operating profit of Finnish banking[13] grew by 19%, to about EUR 917 million. The operating profits of financial conglomerates operating in Finland[14] grew by 10%, to EUR 2,838 million. The comparability of the results is however weakened by the merger of OP Bank Group and Pohjola[15]. The good results boosted groups' profitability and cost efficiency.

Chart 3. Semi-annual operating profits of financial conglomerates



Source: Banks' interim reports.

[13] Savings banks, Aktia Savings Bank plc Group, local cooperative banks, Bank of Åland plc Group, Evli Group, eQ Group, OP Bank Group's retail and corporate banking services, Sampo Group's banking and investment services, and Nordea's retail banking activities in Finland.

[14] Savings banks, Aktia Savings Bank plc Group, local cooperative banks, Bank of Åland plc Group, Evli Group, eQ Online Group, OP Bank Group, Sampo Group, and Nordea Group.

[15] Pohjola is included in OP Bank Group's figures for January–June 2006 but not in corresponding figures for 2005.

Table 1. Key items of banks' income statements, Jan–Jun 2006 (EUR m) and changes on the corresponding period in 2005

	Net interest income, EUR m		Other income, EUR m		Total expenses, EUR m	
	1-6 2006	Change %	1-6 2006	Change %	1-6 2006	Change %
Nordea Group	1 884	4.1 %	1 664	13.1 %	1 878	3.4 %
Retail banking	1 560	4.6 %	933	21.2 %	1 316	2.2 %
Retail banking in Finland	424	5.7 %	233	22.6 %	324	2.5 %
Nordea Bank Finland Group	649	8.9 %	512	49.3 %	428	-1.4 %
Sampo Group	159	3.9 %	2 746	-3.8 %	2 347	-1.1 %
Banking and investment services	180	7.1 %	216	19.3 %	223	5.2 %
Insurance services	-	-	2 517	-6.3 %	2 115	-2.3 %
Sampo Bank Group	180	7.7 %	216	45.0 %	225	13.7 %
OP Bank Group *	409	2.0 %	560	98.6 %	578	48.6 %
Retail and corporate banking services	393	-	143	-	236	-
Non-life insurance services	-	-	-	-	-	-
OKO Bank Group *	44	-44.3 %	290	293.0 %	209	171.4 %
Savings banks (excl. Aktia), total	62	8.2 %	27	12.4 %	56	3.9 %
Aktia Savings Bank plc (Group)	41	5.1 %	27	24.3 %	42	10.4 %
Local cooperative banks, total	43	11.7 %	14	21.4 %	36	3.8 %
Bank of Åland plc (Group)	16	1.9 %	15	28.3 %	20	10.8 %
Evli Group	1	150.0 %	25	-12.1 %	25	4.1 %
eQ Group	2	48.0 %	21	62.1 %	15	13.9 %
1. Finnish banking business (incl. Nordea retail banking Finland)	1 162	-	720	-	976	-
2. Finnish banking and financial groups (incl. Nordea retail banking in Finland)	1 178	4.9 %	1 137	49.1 %	1 318	20.0 %
3. Financial conglomerates operating in Finland	2 617	4.0 %	5 098	8.1 %	4 996	5.0 %

Other income includes net fee income, capital gains and losses from the sale of tangible and intangible assets, and shares in profits/losses of associated companies.

Expenses include depreciation and write-downs on tangible and intangible assets.

The various items do not equal operating profit, as some profit and loss account items have not been included.

The change % was calculated on the corresponding figures for 2005.

* The OP Bank Group (and OKO Bank Group) profit and loss account includes the result for Pohjola Group plc for January–June 2006. Pohjola's figures are not included in the comparative data on 2005. In addition, the substantial change in the structure of OKO Bank Group as a consequence of the Pohjola deal has weakened the comparability of OP Bank Group and OKO Bank Group figures for 2006 and 2005.

Finnish banking business includes savings banks, Aktia Savings Bank Plc Group, local cooperative banks, Bank of Åland plc Group, Evli Group, eQ Online Group, OP Bank Group's retail and corporate banking services, Sampo's banking and investment services and Nordea's retail banking activities in Finland.

Finnish banking and financial groups include the same units as Finnish banking business, except that the figures include OP Bank Group, instead OP Bank Group's retail and corporate banking services.

Financial conglomerates operating in Finland include Finnish banking and financial groups, Sampo Group and Nordea Group.

Source: Banks' interim reports.

2.2 Good capital adequacy in the insurance sector

Pertti Pylkkönen

Profitability and capital adequacy in the insurance sector weakened in the second quarter of 2006, as a result of a decline in asset prices. But the aggregate capital adequacy of insurance corporations is still good.

Insurance corporations' financial performance varied considerably in the first half of 2006, depending on the investment portfolio. Falling share prices and rising long-term interest rates weakened the results and the total capital adequacy ratios of the insurance sector in the second quarter of 2006[16].

Despite short-term fluctuations in investment results, the average profitability of the insurance sector remains solid. The results of regular insurance operations, ie the balance on technical account, are mainly good.

Non-life insurance

Earnings in insurance corporations' insurance business have remained good, due to the rarity of catastrophic events. Many companies have been able to improve cost efficiency and push down expense ratios. Non-life insurers' total ability to bear financial obligations, ie their solvency capital-to-premium income ratio is still good, despite a slight decline.

Insurance corporations' premium income grew by about 6% in 2005. The rate of growth for the first half of 2006 seems to be broadly the same as for 2005[17].

Life insurance

The results of life insurers that have published their six-month reports vary considerably. A few corporations were able to improve their results on 2005, despite fluctuations in the investment markets.

The poor performance of the investment markets in the second half of 2005 was clearly reflected in the narrowing of life insurers' solvency margin. At the same time, life insurers' total capital adequacy ratio, ie their solvency capital-to-technical provisions ratio, fell by some 3 percentage points, from just over 20%.

Life insurers' premium income grew in 2005 by some 10%. The growth was concentrated in unit-linked life and pension insurance products. This structural change in the life insurance market continued in the first half of 2006. The rate of growth of life insurers' premium income has slowed compared to 2005. An examination of product groups shows that the strongest growth occurred in capital redemption contracts[18]. However, this product group accounts for only about 2% of life insurers' premium income. Growth in premiums written on personal pension plans was very subdued, despite a sharp increase in the number of contracts concluded.

The proportion of savings in personal endowment insurance policies and pension insurance policies in households' total financial wealth is slightly larger than that of direct holdings of mutual funds. Insurance-related investment has nevertheless grown at a slower

[16] Report by the Insurance Supervisory Authority on the capital adequacy of insurance corporations, pension foundations and pension funds, 30 June 2006.

[17] www.vakes.fi

[18] Capital redemption contracts are fixed-term investment contracts offered by insurance corporations, tailored to the needs of companies, municipalities and other entities. The contracts do not usually include insurance coverage.

pace than mutual fund investment for several years already.

Pension insurance

For employee pension insurers, the second quarter of 2006 was difficult, due to falling share prices and rising interest rates. The solvency margin declined in the second quarter from just over EUR 16 billion to just under 14 billion. At the same time, employee pension insurers' capital adequacy ratio, ie solvency capital-to-technical provisions, fell by some 5%, to 26.5%.

Employee pension insurers' capital position is nevertheless still solid. Capital adequacy is highest for pension funds. The capital adequacy of pension foundations is also slightly better than that of pension insurers[19].

As a result of the fall in share prices and rise in long-term interest rates in the spring, the market value of pension funds' investments declined in the second quarter of 2006 by a few billion euros. At the end of June, statutory pension funds' assets totalled nearly EUR 105 billion. Of the assets, about 65% were held by employee pension insurers. Employee pension insurers' combined results plummeted from EUR 2.3 billion in the first half of 2005, to a loss of EUR 0.6 billion.

In June, 40% of pension insurers' total investments were in equities and about 46% in various fixed-income instruments. Real-estate investments accounted for slightly under 10% of total investments.

Slightly over a fifth of employee pension insurers' total equity investments are in domestic companies, and slightly less than that are in companies from other euro area countries. Investments outside of the euro area account for 40% of total equity investments. Of pension insurers' investments, about EUR 3 billion are in various hedge funds and slightly over EUR 2 billion are in venture capital and in other unquoted shares.

The structure of pension insurers' fixed-income investments has changed significantly in the past couple of years. Previously, these were concentrated in bonds issued by the Finnish government. In June, these bonds accounted for only EUR 3.4 billion of total fixed-income investments (EUR 45 billion). Of fixed-income investments, almost half are in bonds issued by other euro area general government entities. To achieve higher yields, pension insurers have increased their investments in corporate bonds.

The proportion of domestic investments in the geographic distribution of investments has continued to decline. Of pension insurers' total investments in 2000, nearly 60% were in the domestic market. By June 2006, the proportion of investments in the domestic market had declined to slightly less than 30%. Investments in other euro area markets accounted for about 40% of pension insurers' total investments in June 2006.

Pension insurers have managed to effectively disperse their investment risk, both geographically and by instrument.

Changes are to be made in the framework for pension insurers' investment activities. Government proposals to amend regulations on solvency margin and technical provisions seek to alter pension insurers' funding and solvency requirements so as to allow for a higher proportion of equity investments in total investments and so enable higher returns on investment.

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[19] Report by the Insurance Supervisory Authority on the capital adequacy of insurance corporations, pension foundations and pension funds, 30 June 2006.

2.3 Rapid growth and good profitability in the European banking sector

Sampo Alhonsuo

The latest financial data show good results and rapid growth of business volumes in European financial groups. Banks' good performance is due to a favourable operating environment.

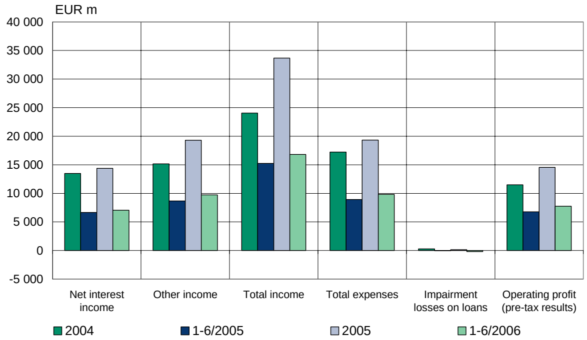
In the first half of 2006 the combined pre-tax profits of the **10 largest Nordic banking and financial groups**[20] totalled EUR 7.9 billion, up by 14% on the year-earlier period (Chart 4).

Nordic banks' results have improved since 2003. The good performance can be explained by several factors. The economic environment has enabled profitable expansion of business operations in the Nordic countries. The rapid growth of lending stock and the increase in interest rates in the past year have supported the growth in the groups' net interest income. The development of other income has been mainly favourable, due to volume growth and good results in securities trading.

Nordic groups have in recent years enhanced their operations in many ways and improved cost efficiency. The results for the first half of 2006 however indicate that the situation is changing: groups' combined expenses jumped 10% year-on-year.

The low amount of impairment losses on loans and the very low amount of nonperforming assets point to improved risk management and a favourable operating environment.

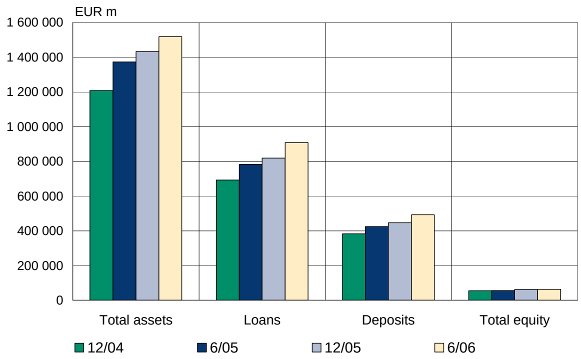
Chart 4. Main income statement items of large Nordic financial groups



Sources: Interim reports and financial statements.

In the past 12 months the balance sheets of large groups have grown by more than 10% (Chart 5). Deposits and lending have increased rapidly. Equity accounts for over 4% of the aggregate balance sheet total.

Chart 5. Balance sheet items of large Nordic financial groups



Sources: Interim reports and financial statements.

The key financial ratios of Nordic financial groups are good or excellent (Chart 6). However, they have not improved in the past year, despite the income growth in absolute terms.

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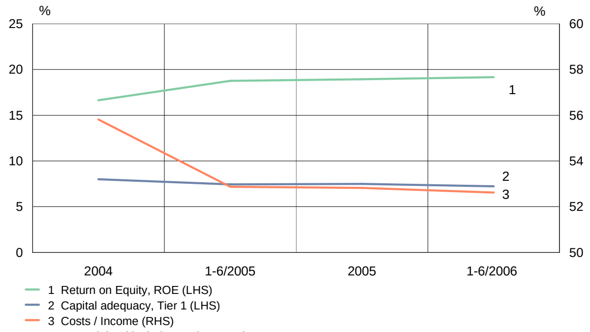
[20] The data covers the 10 largest Nordic banking and financial groups (in order of balance sheet totals at 30 June 2006): Danske Bank, Nordea, SEB Group, Svenska Handelsbanken, DnB Nor Group, FöreningsSparbanken (Swedbank), OP Bank Group, Sampo Group, Kaupthing Bank, and Jyske Bank. All the data is group-level. Income statement and balance sheet figures were converted into euro (respectively) at the average exchange rate for the first half of 2006 and at the exchange rate for 30 June 2006.

Chart 6. Key financial ratios for Nordic financial groups



Averages, weighted by balance sheet totals.
Sources: Interim reports and financial statements.

Looking at the situation outside the Nordic countries, the results of **large European financial groups**[21] have also improved since 2003. In January–June 2006 the combined results of 25 large European financial groups totalled EUR 91 billion, up by nearly 30%, year-on-year (Chart 7). All the groups, except one, improved their results on the previous year. Financial groups' combined balance sheet totals have grown by 14% in the past year.

[21] The figures for Europe cover the following 25 large financial groups (in order of balance sheet totals): BNP Paribas, Barclays, UBS, HSBC, ING, RBS, Credit Agricole, Deutsche Bank, ABN AMRO, Societe Generale, Credit Suisse, HBOS, SCH, UniCredit, Fortis, Commerzbank, RaboBank, Dresdner, Dexia, Lloyds TSB, BBVA, Banca Intesa, Erste, AIB, and Millenium bcp. All the data is group-level. Income statement and balance sheet figures were converted into euro (respectively) at the average exchange rate for the first half of 2006 and at the exchange rate for 30 June 2006. The data is based on interim reports issued in July–September 2006 and financial reports issued earlier.

Chart 7. Operating profit and balance sheet totals of large European financial groups

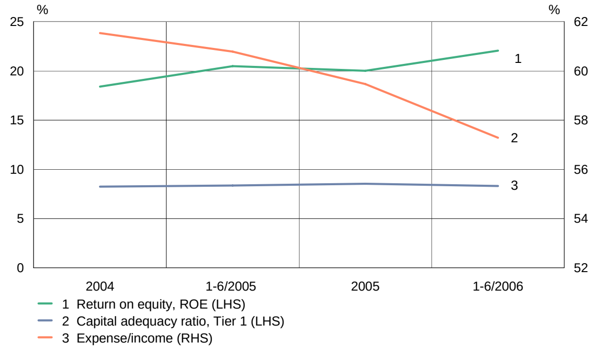
Sources: Interim reports and financial statements.

The European groups' good performance is based on the same factors as that of the Nordic groups, ie primarily on favourable economic developments. The development of income has been good or excellent for all the groups. Expenses have grown at a slower pace than income, and impairment losses on loans have been very modest. Results for the first half of the year indicate that 2006 will be an even better year.

Key financial ratios have developed favourably. The return on equity (weighted by balance sheet totals) of 25 large European financial groups rose to over 20% in the first part of the year. The income-to-expense ratio has improved in the past two years. Measured by key financial ratios, the best large European financial groups have been able to achieve roughly 40% returns on equity. The expense/income ratio of some of the groups is also about 40%. Reform of the International Financial Reporting Standard (IFRS) has not had a significant impact eg on the banks' financial ratios.

Large banking groups are preparing for the introduction of Basel II requirements at the beginning of 2007. In the past two years, risk-weighted claims have increased as fast as own funds. The risk-weighted capital adequacy ratio (tier 1) has remained steady at about 8% (Chart 8).

Chart 8. Key financial ratios of large European financial groups



Averages, weighted by balance sheet totals.
Sources: Interim reports and financial statements.

Europe's growth rates of recent years in business volume and lending stock cannot continue over the long run. Moreover, the quality of the lending stock is likely fall from its current good level[22]. The difficulty of increasing overall business operations in mature markets is probably the main reason for the rapid expansion of large European groups eg to new EU member states and for the cross-border bank mergers.

2.4 Nordic retail bank lending rates converging

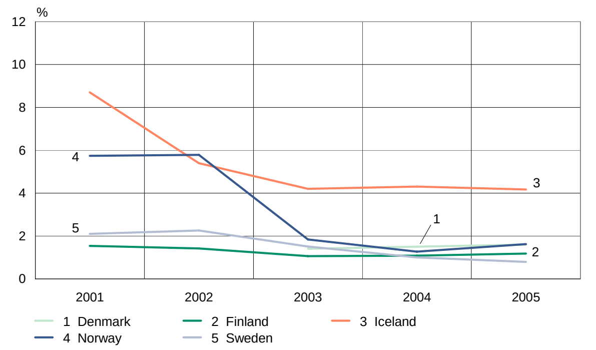
Sampo Alhonsuo – Mervi Toivanen

Nordic retail bank lending rates have converged and interest rate margins have narrowed. This is due to market integration, developments in market interest rates, and tighter competition.

In recent years, the Nordic and Baltic banking markets have become increasingly international and integrated. This is reflected eg in convergence of lending and deposit rates in the Nordic retail banking markets.[23]

In four of the Nordic countries (Iceland being an exception), deposits rate level were quite similar at the end of 2005. They ranged from just under 1% to 1.6%. Deposit rates have declined slightly since the early years of the current decade.

Chart 9. Average interest rates on Nordic banks' deposit stock



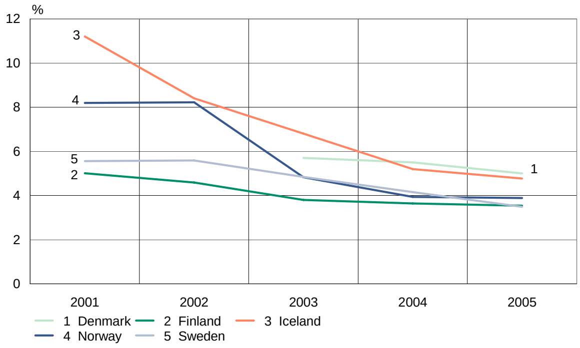
Source: Nordic Banking Structures - Report.

Lending rates have also converged. At the end of 2005, banks' average interest rate on total lending stock ranged from slightly under 4% to 5%. There are two natural explanations for this development. First, market interest rates declined in all the Nordic countries in 2001–2004, which led to lower lending rates. Second, interest rate competition in bank lending has tightened. Banks in the Nordic countries have frequently used interest rates on housing loans as a means of attracting new customers. Interest rates on lending and deposits are lowest in Finland and Sweden.

[22] See also eg FitchRatings: Major European banks – Semiannual Review and Outlook, and ECB: Financial Stability Review, June 2006.

[23] Interest rate data are based on the report 'Nordic Banking Structures', available at the Bank of Finland's website: http://www.bof.fi/fin/3_rahoitusmarkkinat/Nordic_banking_structures.pdf

Chart 10. Average interest rates on Nordic banks' lending stock



Source: Nordic Banking Structures - Report.

In all the Nordic countries, movements in deposit rates have been more sluggish and lagged behind movements in lending rates. However, the margins between deposit and lending rates have narrowed in all the Nordic countries in recent years, which is a significant development.

Table 2. Difference between banks' average lending and deposit rates (total margin)

%	2001	2003	2005
Denmark	na	4.3	3.4
Finland	3.5	2.7	2.4
Iceland	2.5	2.6	0.6
Norway	2.5	3.0	2.3
Sweden	3.5	3.3	2.7

na = not available.

Source: Nordic Banking Structures - Report.

3 Securities markets

3.1 Nordic List

Pertti Pylkkönen

A joint Nordic List, maintained by OMX and covering Finnish, Danish and Swedish listed companies was launched at the start of October.

The lists of the Helsinki, Copenhagen and Stockholm Exchanges, members of the OMX Group, have been combined into a joint list. The Nordic List includes all companies listed on the above exchanges and replaces the Main List, I List and NM List in Helsinki, the A List and O List in Stockholm, and the Copenhagen List[24].

The purpose of the change is to create a large and liquid marketplace that will attract also international investors. The joint list also improves comparability eg of companies within a given sector.

In the new list, companies are divided into three segments by market capitalisation: Large Cap, Mid Cap, and Small Cap. Within each segment, the companies are further divided by industry sector, based on the Global Industry Classification Standard (GICS). The sectors in the GICS classification are: Energy, Materials, Industrials, Consumer Discretionary, Consumer Staples, Health Care, Financials, Information Technology, Telecommunication Services and Utilities.

Large Cap: companies with market capitalisation of EUR 1 billion

The Large Cap covers companies with market capitalisation of at least EUR 1 billion. The market value of Mid Cap companies is at least EUR 150 million but less than EUR 1 billion, and Small Cap companies have market capitalisation of less than EUR 150 million. The companies' market capitalisation is assessed semi-annually, at the start of January and July.

In September, the lists of Nordic exchanges included 577 companies. Of those companies, 120 (27 Finnish) were large, 173 (42 Finnish) mid-size, and 284 (65 Finnish) small. The proportion of Finnish companies is thus highest for the group of medium-sized companies (ca 24%).

Trading on the Nordic List starts at 10.00 am and ends at 6.30 pm (Finnish time). The clearing of share trades will be done (as before) via the national securities depositories: VPC in Sweden, APK in Finland, and VP in Denmark. The clearing of derivatives trades is handled by OMX.

In connection with the reform, OMX launched new Nordic indices. OMX produces indices for each Cap, on both the Nordic and national level. OMX continues to issue the local all-share indices OMX Helsinki, OMX Copenhagen and OMX Stockholm.

[24] www.omxgroup.com

The Helsinki Exchange calculates the OMXH CAP portfolio index, the OMX Helsinki 25 index of the most traded shares, and the OMX Helsinki Benchmark index – in addition to the All-Share Index and the business sector indices.

OMX also launched OMX Nordic 40, an index for the most heavily traded companies on the Nordic List.

In addition to indices based on the Nordic List, OMX produces all-share indices in Sweden and Denmark. The indices are based on quotations on the First North marketplaces[25]. While Finland does not yet have this type of a marketplace for small and medium-sized companies, OMX is considering launching a First North marketplace also in Helsinki.

First North is an alternative marketplace for previously unlisted small and medium-sized growth companies. A First North marketplace does not have the status of a regulated marketplace like a regular stock exchange. The entry and disclosure requirements for these companies are less comprehensive than in a stock exchange.

3.2 Finnish mutual funds growing fast

Pertti Pylkkönen

The growth of mutual funds registered in Finland continues at a rapid pace – second only to Ireland in the EU15.

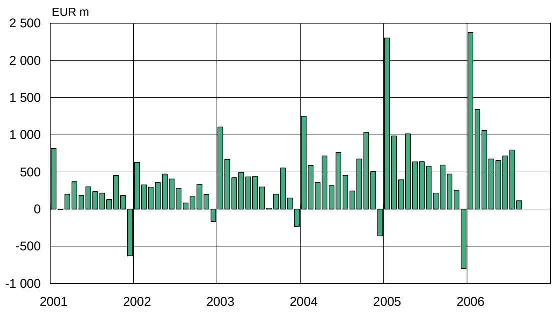
Finnish mutual funds are continuing to post robust growth, despite uncertainties in the financial markets. At the end of August 2006, the assets of Finnish mutual funds totalled almost EUR 54 billion. Fund assets have grown by a fifth in the past year. In recent years, the growth of Finnish funds' assets has been among the fastest in Europe: of the old EU member states, only in Ireland has the growth been faster.

In the first eight months of 2006, net investments in domestic funds reached slightly under EUR 8 billion. A large proportion of the net investments (ca 40%) went into short-term funds. Also long-term funds have attracted more capital than eg equal funds.

Assets of funds investing solely in domestic equities have declined

Assets were withdrawn from equity funds as a result of the downturn in share prices in the spring. Nonetheless, in the first part of the year, the value of net investments in equity funds was a positive EUR 1.3 billion. Funds investing in the Finnish equity market are the only equity funds with negative net investments so far in 2006. The majority of new investment money went into funds investing in Europe and into global funds. Funds investing in equity markets of emerging economies also experienced a large injection of new capital. As a result of the fall in share prices in the spring, investors started to sell their fund assets. The situation nevertheless stabilised quickly and net investments have turned positive again.

Chart 11. Mutual funds registered in Finland, net investments



Sources: Helsinki Stock Exchange and Finnish Association of Mutual Funds.

[25] www.omxgroup.com/firstnorth

Households' investment fund holdings have increased slightly. In July they totalled about EUR 14 billion, ie about 29% of total domestic investment fund investments[26]. Fund units already account for over 10% of households' financial wealth and equal about a fourth of their bank deposits (EUR 56 billion).

Average size of Finnish fund EUR 120 million

The number of mutual funds registered in Finland has nearly doubled since 2000, nearly 450. The amount of assets in Finnish mutual funds is fairly low on average, at ca EUR 120 million. At the end of August 2006, the assets of the largest domestic fund totalled about EUR 1.6 billion, and those of the smallest ones only about EUR 2 million. The number of management companies managing domestic funds is currently 26.

Amendments will be made to legislation on mutual funds. A Government bill on amending the mutual funds act is currently under parliamentary review. The bill would supplement the act with provisions on special mutual funds investing mainly in real-estate and real-estate securities. Other proposed changes include amendments to the current act on real-estate funds so as to render shares of limited partnerships that are offered for sale to the public 'securities' as per the Securities Markets Act[27].

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[26] www.rahoitustarkastus.fi

[27] HE 102/2006.

4 Infrastructure

4.1 Retail payment systems face scrutiny by competition authorities

Kari Kemppainen

Competition authorities have done several surveys on the structure of retail banking markets and related competition issues. Among the key findings are that the markets are concentrated and that customers are unable to compare services and prices effectively. Barriers to payment system access and the lack of customer mobility are reported as the key factors hindering effective competition.

Retail banking markets, and particularly retail payment systems, have in recent months been the focus of competition authorities' surveys, four of which were performed in Europe. The European Commission's Directorate General Competition has published two sector inquiries: a payment cards report in April[28] and a more general report on the retail banking market in July[29].

In its report published in April, the Commission stressed that payment card markets are still nationally segmented and that cross-border competition is virtually nonexistent. The Commission estimates that increased competition could save the EU economy between EUR 50 and 100 billion per year. Before taking regulatory action, the Commission will continue discussions with operators in the payment card industry.

The Commission's report published in July examined current accounts and related services. According to the report, there is clear evidence of a lack of competition in European markets for retail banking services. The markets are still extremely fragmented along national lines and entry barriers are significant eg in terms of difficulties of entering payment systems. Also in this field, the Commission will continue its dialogue with market participants and authorities, before taking regulatory action.

Comparability of prices must be improved

The European Competition Authorities (ECA), a joint body of European competition authorities, published a report in summer 2006 on competition issues in retail banking and payment system markets.[30] The survey concluded that it is very difficult for customers to compare products, services and prices of different

[28] For more details, see Financial Market Report 2/2006.

[29] See http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/interim_report_2.pdf

[30] See http://mineco.fgov.be/organization_market/competition/competition_issues_retail_bankingandpayments_systems.pdf

service providers, and to change service providers if necessary. Increasing the transparency of services and prices was seen as a means of improving the situation. The report concludes that one of the key barriers to market entry by new service providers is the difficulty/costliness of accessing a payment system. Access could be facilitated by non-discriminatory and objective access rules. The report also urged national competition authorities to carefully monitor the development of the Single Euro Payments Area (SEPA) to ensure that it will not hamper competition in the area.

Nordic markets concentrated

Nordic competition authorities published a report in August on competition in Nordic retail banking.[31] The report examined the market structure, entry possibilities for new banks, and customers' possibilities to tender banks against each other. The report concluded that the Nordic banking market is highly concentrated and is dominated by a few large national operators. On the question of market entry by new competitors, the Nordic competition authorities stressed that effective competition requires easy access to interbank payment systems as well as ATM and payment card systems. Access criteria should be transparent and non-discriminatory, and system ownership should be differentiated from system usage. The Nordic competition authorities recommend that customer mobility be improved by eg enhancing the transparency of services and prices and by making it easier for customers to change banks.

[31] See http://www.kilpailuvirasto.fi/tiedostot/Nordic_Retail_Banking.pdf

4.2 Eurosystem to reform securities settlement in Europe?

Emilia Koivuniemi

The European Central Bank (ECB) is currently exploring the possibility of connecting a securities settlement platform to the TARGET2 system. This initiative, referred to as TARGET2-Securities, would replace the complex technical solutions currently used in the euro area.

With the anticipated implementation of the TARGET2 system the idea of creating a pan-European technological solution for securities settlement has been floated. If the Governing Council of the ECB approves the TARGET2-Securities (T2S) initiative, the settlement services provided by any member of the system would be based on a common infrastructure. A decision on the go-ahead is expected in early 2007, after consultations with central securities depositories and other market participants.[32]

The objective of T2S is to optimise payment flows between the central bank payment system TARGET2 and securities settlement systems. Implementation of the project would enable large cost savings, as a result of improved efficiency of securities settlement due to technical harmonisation of the participating systems. According to the ECB, T2S would facilitate cross-border management of collateral and liquidity management in the EU. T2S is also a major step towards a single Eurosystem interface with the market.

[32] Press release by the ECB, 7 July 2006.

Currently, only a preliminary project concept is in place. The plan is to build an IT system that would observe the opening hours of the TARGET2 system. At the start of the operating day, the national central securities depositories (CSD) would transfer securities transactions and account balances to the new system, which would settle in central bank money according to the delivery versus payment (DVP) principle. The other CSD functions would continue as before. The ECB published an English brochure on the draft system on 21 September 2006[33].

The Eurosystem is currently cooperating with the CSDs and their counterparties to study the feasibility of the project and market participants' views on the appropriate features of the future system.

Finnish participants are cautiously positive about the T2S project. Improving the efficiency of securities settlement is seen as necessary and welcome. The participants underline that potential cost savings depend on the final implementation of the technical details – which at this point is still uncertain. From the market's perspective it is most important to create a modern and efficient system that does not hamper operational activities.

The ECB has been warned of the difficulties often faced by large IT projects involving the creation of completely new infrastructure.[34] Preparations for TARGET2-Securities are ongoing, and many details on the system's operating principles are still being formulated. The services to be offered and the types of securities accepted in the system are also still under consideration. The Governing Council of the ECB will ultimately decide the future of the T2S initiative. Decisions on project implementation and timetable have not yet been made. Despite the preliminary nature of the proposal, the market participants consider it crucial that they receive up-to-date information on the progress of the project and required changes, in order to be able to plan their own operations.

[33] http://www.ecb.int/pub/pdf/other/target2_securitiesen.pdf

[34] "Tough IT challenge of forging a single European clearing house", The Banker, August 2006.

5 Key regulatory and supervisory initiatives

Jyrki Haajanen

Several regulatory initiatives are currently underway on both the EU and national level. These initiatives also impact companies operating in the financial markets.

Directive on Markets in Financial Instruments (MiFID)

The Directive on Markets in Financial Instruments MiFID) represents an extensive reform of securities market structure, provision of investment services, requirements for service providers, and investor protection.

One of the key objectives of MiFID is to create competitive alternatives for exchange trading. The directive will also include more detailed provisions on the provision of investment services. The directive emphasises eg the obligations of an agent in the context of assignments. An agent should always seek an outcome that is optimal for the customer. The new directive will also improve investor protection.

The deadline for the working group on markets in financial instruments (set up by the Ministry of Finance), which is preparing for implementation of the directive into Finnish legislation, was 31 May 2006. The Ministry of Finance will prepare a Government bill for presentation to the Parliament, based on the working group's report and related comments. The working group will also take into account the Statute implementing the Directive. The Statute implementing the Directive will be issued by the Commission around the start of October.

Company law concerning cross-border mergers

The purpose of the directive on cross-border mergers is to facilitate cross-border mergers of limited liability companies and to promote competition. Companies referred to in the directive as 'limited liability companies' would in Finland include not only limited liability companies but also at least cooperatives and such mutual insurance companies in which the guarantee capital creates a share in the company.

The possibility to abandon the group structure could reduce the administrative expenses of a company operating in several member states and enhance its use of capital. This benefits particularly large companies engaging in financial or insurance business subject to authorisation.

Current regulations on deposit guarantees and investor compensation schemes do not take into account cross-border mergers and the transfer of a registered office to another member state. The new regulation may thus give rise to the harmonisation of regulations. The obligation of financial companies to maintain operational reliability in a crisis situation, as referred to in legislation on state of readiness, may also turn out to be problematic in connection with the transfer of registered office.

Implementation of the directive on cross-border mergers will essentially decrease the importance of the company forms 'European company' and 'European cooperative society'.

The term of the working group set up by the Ministry of Justice ends on 31 December 2006. The Government will issue a bill during spring session 2007, after a round of consultation. The directive must be transposed to national law by 15 December 2007.

Statute for a European Cooperative Society

The Council Statute for a European Cooperative Society established a cooperative society for cross-border activities. The Statute is directly binding on member states, but in certain matters, it will permit or even require additional national provisions. National regulations take into account eg the needs of members, investors and creditors in connection with possible transfer of registered office to another member state. The Statute for a European Cooperative Society entered into force on 18 August 2006.

Company Law Action Plan

At the end of 2005 the European Commission launched an initiative to update the company law action plan. The objective of the new action plan is to foster the competitiveness of European companies by eg reducing the corporate administrative burden and improving the quality of regulation. The comments received indicate that many companies support regulatory measures that give them new options for arranging their operations.

In autumn 2006 Finland hosted a conference on company law, for the purpose of discussing the development of EU regulations on company law and deepening the discussion on the voting-right arrangements. The objective of the conference was to increase the transparency and quality of preparations for EU regulations on company law, in accordance with the principles of better regulation.

The new Companies Act

The new Companies Act came into force on 1 September 2006. The new act is clearer and more comprehensive than the previous one. It gives companies more freedom to operate, by removing various restrictions and formal requirements and introducing new operating methods. Provisions on the legal protection of creditors and minority shareholders have been enhanced, and special attention has been paid to the position of small limited liability companies.

The nominal value of shares will be abandoned, and thus the connection between share and share capital will be eliminated. This will facilitate procedures in connection with share issues and other arrangements. Share capital can be raised without issuing shares and shares can be issued without raising the share capital. Under certain conditions, a bonus issue will be possible without fund transfers and eg splitting can be carried out by issuing new shares without payment. Investments in the unrestricted equity of a company will be recorded in a separate fund, which will increase their transparency.

A directed bonus issue is allowed, for exceptionally weighty economic reasons, taking into account the interest of the company and all its shareholders. A company can also issue bonus shares to itself. A directed bonus issue does require a statement by an approved auditor on the grounds for this type of issue.

Publicity concerning shareholdings remains unchanged. As before, foreign holders can have their shares nominee registered, in which case their holdings will not be made public.

The new Credit Institutions Act and Basel II

In June 2004, the Basel Committee on Banking Supervision issued recommendations for a new capital adequacy framework for credit institutions (Basel II). The reform of capital adequacy requirements for credit institutions is one of the most extensive and important of recent regulatory projects concerning the global financial markets. The new minimum capital requirements for credit institutions reflect their credit risk more precisely than before.

In Finland, the provisions on capital adequacy will be included in the new Credit Institutions Act. The act is currently under parliamentary review and will enter into force on 1 January 2007.

Solvency II

The reform of solvency requirements for life and non-life insurance corporations in the EU (Solvency II) is moving ahead. The planned new solvency requirements reflect the risks of insurance and investment activities more precisely than before. The intention is also to approve the use of internal models for determining solvency requirements for supervised entities. The aim is to introduce Solvency II in 2010.

6 Key corporate arrangements and events in the financial sector

Date	Event and description
January 2006	Austrian bank Raiffeisen International announces it will acquire the Russian bank JSC Impexbank.
	Insurance operations of life insurance corporation Kansa's receiver to wind down by end-2006.
	Pohjola Group plc sells Pohjola Asset Management Limited to OKO Bank and Pohjola Life Insurance Company to OP Bank Group Central Cooperative.
February 2006	SOK Corporation's S-Bank Ltd granted a credit institution licence. Operations to start in 2007.
	Savings Banks' Group and its member banks announce they have cancelled cooperation agreement with Pohjola Group plc and Suomi Mutual Life Assurance Company. Sp-Fund Management Company Ltd also terminated its funds' asset management agreements with Pohjola Group plc.
	Aktia Life Assurance Ltd merges with Veritas Life Insurance Company.
March 2006	Ahlstrom Plc and Salcomp plc listed on the Helsinki Stock Exchange.
	Nasdaq makes a bid for the London Stock Exchange (LSE), but withdraws from it at the end of the month.
April 2006	Nasdaq purchases 16% of the shares in LSE. In May, it owned ca 25% of LSE's share capital.
	Sampo Bank announces it will acquire Profibanbk (Industry and Finance Bank) operating in St. Petersburg.
	The Australian Stock Exchange announces it will acquire the country's largest futures trading place, the Sydney Futures Exchange, for AUD 2.3 billion.
May 2006	Savings banks announce they will start co-operation with Fennia Life and start selling Fennia Life's endowment and pension insurance policies.

Date	*Event and description*
	The Government of Austria announces it will issue a framework guarantee in the amount of EUR 900 million to save the BAWAG PSK bank. In addition, a consortium of Austrian banks will grant an EUR 450 million loan to BAWAG.
	NYSE Group makes an EUR 8 billlion bid for Euronext. Deutsche Börse makes a competing bid of EUR 8.5 billion. A decision on the merger of NYSE and Euronext was taken in early June. The new company will be called NYSE Euronext.
	FIM Group Corporation announces it will establish a subsidiary in Russia that will engage in asset management and mutual fund operations.
	If P&C Holding Ltd announces it is planning to establish a non-life insurance corporation in Russia. The company has had a representative office in St. Petersburg since 1995.
	OP Bank Group Central Cooperative announces it will purchase OP Bank Group Mortgage Bank plc shares held by OP Bank Group member banks.
June 2006	*OMX launches the First North marketplace in Stockholm.*
	The French group Axa announces it will acquire Winterthur, an insurance corporation owned by Credit Suisse.
	OP Bank Group and Kesko Corporation start cooperation in the development of payment cards.
	Nordea sells its stake in the Russian bank International Moscow Bank to HypoVereinsbank, a German subsidiary of Unicredit.
July 2006	*Spanish stock exchanges listed on the Madrid Stock Exchange.*
August 2006	*Sampo Bank plc concludes acquisition of Profibank, a bank based in St. Petersburg.*
	Banca Intesa announces it will acquire Sanpaolo IMI.
	The Finnish Bankers' Association and the Federation of Finnish Insurance Companies to merge at the start of the year 2007.
September 2006	*Nationwide Building Society and Portman Building Society announce their decision to merge.*
	OMX and the Icelandic stock exchanges announce the signing of a letter of intent on the acquisition of the Icelandic Stock Exchange by OMX.
	Helsinki Stock Exchange adopts round lot 1 trading.
	S&P's revises its outlook on OKO Bank plc from negative to stable. Short-term rating is A1+ and long-term AA-.
	Fitch Ratings rates Teollisuuden Voima Oyj for the first time. Ratings: short-term F2 and long-term A-.

Date	*Event and description*
	Moody's upgrades Metso's long-term rating from Ba1 to Baa3. *Nordea will apply for a banking licence in China to open a branch in Shanghai.*