Financial Market Report

1 • 2005

- Banks gaining share in domestic financial intermediation
- Financial sector's profitability and capital adequacy good in 2004
- Considerable fluctuations in P/E ratios of the Helsinki Stock Exchange's business sector indices
- Popularity of card payment increasing rapidly

Bank of Finland

Financial Markets and Statistics

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1 Financial intermediation

1.1 Deposit banks gaining share in domestic financial intermediation

Hanna Putkuri – Pertti Pylkkönen

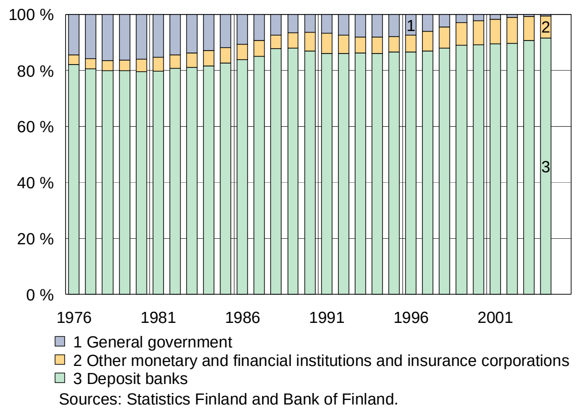
The Finnish credit market has always been highly bank-centred. In recent years, deposit banks' share of domestic financial intermediation has increased still further.

Deposit banks' share of the stock of lending to the domestic public[1] was approximately 7% at the end of 2004. The remaining part was divided quite evenly between insurance corporations (incl. employee pension insurers), other credit institutions and general government (see Annex Chart 1).

Deposit banks have always played a key role in domestic financial intermediation. Since the mid-1990s, their share of lending has increased further, as the rate of growth of bank loans has clearly exceeded that of other lending[2]. The previous period of growth in deposit banks' share was in the latter half of the 1980s, when bank lending grew rapidly as a result of financial deregulation. During the recession and banking crisis, banks' share of the lending stock decreased.

Deposit banks' share of household (incl. employers and own-account workers) lending reached a peak of over 92% (Chart 1) at the end of 2004. The share of other monetary financial institutions engaged in financial intermediation (ie finance companies, mortgage banks and credit card companies) was a good 6% and that of other financial institutions was less than 2%. Insurance corporations and general government have not been significant lenders to households in recent years.

Chart 1. Breakdown of household debt by creditor sector, 1976–2004



Sources: Statistics Finland and Bank of Finland.

[1] Lending to the public does not include lending between financial and insurance corporations and general government, nor loans granted from central government funds to local government for re-lending.

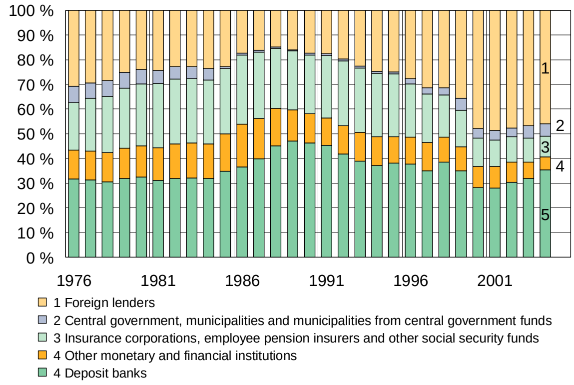
[2] Outstanding credit statistics include euro- and other-currency-denominated credit granted by lenders operating in Finland, including overdrafts, bills of exchange, direct debt securities, loans granted from central government funds, other loans, bonds classified as investments, and promissory notes tradable on the secondary markets.

Deposit banks' share of the stock of household lending has grown continuously since the mid-1990s. The growth is a result mainly of rapid growth in housing loans granted by deposit banks (see Annex Chart 2). At the same time, the share of housing loans in the stock of household debt has grown steadily. In September 2004, housing loans accounted for more than 70% of total household borrowing, which is approximately ten percentage points more than a decade ago.

The share of general government in the stock of household lending has correspondingly decreased continuously. As recently as in the mid-1980s, loans granted by local government from central government funds accounted for over 10% of the stock of household lending. The role of general government as a source of housing loans to households remained quite significant until the mid-1990s.

The share of deposit banks operating in Finland in the stock of lending to non-financial corporations (excl. housing corporations) was at the end of 2004 slightly more than a third, which is close to the long-term average (Chart 2). By contrast, banks' share of domestic corporate loans was a record high, ie approximately 66%, whereas the relative importance of other domestic monetary and financial institutions has decreased considerably.

Chart 2. Breakdown of corporate debt by creditor sector, 1976–2004



Sources: Statistics Finland and Bank of Finland.

The stock of corporate lending by insurance corporations and employee pension insurers has decreased steadily since the early 1990s. The rising cost of re-lending in comparison to bank loans has dampened the demand for re-lending. The stock of employee pension insurers' investment loans has decreased even more. Drawings of new loans based on promissory notes from employee pension insurance corporations have been subdued in recent years because the interest rate on these loans is much higher than that eg on new corporate loans granted by banks. The average interest rate on new loans granted by employee pension funds in 2004 was 4.1%, and the average interest rate on new investment loans granted by employee pension insurance insurers was 4.3%, whereas the average interest rate on new corporate loans granted by deposit banks was 3.6%[3].

Life and non-life insurance corporations' direct lending to non-financial corporations is nowadays virtually nonexistent. The remaining loan stock consists mainly of loans granted to companies that are members of the insurance group in question, or to joint ventures.

[3] The Finnish Pension Alliance, and the Bank of Finland publication Financial Markets – Statistical Review.

The share of foreign debt in the stock of corporate credit grew sharply in 1999–2000; the stock of foreign credit doubled from the level of late 1988[4]. Loans from foreign lenders account for the majority of foreign credit: at the end of 2004, loans amounted to one-third of total foreign credit of non-financial corporations. Shareholder loans (direct investment in capital other than equity capital) and bonds accounted for approximately 27%, money market instruments for more than one percent, and trade credit for approximately 11% of foreign corporate credit.

[4] Non-financial corporations' foreign debt refers to *direct foreign* credit, and it is included in the Bank of Finland's balance of payment statistics. For more information on the foreign debt of Finnish non-financial corporations, see the spring 2003 issue of the Financial Market Report (Finnish only).

2 Banks

2.1 Finnish banks' operating profits generally improved

Mervi Toivanen

The operating profits of Finnish banking groups improved in 2004, with an increase in combined net income and a decrease in costs and loan losses. This positive development resulted in improved cost efficiency for the majority of banks. Profitability and capital adequacy also remained good on average.

In 2004, the total operating profits of Finnish banking groups[5] grew by approximately 6%, to EUR 919 million (Table 1). The increase in net fee income offset the decrease in net interest income so that bank's total income increased. At the same time, total costs decreased. Loan losses either remained very low or loan loss recoveries exceeded total new loan losses. Of the individual banks, only the OP Bank Group, local cooperative banks, and the Evli Group posted decreases in operating profit.

When Nordea's retail banking business in Finland is included in the results of Finnish banking groups, banks' total operating profits decreased. Nordea's retail banking operating profit decreased as a result of a 1.5% decline in net interest income, a 3% decline in other income, and a 1.5% increase in costs.

The operating profit of financial conglomerates[6] operating in Finland, on the other hand, improved by almost 35%. Groups' results were boosted by the improved results from life and non-life insurance and non-recurring items.

In 2004, the average interest rates on banks' lending and deposit stocks were lower than in 2003. The average interest rate on the lending stock fell by more than that on the deposit stock. Consequently, banks' net interest income fell by approximately 2% on 2003. The growth in net fee income was supported particularly by improved fee income from securities trading, asset management and mutual fund activity. Fee income from commercial banking also improved, due to an increase in the number of transactions and a new pricing system for services.

The decline in banks' costs in 2004 was not based on a single factor; cost developments differed across banks. Although staff expenses overall grew somewhat, a few banks posted a decline due to a decrease in pension fund contributions. Cost cutting

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

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

was thus targeted mainly at costs other than staff expenses.

The growth in income and decrease in expenses improved banks' income-expense ratio and thus banks' cost-efficiency. High profits supported profitability, measured by return on equity (ROE, %), which remained good on average. Moreover, the capital adequacy of Finnish banking groups has remained high.

Table 1. Banks' income statement items and key indicators in 2004

	Net income		Other income		Total expenses		Operating profit		Expences, % of income		Return on equity, % (ROE)		Capital adequacy, %, 2004	
	EUR m	Change %	EUR m	Change %	EUR m	Change %	EUR m	Change %	2004	2003	2004	2003	Tier 1 capital	Tier 1 + Tier 2 capital
Nordea Group	3 510	4.3 %	2 210	-2.8 %	3 345	-15.4 %	2 284	26.0 %	-	-	15.7	12.3	7.3	9.5
*Nordea Group, banking	3 543	-3.1 %	2 531	16.9 %	3 674	-6.5 %	2 428	53.0 %	60	63	-	-	-	-
*Nordea Group, life insurance	-	-	-	-	-	-	156	23.8 %	-	-	-	-	-	-
*Nordea retail banking in Finland	770	-1.5 %	367	-2.9 %	624	1.5 %	511	-11.1 %	53	69	4.7	7.5	-	-
*Nordea Bank Finland Group	1 121	-	563	-	896	-	786	-	53	51	35.0	44.0	19.9	22.9
Sampo Group	-	-	-	-	-	-	1 014	114.8 %	-	-	33.3	14.0	14.5	15.4
*Sampo Group banking and investment services	394	-2.5 %	264	10.5 %	375	3.1 %	240	56.9 %	60	64	21.5	17.8	-	-
*Sampo Group, P&C insurance	-	-	-	-	-	-	716	169.2 %	-	-	-	-	-	-
*Sampo Bank Group	375	9.2 %	217	29.9 %	375	3.1 %	240	56.9 %	65	73	17.9	11.3	7.3	10.7
OP Bank Group	783	-1.9 %	461	0.7 %	760	-0.8 %	504	-2.1 %	62	62	10.5	11.5	14.4	15.8
*OKO-konserni	164	1.9 %	111	-31.5 %	147	5.8 %	134	-23.0 %	56	45	13.9	18.5	7.1	10.8
Savings banks (excl. Aktia) Total	109	-4.6 %	44	22.4 %	109	-0.1 %	43	5.6 %	71	73	-	-	16.5	18.5
Aktia Savings Bank plc Group	73	-1.8 %	43	5.7 %	78	-6.1 %	36	18.5 %	69	73	11.2	11.1	9.4	14.1
Local cooperative banks	74	-3.4 %	24	4.7 %	70	2.0 %	27	-9.3 %	72	70	-	-	20.4	20.4
Bank of Åland plc (Group)	30	-0.3 %	19	0.5 %	32	-4.2 %	15	1.3 %	68	69	10.8	11.4	8.2	11.4
Evli Group	1	-18.0 %	49	2.1 %	46	7.2 %	4	-41.4 %	91	83	5.2	9.3	20.3	20.0
eQ online Group	3	34.0 %	19	34.2 %	19	22.4 %	2	-	91	100	9.2	0.4	23.1	23.1
1. Finnish banking groups (excl. Nordea)	1 466	-2.3 %	923	5.2 %	1 512	-1.3 %	919	5.6 %						
2. Finnish banking business	2 236	-2.0 %	1 290	2.7 %	2 136	1.9 %	1 430	-1.0 %						
3. Financial conglomerates operating in Finland	-	-	-	-	-	-	3 930	34.5 %						

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 2003.
ROE percentages are not fully compareble.

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.

Sources: Banks' financial press releases.

2.2 Performance of large Nordic banks improved in 2004

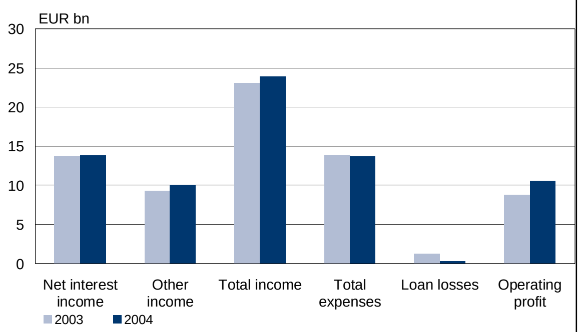
Sampo Alhonsuo

The extremely low amount of loan losses recorded in 2004 improved the operating profits of Nordic and Baltic banking groups. Even so, banks' net interest income did not increase. The key figures show that Nordic banks' performance capacity and capital adequacy are currently at a high level.

In 2004, the pre-tax operating profit of the largest Nordic banking and financial groups[7] increased to EUR 10.5 billion from EUR 8.7 billion in the previous year (Chart 3). Banks' other income – mainly from fees and returns from equities and securities markets – developed favourably. Rationalisation and improved efficiency resulted in a decrease in total costs from 2003. The main factor contributing to growth in operating profits was, however, the decrease in loan losses and write-downs.

The combined net interest income of large Nordic banks remained unchanged from 2003. The banks' most important income item did not increase significantly in any of the examined groups, although their total stock of lending to the public grew by more than 9% and the stock of deposits by 6.5%. Low market rates constrained net interest income. Moreover, intense lending rate competition squeezed the margin on lending.

Chart 3. Main income statement items of large Nordic banks, 2003–2004

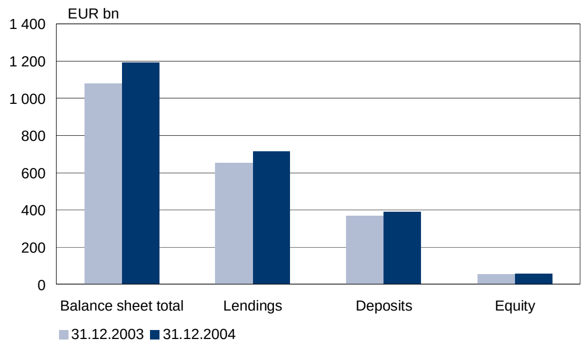


Sources: Financial statements of banking and financial groups, February 2005.

Banks' balances sheets have grown as a result of both increased overall business operations and changes in the structure of operations (Chart 4). Some groups acquired new companies and new business in 2004. At the turn of the year, the stock of lending in the balance sheets of large Nordic banking groups exceeded the stock of deposits by approximately EUR 325 billion. This higher stock of lending is financed ultimately via the international financial markets. At the turn of the year, the groups' equity amounted to EUR 57 billion, ie a little less than 5% of the combined balance sheet total.

[7] The data in this article covers the 10 largest Nordic banking and financial groups: Nordea, OP Bank Group, Sampo (banking and investment services), FöreningsSparbanken (Swedbank), Svenska Handelsbanken, SEB Group, Danske Bank, Jyske Bank, DnB NOR, and Kaupthing Bank. The cross-sectional chart also includes Hansabank and Uhispank. All the data is group-level. The figures have been converted into euro at end-2004 exchange rates.

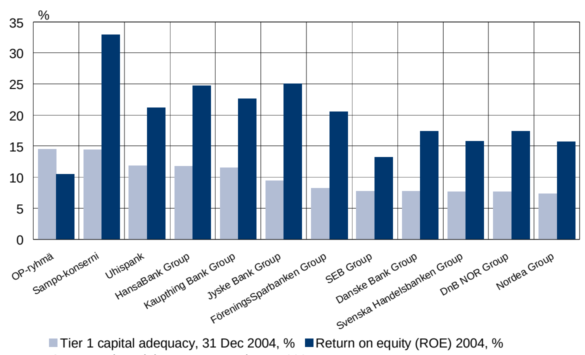
Chart 4. Main balance sheet items of large Nordic banks at the end of 2003 and 2004



Sources: Financial statements of banking and financial groups, February 2005.

The key business indicators of Nordic (and also Baltic) banking and financial groups are good or excellent. For individual banks, the best expense-income ratio is below 50% and even the worst clearly below 70%. Indicators show that capital adequacy and profitability were good in 2004 (Chart 5).

Chart 5. Tier 1 capital adequacy and return on equity (ROE), %



Sources: Financial statements, February 2005.

Results for 2005 are published for the first time based on the new Financial Reporting Standards (IFRS reform). Nordic banking groups have issued assessments on the impact of the reform. It is difficult to draw unequivocal conclusions on the impact of IFRS standards on banks' results. At the start of 2005, the amount of capital will decrease in some banking groups and increase in others. The impact on published capital adequacy ratios will be minor at most. The results of some banking groups for 2004 would have been somewhat better if the accounts had been prepared using the new reporting standards.

2.3 Performance of large European and American banks good in 2004

Sampo Alhonsuo

A decrease in loan loss provisions was the main factor in the improved financial performance of large European banking and financial groups in 2004. The results of large American banking groups improved because of higher income.

Large European banking groups improved their performance in 2004. Of the 25[8] examined banking and financial groups, 23 recorded higher operating

[8] This examination covers the following large European banking and financial groups: Bayerische Hypo- und Vereinsbank (HVB Group), Deutsche Bank, Commerzbank, ING Group, ABN AMRO Group, Fortis Group, RaboBank Group, Dexia Bank, Credit Agricole Group, Societe Generale Group, BNP Paribas Group, Banco Santander Central Hispano Group (SCH Group), Banco Bilbao Vizcaya Argentaria Group (BBVA Group), Banca Intesa Group, Allied Irish banks (AIB Group), Erste Group, Bank Austria Creditanstalt Group, HSBC Group, HBOS Group, The Royal Bank of Scotland (RBV Group), Barclays Group, Lloyds TSB Group, Abbey National Group, Credit Suisse Group, and Union Bank of Switzerland (UBS Group). The information used in the charts is derived from the groups' financial statements released in February–March 2005. All figures have been converted to euro at the exchange rates prevailing at the turn of the year 2004–2005.

profit compared to 2003. Only one group reported a loss.

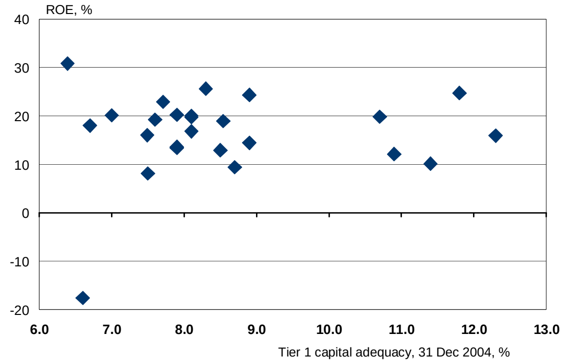
The strong improvement in performance was a result of three factors having similar effects. Lower loan loss provisions was the main factor contributing to improved operating profits and performance. For several large banking and financial groups, these provisions were very small.

Another factor contributing to improved results was the strong growth in income. This was due to a notable increase in business operations and a diverse income structure. In several banks, net interest income was constrained by the intense margin competition. Results were good for other income items, such as securities trading and capital markets. The insurance operations of some groups also posted good results in 2004.

The third important factor contributing to improved performance was cost control and some specific cost-cutting measures that have restrained and will continue to restrain costs.

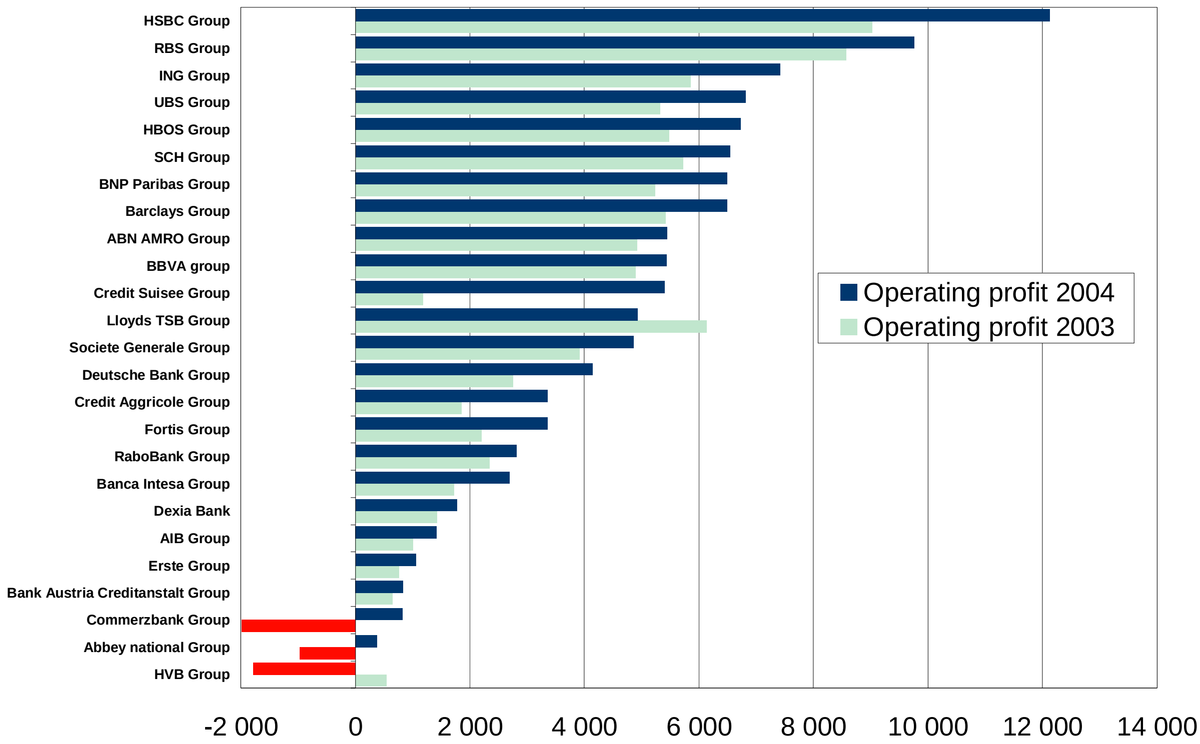
In general, the key figures of large European banking and financial groups are currently good. Cost-efficiency, measured by the expense-income ratio, improved as a result of high income and tight cost control. High capital adequacy ratios, on the other hand, reflect large buffers against losses relative to risks and effective control of balance sheets. The groups' profitability is also generally very good at present.

Chart 6. 25 large European banking and financial groups: capital adequacy (Tier 1, %) and profitability (ROE, %)



Sources: Financial statements of banking and financial groups.

Chart 7. 25 large European banking and financial groups: pre-tax profits, EUR million



The year 2004 was good for also large American banks[9]. The total pre-tax operating profits of the 20 largest banking groups grew by approximately 10% on 2003. The pre-tax profits totalled almost EUR 77 billion, when converted to euro at the exchange rate prevailing on 31 December 2004. The improved performance was a result of balanced growth in income and expenses. The banks' business volumes and balance sheet totals increased, and loan loss provisions remained unchanged from 2003.

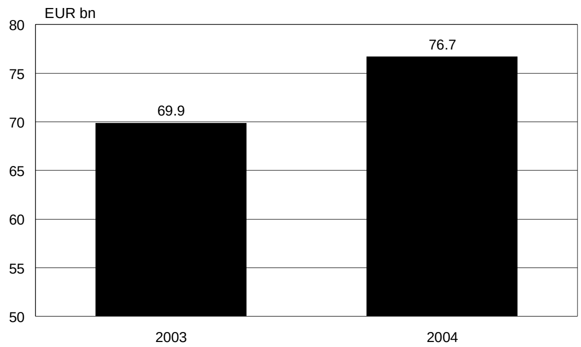
The four quarters of the year 2004 differed considerably in terms of financial performance. During the last three quarters of the year, the improvement in performance was mainly due to the growth in the stock of lending, which boosted net interest income. The growth was more subdued for other income items, particularly income from securities trading. Fourth-quarter results were generally weaker than those for the earlier quarters.

The loan loss provisions of large banks have in the past two years been much lower than in 2001–2002. For large American banking groups, the growth in expenses is being curbed in many ways. Also in the United States, the banks' capital adequacy ratios are generally good or excellent. For example, the average

[9] Chart 3 includes 20 large American banking groups: Citigroup, J.P. Morgan Chase & Co, Bank of America Corporation, Wachovia Corporation, Wells Fargo & Company, Washington Mutual, US Bancorp, Sun Trust, National City, BB&T Corporation, Bank of New York, Fifth third Bancorp, KeyCorp, Regions Financial Corporation, PNC Financial Services Group, Sovereign Bancorp, North Fork Bancorp, M&T Bank Corporation, Comerica Incorporated, Am South Banccorporation. The information used in table 3 is derived from the groups' financial statements released in January–February 2005.

Tier 1 capital adequacy ratio of the examined banking groups was 8.5% at the turn of the year.

Chart 8. 20 large American banking groups: pre-tax operating profits, EUR billion



Sources: Financial statements of banking and financial groups.

2.4 Stable performance in the Finnish insurance sector

Pertti Pylkkönen

The profitability of insurance corporations was generally good in 2004. Their capital adequacy has also remained good on average.

According to preliminary data, the growth in premiums written by life insurers last year amounted to only about 1%. Uncertainty surrounding changes in insurance-related taxation hampered sales of life and non-life insurance products in early 2004. The removal of that uncertainty and clarification of the new tax regime revitalised the growth in premiums written by life insurers in late 2004.

Premiums written on endowment insurance declined somewhat on 2003. However, premiums written on personal pension plans picked up sharply towards the end of the year, and growth for the year topped 10%. The proportion of unit-linked pension insurance of premiums written by life-insurers continued to grow in 2004.

Preliminary data show that the premiums written by non-life insurers developed quite favourably, with growth of over 4%. Premiums written by employment pension insurers increased last year to almost 4%.

The financial performance of the whole insurance sector was good in 2004. Several life and non-life insurers improved their financial performance. Results for pension insurers also remained good despite a slight deterioration in the performance of the largest pension insurers.

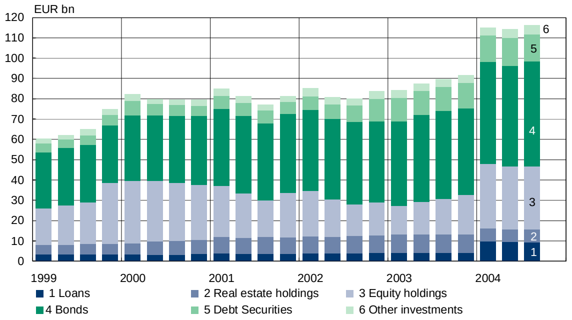
The rather good performance of life insurers was supported by the fall in long-term interest rates and the rise in share prices in the second half of 2004. The largest non-life insurers also succeeded in cutting their costs. The improved performance of non-life insurers was also supported by the low volume of claims expenditure.

The investment income of insurance corporations varied last year between 7 and 9%, depending on the investment portfolio. There were only minor changes in the investment income compared to last year.

Finnish insurance corporations'[10] investment portfolio has grown to almost EUR 120 billion (Chart 9). The focus of investments is on long-term fixed income investments, mainly bonds.

[10] Life and non-life insurance corporations and private and public sector employee pension insurers.

Chart 9. Insurance corporations' investment portfolio



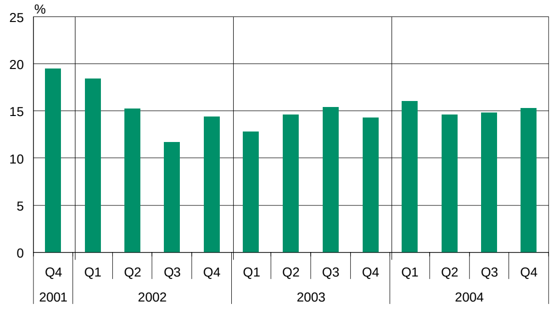
* Life, non-life and pension insurance corporations.
* Data since the start of 2001 also covers pension funds.
Sources: Finnish Pension Alliance and Federation of Finnish Insurance Companies.

The number of loans based on promissory notes to eg the corporate sector has shrunk continuously (see Section 1). The amount of relending by pension insurers has also decreased to total a few billion euro. Relending reached its peak in the early 1990s, when the loan stock totalled approximately EUR 12 billion. Another significant feature in the investments of insurance corporations is the reduced focus on the domestic market, which is due to the allocation of investments to the whole euro area. Approximately 60% of insurance sector investments are allocated outside of Finland.

Insurance corporations' capital adequacy was good in 2004 (Chart 10). The capital adequacy of both life and pension insurers improved and it was good in both sectors on average. The total capital adequacy of non-life insurers also improved, whereas the ability to bear financial obligations weakened somewhat[11].

[11] Insurance Supervisory Authority. Capital adequacy of insurance corporations and pension funds as at 31 December 2004.

Chart 10. Life insurers' solvency capital as a percentage of technical provisions (solvency ratio), %



Source: Insurance Supervisory Authority.

2.5 Banks of new member states in the EU environment

Jyrki Haajanen

The banks of the new EU member states have adjusted well to the new operating environment. Their profitability and capital adequacy is good, thanks to several structural changes.

The accession of ten new member states to the European Union in spring 2004 has changed the structure of the EU banking sector. The banking sectors of the new member states differ somewhat from those of EU15 countries. In the past 5 years, the economies of the new EU countries have developed very favourably, which has eased their banks' adjustment to the new competitive situation.

In the new EU countries, banks play an important part in financial intermediation, whereas market financing is less important than in the other EU countries. The stock markets are in an early phase of development, and their share of financial intermediation is at present smaller than in the other industrialised countries. The banking sector's share of private sector loans differs considerably across countries. The loans-to-GDP ratio for some countries (Cyprus, Malta) is about the same as in the EU15 countries (approx. 120%), whereas in some Eastern and Central European countries, it is only about 30%.

Foreign banks have gained a strong position in the new member states. Of the banking sector's aggregate balance sheet, 70% is under foreign-bank ownership. The figure is very high compared to the EU15 countries' average of about 20%. Foreign banks first acquired small minority stakes when the national banks were being privatised, and their stakes grew quickly during the transition period. Many foreign banks have also established new branches and subsidiaries, which means that they will not be burdened by former non-performing loans.

The banking sector of the new EU countries is fairly concentrated. The combined market share of the five biggest banks (CR5) is between 52% and 98%, the average being 72%. However, it might be more useful to compare the degree of concentration of the new member states' banking sector to that of the smaller EU countries (population less than 20 million). In terms of CR5, the difference between the new and the small EU countries is only 7 percentage points.

Concerns about the adverse effects on banking competition of the large market share of foreign banks and concentrated nature of the banking sector have mostly turned out to be unfounded. In contrast, the market entry of foreign banks seems to have speeded up the development of banks' operational functions and risk management systems and to have increased competition, rather than creating competition-reducing monopolies. It can thus be said that the banking sector is in good condition and that structural changes have had a positive impact on EU financial market stability.

Despite tightening competition, banks' profitability has remained good (Table 2). Their capital adequacy is also good. Their Tier 1 ratio is particularly high: at 13.6%, it is 4.6 percentage points higher than that of the banks in the EU15 countries. However, the profitability of banks' differs considerably across the new member states. The otherwise good situation is overshadowed by the large amount of non-performing loans, 10.7%, compared to 3.1% in EU15. Although loan margins are still considerably higher than in the EU15 countries, tightening competition is likely to squeeze margins and weaken the banking sector's profitability over the next few years.

Table 2. Ratios (2003)

		Number of banks	Number of branches	Number of staff	Total assets (mil €)	Market share	Tier1 ratio	Total capital ratio	ROE	Cost-income ratio
CY	Commercial banks	11	459	7 744	23 765	87.4	9.7	14.0	7.4	76.9
	Co-operative banks[a]	1	5	201	2 497	9.2	59.1	64.9	-27.9	52.5
	Special purpose	2	7	111	920	3.4	16.5	16.8	19.8	22.1
CZ	Commercial banks	20	1636	36392	63462	79.9	5.8	14.5	23.6	52.3
	Foreign branches	9	19	857	7 610	9.6	n.a.	n.a.	n.a.	58.8
	Building Societies	6	15	1 755	8 344	10.5	3.7	13.3	13.3	57.2
EE	Commercial banks	7	194	4 204	6 302	100.0	9.9	14.5	12.6	54.0
HU	Commercial banks	31	1 147	26 549	50 730	85.0	8.4	11.6	19.8	60.6
	Co-operative banks	182	n.a.	n.a.	3 640	6.5	n.a.	n.a.	17.9	74.0
	Mortgage banks	3	8	316	4 131	7.6	4.1	10.8	32.4	58.3
	Building Societies	2	7	302	471	0.9	4.7	38.3	-15.6	116.6
LT	Commercial banks	13	117	#n.a.	6 375	100.0	7.8	13.2	13.5	72.0
LV	Commercial banks	22	206	8 112	8 459	100.0	11.7	11.7	16.3	56.1
MT	Commercial banks	16	103	3 411	17 800	100.0	16.9	19.1	11.0	66.3
PL	Commercial banks	60	3 119	124 096	105 439	94.7	8.3	13.6	5.9	68.0
	Co-operative banks	600	1 275	27 161	5 843	5.3	9.5	14.2	12.3	75.2
SI	Commercial banks[d]	20	1176	11 397	21 367	98.7	9.8	11.5	12.6	62.5
	Savings banks	2	16	58	83	0.4	7.1	8.8	15.4	76.4
	Co-operative banks[b]	8	16	26	192	0.9	17.2	2.6	11.8	76.6
SK	Commercial banks[c]	18	553	19 147	22 380	94.2	21.2	20.7	13.8	70.7
	Building Societies	3	0	650	1 371	5.8	29.4	30.9	12.1	55.9

Source: ECB/ BSC.

Structural changes in the banking sectors of new member states are not yet fully completed, and many challenges still lie ahead, despite the positive development so far.

Rapid balance sheet growth will in future pose increasing challenges to banks' risk management. Tightening competition and narrowing margins will also test the banks' ability to adjust to the new open operating environment. Foreign banks may also transmit unwelcome shocks to their home markets.

The balance sheets of many banks also include large amounts of currency-denominated claims and liabilities. Moreover, many non-financial corporations and households have taken currency-denominated loans. Wide fluctuations in exchange rates may thus cause larger-than-normal shocks in the economies of the new member states in particular.

3 Securities markets

3.1 New information on Finnish stock market P/E ratios

Jukka Vauhkonen

The median of P/E ratios for shares included in the HEX All-Share Index shows that the record years of the stock market in the late 1990s were not exceptional in light of historical performance.

The most common measure of the level of valuation of a company's share is the P/E (price-earnings) ratio, which is the ratio of the share's price to the company's earnings per share. P/E ratios are also calculated for stock indices.

In the late 1990s, share prices, and consequently P/E ratios, rose to record high levels worldwide. In many countries, current share prices are considerably lower than during the record years of the late 1990s. Viewed historically, P/E ratios are however still quite high in several countries.

Particularly in the United States, there has been much debate on whether historically high P/E ratios reflect the overvaluation of share prices or companies' improved long-term growth prospects. According to pessimists, a large price bubble was created in the US stock market in the late 1990s, the deflation of which may take several years[12]. According to optimists, P/E ratios are permanently higher than earlier. Optimists have explained the high valuation of shares eg in terms of accelerating productivity growth due to information technology, lower risk premia on equity holdings, improved possibilities for portfolio diversification, low inflation and interest rate expectations, as well as lower taxes on equity financing.

High share prices and high P/E ratios are justified if a company's long-term earnings outlook is very favourable. American researchers[13] have empirically examined the persistence of companies' earnings, ie whether companies' high earnings in the near past is an indicator of continuous high earnings in future. This would provide rational justification for extremely high company P/E ratios. Studies based on American data show that companies' past high earnings have not been a very good indicator of future high earnings.

In a recent Bank of Finland study on P/E ratios in the Finnish stock market[14], the persistence of companies' earnings growth rate is examined using Finnish data. The results are consistent with earlier American studies: companies' earlier high growth rates

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[12] Particularly Shiller (2005): *Irrational Exuberance*, 2nd ed., Princeton University Press. See also http://www.econ.yale.edu/~shiller/.

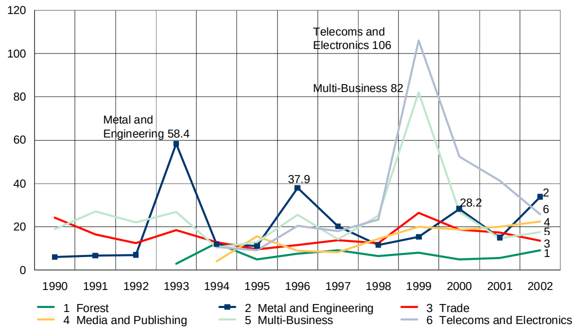
[13] Eg. Chan, Karceski and Lakonishok (2003): The Level and Persistence of Growth Rates. Journal of Finance, Vol LVIII, No. 2.

[14] Jani Kinnunen (2004). Price-Earnings Ratio: An Indicator of Future Earnings or a Red Flag of Overvaluation? Bank of Finland, Financial Markets Department, Working Paper 4/2004.

are reflected in their share prices and P/E ratios, but these do not seem to predict well the long-term earnings growth.

The study also focuses on the development of P/E ratios for the HEX All-Share Indices (HEX and HEX-25) and business sector indices in 1986–2002. Business sector indices' P/E ratios and their movements have differed considerably across business sectors (Chart 11).

Chart 11. P/E ratios for business sector indices of the Helsinki Stock Exchange



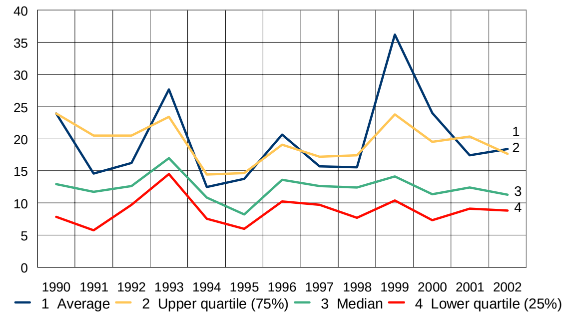
Sources: Etla, Helsinki Stock Exchange.

The study clearly shows that analysis of the P/E ratios for the All-Share Index alone may give an incomplete and misleading picture of the valuation level of Finnish shares. The study also shows that individual companies' exceptionally high P/E ratios, like Aspo's and PMJ-Automec's in 1999, can significantly raise both sector-specific P/E ratios and P/E ratios for the All-Share Index.

The study suggests that, in order to eliminate the effect of individual companies' exceptionally high P/E ratios, it is useful to examine movements in other statistical indicators of P/E ratios, such as medians, and upper and lower quartiles.

Results show that the median P/E ratios were very stable during the period under review, despite wide fluctuations in P/E ratios of the All-Share and business sector indices (Chart 12). In fact, the median P/E ratio for shares included in the All-Share Index peaked in 1993, ie before the peak in share prices in 1999.

Chart 12. Median P/E ratios and upper and lower quartiles of share prices in the HEX All-Share Index



Sources: Etla and Helsinki Stock Exchange.

3.2 Subdued financing in the domestic bond market

Pertti Pylkkönen

The stock of domestically issued bonds increased only modestly in 2004. This was due to the meagre net financing needs of the central government and a decline in the stock of corporate bonds.

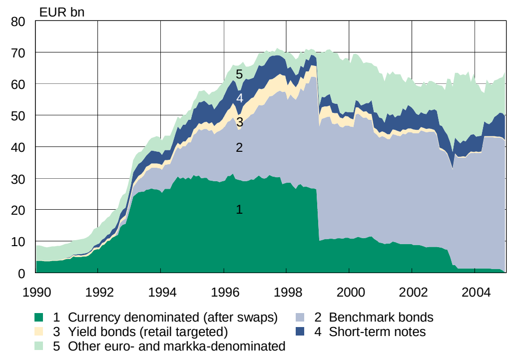
In 2004, the value of bonds issued in Finland grew by more than 3%. At year-end, the value of outstanding domestic bonds totalled EUR 53 billion, of which central government bonds accounted for 84%, bonds issued by financial institutions for 9%, and corporate bonds for more than 6%.

The value of outstanding central government bonds – which dominate the bond market – increased by almost 3%. Bond issuances by financial institutions, particularly banks, increased rapidly by 17%. Good profitability, strong finances, and subdued investment activities of non-financial corporations were reflected in the bond market such that the stock of corporate bonds contracted by more than 9% last year.

The value of outstanding domestic bonds dropped to EUR 8 billion, from EUR 14.5 in 2003. The decline reflected a decrease of more than 50% in gross issuance of central government bonds compared to 2003. The gross issuance of corporate bonds remained at the level of 2003 (approx. EUR 0.5 billion) while issuances by financial institutions nearly doubled. Banks issued many different types of structured loans, which were offered also to households for investment.

The structural change in Finnish government debt continued in 2004 (Chart 13). Government borrowing is concentrated on long-term euro-denominated benchmark bonds. At the turn of the year, they accounted for two-thirds (EUR 42 billion) of the government gross debt of EUR 64 billion. In addition to benchmark bonds, the government uses the EMTN programme[15], which was updated in November. In fact, some funding has already been raised via the programme. The stock of government yield bonds targeted at households is still small, at EUR 0.3 billion. The stock of foreign currency-denominated bonds totalled some EUR 3 billion at year-end. The post-swap, foreign currency-denominated stock of bonds amounted to only EUR 43 million. Other long-term bonds totalled over EUR 11 billion, and short-term notes amounted to EUR 7.5 billion at the turn of the year. The government debt-to-GDP ratio has remained at just over 40% for several years now.

Chart 13. Structure of government debt, EUR bn



Source: State Treasury.

With the fall in interest rates, the amount of interest paid by government has declined for some time now. Last year, interest paid by the government totalled EUR 2.6 billion. In recent years, the interest burden has been eased also by strong general government finances, as reflected in the government's rating and price of financing. Currently, the Finnish government

[15] Euro Medium Term Note.

is able to obtain finance at virtually the same interest rates as eg the German and French governments.

Gross issuances on the international bond markets reached a peak in 2004. The value of new bond issues totalled EUR 3300 billion, up by more than 14% on the previous year. Corporate financing in the international market remained at the level of 2003. Issues by financial institutions increased by 18%. In February, the French government issued a 50-year bond. The demand for long-term fixed-rate bonds is currently strong. In March, a 50-year bond was also issued in the corporate sector, by Telecom Italia. Such bonds have been rare, although China did issue a 100-year bond in the United States in 1996.

MTS Finland

The key market place for trades between dealers in Finnish government benchmark bonds is MTS Finland, which is part of the MTS Associated Markets SA group[16]. It is an electronic market place operating in Belgium and supervised by the Belgian supervisory authorities. The most important products traded include benchmark bonds issued by euro area countries, but the market place is seeking to include bonds issued by the private sector in its product portfolio. In the MTS system, the minimum size of a government bond issue is EUR 5 billion.

The MTS system was originally established in Italy in 1988, by Banca d'Italia and the Ministry of Finance, as a market place for government bonds. The system has from the outset been an ‘interdealer’ system, in which investors cannot take part. The system was privatised in 1997, and in April 1999, EuroMTS was established. The Italian MTS SpA and EuroMTS merged in 2001 to form MTS Global Market.

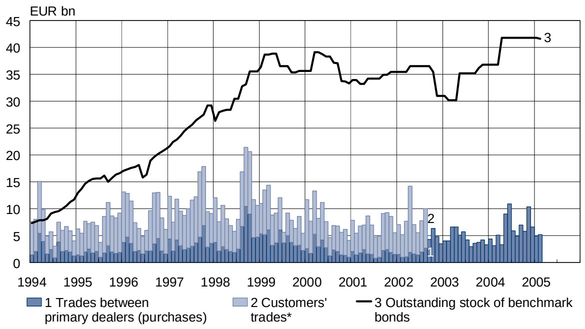
MTS Finland started operating in April 2002. Initially, ten primary dealers operated in the system; now there are 14. Seven market-makers also participate in the system. The Finnish primary dealers are Nordea Bank Finland and OKOBank. In the MTS Finland system, the minimum trading lot is EUR 5 million.

In addition to trading, the MTS system can also be used in connection with bond issuance and the buy-backs. The buy-back facility for Finnish government bonds was introduced last year.

With the arrival of foreign market-makers, trades between market-makers of government benchmark bonds are conducted primarily in the MTS Finland system (Chart 14). Consequently, there has been a considerable change in the composition of investors in benchmark bonds. The key domestic investors in benchmark bonds, employee pension insurers and other insurance corporations, have spread their fixed-income investments around the euro area, and their share has decreased with the growing importance of foreign investors.

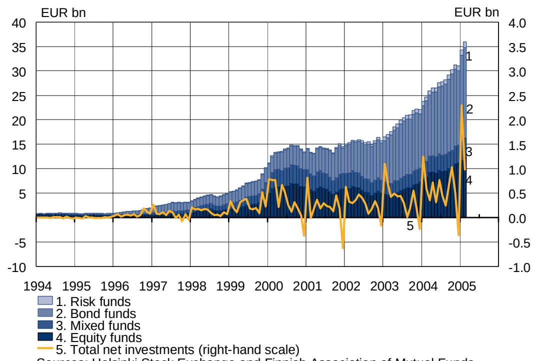
[16] The MTS group consists of the following markets: EuroMTS, EuroCreditMTS, NewEuroMTS, MTS Quasi-Government Market, EuroBenchmark Treasury Bills Market, MTS Amsterdam, MTS Austria Market, MTS Belgium, MTS Denmark, MTS Deutschland, MTS Espana, MTS Finland, MTS France, MTS Greek Market, MTS Ireland, MTS Italy, MTS Portugal. The group also includes BondVision, a regulated Internet trading place in which private investors also can operate. The MTS system also operates in Japan.

Chart 14. Finnish government benchmark bonds



*) Data not available after September 2002.
Sources: Helsinki Stock Exchange, State Treasury and MTS Finland.

Chart 15. Mutual fund issues



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

Besides the Finnish government, the banks have recently issued several bonds, most significantly an EUR 1 billion issue by OKOBank and an EUR 500 million issue by Sampo Bank.

3.3 Continued robust growth of mutual funds

Pertti Pylkkönen

The growth of domestic funds was last year concentrated on short-term funds and equity funds.

The Finnish mutual funds market expanded at a record pace in 2004. Fund assets increased from EUR 22 billion to EUR 31 billion (Chart 15). Equity fund assets grew by 55%. The growth of equity fund assets was fuelled by net investments and favourable developments in share prices. The assets of short-term funds increased by 30%.

Most of the net investments went into bond funds: The inflow of new capital into bond funds amounted to EUR 3.6 billion. In the same period, net investment in equity funds totalled EUR 2.2 billion, almost twice that in 2003. Last year, total net investment in domestic funds reached EUR 6.6 billion, up EUR 2 billion on the previous year.

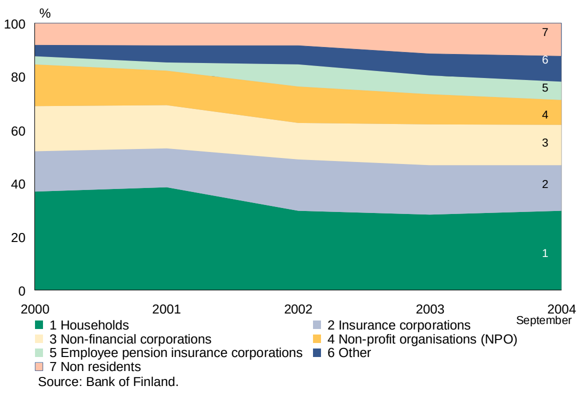
Finnish mutual fund investments focused heavily on bond markets. At year-end, about half of mutual fund investments were in various types of bond funds. Investments in short-term funds, which have dominated bond fund investments for a long time, accounted for 30% of total fund assets at year-end. At the same time, investments in long-term funds accounted for one-fifth of fund investments. Equity funds accounted for little over a third of fund assets. Leverage and hedge fund assets totalled EUR 1 billion.

Amendments to the Mutual Funds Act took effect in April 2004. In connection with the new regulations, the rules of several funds were amended, and several funds of funds have entered the domestic funds market. Many of the funds of funds are former mixed funds, and thus only a few new funds were created as the result amendment of the Mutual Funds Act. The new Mutual Funds Act allows fund management companies to expand their product portfolios to include asset management services. None of the fund management companies have yet taken advantage of this opportunity.

Currently, 27 fund management companies operate in Finland, managing almost 400 funds. In 2004, nearly 50 new mutual funds were registered in Finland. The new types of funds that have entered the market include funds of funds and funds investing in the real estate market.

Households' relative importance as fund investors has been declining for already several years. In 2000, households held 37% of mutual fund units. By the end of 2004, households' ownership of fund units had decreased to just over 26% (Chart 16). The good financial position of non-financial corporations and other corporations is reflected particularly in the growth of bond fund assets. Also households have made major investments in short-term funds. Of households mutual funds investments, over 40% were in short-term funds.

Chart 16. Ownership of fund units, %



Source: Bank of Finland.

The start of 2005 has also been good: in January, investments in mutual funds totalled EUR 2.6 billion, which is a new monthly record. The heavy inflow of capital continued in February, with net investments reaching about EUR 1 billion.

In January–February, over a third of investments were made in short-term funds, and investments in short-term funds clearly exceeded those in long-term funds. Low long-term interest rates and uncertainty about the future course of interest rates have dampened investments in long-term funds despite the fact that the return on long-term funds was 5 to 6% last year. As for equity funds, investors have become increasingly interested in funds that invest in equity markets of emerging economies. The assets of funds investing in the domestic markets have also developed favourably.

4 Infrastructure

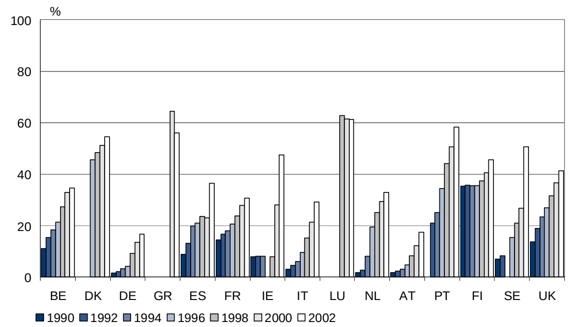
4.1 Number of payment cards increasing

Päivi Heikkinen

An increasing number of consumers are choosing the payment card as the method of payment. At the same time, regulation, European integration, tight competition, and the introduction of new technology create challenges for card companies.

Expanding sector

Chart 17. Share of card payments in various payment methods, EU15



Source: European Central Bank.

Card payment is becoming increasingly popular everywhere. Information published on the websites of large international card companies shows that the number and value of card payments increased by 10 to 20% in 2004. There are, however, country-specific differences in card preferences. ECB statistics show that almost two-thirds of European payment cards are directly linked to the payer's account (eg debit card) and that one-third of the cards are credit cards. The number of cards linked directly to the payer's account is growing fastest. International payment cards are a significant alternative also in online shopping.

Changes

The issuing of payment cards, as well as the processing of card payments (transferring and crediting) require large investments in technical infrastructure, as well as expertise. Both areas of operation are increasingly concentrated in large, specialised companies involved in cross-border operations. Improving the security of card payments by introducing chip cards will further increase card companies' investment needs.[17] Large companies are more able to meet these demands.

For example Skandinaviska Enskilda Banken (SEB Kort AB) issues payment cards in all the Nordic countries, and Barclaycard and Swedbank (Föreningssparbanken) will establish a joint card company in the Nordic market.[18] Another example of concentration is the Irish-American euroConex, which processes card transactions in several European

[17] An attempt to copy payment card data at a cash dispenser, as reported on 22 March 2005, will not succeed with chip cards.
[18] Company websites.

countries (eg United Kingdom, Ireland, Spain, Poland, and Norway). Changes are anticipated particularly in the German market because it includes several operators. As an expanding market it is attractive also to international companies.[19]

The operation of a payment card system requires clear rules between consumers, retailers and card companies: technical systems that enable the integrated use of various cards, terminals and ATMs, as well as clearly defined rights and responsibilities between the parties. The retailer must know how soon card payments will be credited to his/her account, and the consumer must know where his/her card is accepted. But the negotiating power of international commercial networks vs eg retailers is considerable. Particularly in the United States, card companies have been accused of restricting competition through their rules. The EU has studied card payment-related fees, and the objective is to harmonise them.[20]

One of the principles of the European Commission's Single Euro Payments Area (SEPA) initiative is that citizens must be able to use their payment cards not only in their own country but across the euro area. This requires converting cards currently used only nationally into cards that are accepted anywhere in the euro area. This means that Finnish domestic debit cards have to be modified. The method of implementing these requirements is still open, and the matter is being discussed in the European Payments Council (EPC), which is a joint body for European banks.

[19] Banking Automation Bulletin, Issue 215, December 2004/January 2005.

[20] Eg Chakravorti: Theory of Credit Card Networks, June 2003, and Electronic Payments 2004 Review, January 2005, and www.visaeu.com/pressandmedia, 3 March 2005.

Developments in the domestic market

The Finnish card market is dominated by domestic operators – banks and their subsidiaries and Luottokunta, a Finnish credit card service company. Luottokunta has announced that the volume of its card transactions increased by 19.5% in 2004. The use of Visa Electron in particular has increased rapidly. This is a card that requires authorisation of the purchase sum, which is directly debited from the card holder's account.[21] A special characteristic of Finnish card payments is that retailers and banks cooperate and jointly own the major payment card issuer that handles transactions crediting (Luottokunta). This has contributed to the development of an efficient card payment infrastructure and has kept card payment fees reasonable by international standards.

In Finland, competition between payment card issuers has tightened with new operators as well as new types of cards and services entering the market. Cash can be withdrawn also by using a credit card credit feature. For example, Handelsbanken Finance Ltd and Nordea Finance Finland Ltd, which specialise in direct sales finance, have included the international MasterCard feature in their cards. Various co-branded cards are becoming increasingly popular. The first co-branded cards, created jointly with ice hockey clubs, were introduced at the turn of the century. Finnair, like other international airlines, introduced its co-branded payment card several years ago. In early 2004, Marimekko and Viini, a Finnish wine magazine, announced that they both have created an international payment card carrying their name. The payment cards will be processed by a finance company. The Lindex chain too will launch a payment card which is accepted internationally. It will be managed by Ikano

[21] www.luottokunta.fi/media/tiedotteet, 15 February 2005.

Rahoitus Oy, a finance company closely tied to Ikea. Increased competition is also reflected in the benefits offered to cardholders, such as the first year free of administrative charges for credit card holders or an extended interest-free repayment period. So far, customers in Finland have not had direct offers to change an existing payment card credit for a new one.[22]

4.2 STEP 2 to Europe

Päivi Heikkinen

Progress in the adoption of STEP 2 has been irregular. In the Finnish TARGET system outgoing individual payments are of substantially higher euro value than incoming ones.

In December 2004, the ECB published a progress report on the creation of a Singe Euro Payments Area (SEPA). The ECB notes that practical measures for creating a single payments area are not progressing as hoped. The ECB expects national banking communities to draw up clear migration plans by the end of the year.

The number and value of cross-border interbank payments to and from Finland transferred through the Eurosystem's real-time gross settlement system (TARGET) has stabilised. Of incoming TARGET payments, 41% are for less than EUR 12,500, whereas only 23% of outgoing payments are that small. Some 45% of outgoing TARGET payments are for EUR 250,000 to10 million.

The number of incoming TARGET customer payments in Finland has continued to grow despite the decrease in outgoing TARGET customer payments in spring 2004, which was due to Finnish banks transferring to the EBA Clearing systems.

European banks established the EBA Clearing system in 1998. In 2000, an automated transfer system for low-value payments (STEP 1) was introduced, and in spring 2003, a bulk payment system (STEP 2). EBA Clearing, and particularly STEP 2, are the banking sector's own initiatives for creating a Single European Payments Area.

STEP 1 has 119 members, including branch offices of American, Japanese and Australian banks.

STEP 2 has 87 European banks as direct members, as well as 1,400 indirect members. The indirect members include 115 banks from the new EU countries. Through STEP 2, payments can be transferred to almost all banks in the EU15. The Finnish STEP 2 members are Aktia Savings Bank, Nordea Bank Finland, OKOBank, and Sampo Bank. The IT know-how of Finnish banks has enabled their speedy transfer to STEP 2. In other European countries, development has been less consistent.

The number of payments transferred through STEP 2 has almost doubled within the past 12 months. The growth is also supported by a new participation mode (pre-fund participation), as well as the opening up of the system to the EEA countries (EU, Norway, Iceland, and Liechtenstein) in November 2004. A prerequisite for this was that Norway, Iceland and Liechtenstein apply the EU regulation on euro-denominated payments (2560/2001/EC).

The expansion of STEP 2 into European direct debiting will further underline its importance. The Italian members of EBA have announced that they intend to gradually transfer also their domestic

[22] Eg company websites, and Kauppalehti 3 March .2005 and 7.March 2005.

payments to STEP 2. On 4 Mach 2005, EBA announced that the Spanish Banking Association had signed a letter of intent to transfer domestic payment traffic to the STEP 2 platform.

The Spanish national large-value payment system, SPI (Servicio de Pagos Interbancarios), was closed on 15 December 2004.

4.3 Uphill and downhill for securities market infrastructure

Kirsi Ripatti

OMX coins Copenhagen with its trademark. Market consolidation continues to progress in the Nordic area. In Central Europe, however, the picture is more confused.

The offer submitted by OMX on 15 December 2004 to shareholders of the Copenhagen Stock Exchange A/S (CSE) was overwhelmingly accepted at the end of the offer period in February. Shareholders had been offered newly issued shares of OMX or a cash consideration of DKK 3.050 for each CSE share. Over 99% of CSE shares were tendered. As a result of this transaction, the market value of OMX's cash market trade grew by about 20% in January–February.

With the Copenhagen Stock Exchange now part of the OMX group, OMX Exchanges' new organisation – effective as of 1 April 2005 – is divided into the Swedish, Finnish and Danish cash markets, the Baltic market, derivatives markets, and information services.

The stir around the London Stock Exchange (LSE), which started in December 2004, has continued unabated during the first couple of months of this year. Competition over the LSE started in mid-December with Deutsche Börse making an offer of approximately EUR 2 billion (GBP 5.30 per share). This was rejected, but the door was left open for further discussions, which continued until 6 March 2005, when Deutsche Börse withdrew. Its decision was motivated by differences concerning the current share price and by political issues: in Germany the government and many politicians and trade unions were concerned about the transferring of functions to London. After withdrawing its bid, Deutsche Börse decided to pay its shareholders extra dividends.[23]

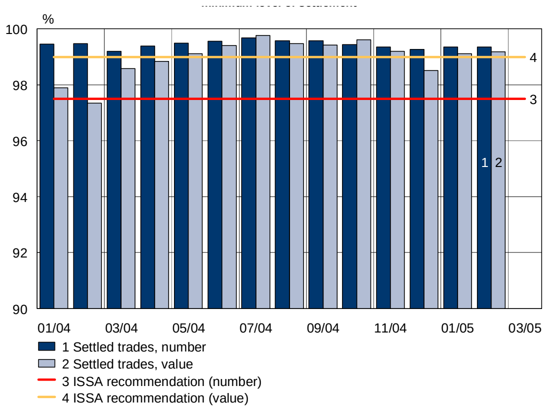
With the withdrawal of Deutsche Börse, the one party still interested in purchasing the London Stock Exchange is Euronext, which operates the Paris, Amsterdam, Brussels and Lisbon stock exchanges and the London derivatives exchange.[24] A research paper by Citigroup maintained that whichever of these operators fails to acquire the London Stock Exchange will probably focus on developing the globalising derivatives markets and on making the growing OTC markets part of stock exchange trading. The loser may also start looking for other exchanges to purchase.[25]

[23] Bloomberg.

[24] Startel.

[25] Citigroup Global Markets (2 February 2005).

Chart 18. Exchange trades settled in three days (T+3) in HEXClear and ISSA recommendations on the minimum level of settlement



Sources: NCSD and ISSA.

On the domestic front, there have been no major peaks in trading activity. Exchange trades settled in APK's HEXClear system continue to meet ISSA[26] recommendations on settlement (> 97.5%) in terms of the average number of trades settled. Between November 2004 and January 2005, an average of 99.3% of exchange trades were settled within the allotted time. In terms of value, the success rate reached 98.9% (Table 3).

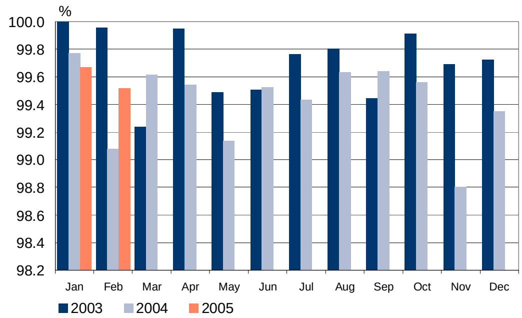
Table 3. The nominal value and total number of settled money market instruments

	EUR bn	Number
2002	294	35,767
2003	167	22,567
2004	159	19,556

Source: NCSD.

In recent years, the volume of settled money market instrument trades has decreased, in terms of both value and number of transactions (Table 3), whereas the corresponding stock of securities has grown slightly. The settlement rate of money market instrument trades has also dropped during the same period. In 2002, the settlement rate was 99.9%, and in 2003 it was still 99.7%. In 2004, the settlement rate dropped to 99.4%, and for November 2004–January 2005, it was 99.3% (Chart 19).

Chart 19. Settlement rates for money market instruments



Source: NCSD.

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

5 Developments in regulation and supervision

5.1 International regulation and supervision

Kari Kemppainen – Hanna Putkuri

The deepening of financial market integration has clearly been reflected in the recent development projects in regulation and supervision. The International Financial Reporting Standards (IFRS) were introduced at the beginning of 2005. A proposal on a directive on the capital adequacy reform is being debated by the European Parliament.

Financial Services Action Plan (FSAP) -related regulation

The International Financial Reporting Standards (IFRS) were introduced in the EU at the beginning of 2005. The standards apply to all listed companies that prepare consolidated financial statements. The reform complies with the standards of the International Accounting Standards Board (IASB), and its key aim is to increase the comparability and transparency of financial statements. The IAS 39 standard on the recognition and measurement of financial instruments, which is a key standard for the banking and insurance sector, entered into force in respect of those sections that were ratified by the European Commission in November 2004. The Commission decided that in the EU's financial statement requirements, the option of fair value is not applicable to liabilities. Moreover, the Commission did not ratify certain regulations on the accounting of hedging instruments.

A key project in international financial systems regulation is reform of the capital adequacy requirements (Basel II), which has been prepared by the European Union and Basel Committee on Banking Supervision. A proposal for directives relating to the taking up and pursuit of the business of credit institutions and on the capital adequacy of investment firms and credit institutions (capital adequacy directive) (COM(2004)486) is currently being discussed by the European Parliament. The ECB issued an opinion on the proposal in February. The Commission's proposal for a directive is largely based on the Basel Committee's recommendation for a new capital adequacy framework for banks, which was published in June 2004. The new rules for calculating capital adequacy will take effect gradually, ie on 31 December 2006 and on 31 December 2007.

Directive 2004/109/EC of the European Parliament and of the Council on the harmonisation of transparency requirements in relation to informing about issuers whose securities are admitted to trading on a regulated market was published in the Official Journal of the European Union on 31 December 2004. This so-called transparency directive must be transposed to national law by the end of 2006.

The objective of the New Legal Framework for Payments in the Internal Market prepared by the European Commission is to create a harmonised legislative framework for the provision of payment services in the European Union. The preparation of the framework is continuing in the Commission's working groups.

In February, the ECB issued an opinion on a proposal for a directive of the European Parliament and of the Council on the prevention of the use of the financial system for the purpose of money laundering, including terrorist financing (CON/2005/2) (so-called third anti-money laundering directive). The opinion was issued on the request of the European Council.

Nine member states (incl. Finland) implemented the directive on financial collateral arrangements (2002/47/EC) within the allotted time (by 27 December 2003). In early 2005, the Commission took measures concerning those member states that have not yet implemented the directive. Of the new member states, seven implemented the directive within the allotted time (by 1 May 2004), and the three remaining member states will implement it during spring 2005. The Commission will present a report to the European Parliament and to the Council on the application of the directive on 27 December 2006 at the latest.

Decisions by the Governing Council of the ECB

The Governing Council of the ECB decided on 14 January 2005 that relayed links between securities settlement systems (SSSs) may be used for the cross-border transfer of securities used as collateral for Eurosystem credit operations. A relayed link is a contractual and technical arrangement that allows two SSSs not directly connected to each other transfer securities through a third SSS, which acts as an intermediary. The decision by the Governing Council of the ECB was taken in response to growing demands by the market organisations for the acceptance of securities transference through relayed links.

The Governing Council of the ECB had taken a decision in August 2004 to include bank loans in the future single list of eligible collateral for Eurosystem credit operations. In connection with this decision, the Governing Council decided on 18 February 2005 that, as from 1 January 2012, a unified regime would be introduced for the use of bank loans as collateral with a single threshold of EUR 500,000 and a common Eurosystem credit assessment framework. An intermediate regime will be put in place starting on 1 January 2007, under which a number of euro area NCBs will already opt for a threshold of at least EUR 500,000.

International rules are being developed to enhance due process in securities management.

The Hague Securities Convention, which is in the process of being ratified, will provide a basis for the choice of law between investor and the relevant depository. The aim of the Convention is to clarify issues in securities disposition, holding and transfer in the context of international securities trading. The ratification of the Convention may affect the above-mentioned collateral directive. The Commission will take these needs to amend the directive into consideration in its implementation report.

In May 2005, Unidroit (International Institute for the Unification of Private Law) will hold the first meeting of government experts for the preparation of a draft Convention on harmonised substantive rules regarding securities held with an intermediary. The Convention will apply to the multi-tiered holding systems that are common outside the Nordic region. From the Finnish perspective, the project is important in terms of management of foreign portfolio investments, which are growing.

5.2 Domestic regulation and supervision

Kari Kemppainen – Hanna Putkuri

Developments in international regulation and supervision call for many changes in Finnish legislation. The national implementation of financial directives is currently being prepared in several working groups.

In late 2004 and early 2005, a number of amendments to Finnish legislation on financial corporations and their supervision took effect. Several legislative amendments are also being prepared.

Recent legislative amendments

Amendments to the Accounting Act and related acts took effect on 31 December 2004, thereby implementing the Regulation of the European Parliament and of the Council on the application of international accounting standards (IAS and IFRS) and the Fair Value Directive, a directive on the fair value accounting of financial instruments. The application of international financial reporting standards – instead of national accounting legislation – became mandatory in the consolidated financial statements of those companies whose securities are traded publicly.

Amendments to the provisions on accounting and financial reporting of the Insurance Companies Act and certain related acts also became effective at the turn of the year. Insurance companies whose securities are publicly traded within the Community were obligated to prepare their consolidated financial statements in accordance with international financial reporting standards.

Amendments to the Act on the Financial Supervision Authority took effect on 1 January 2005. As a result of the amendments, the tasks of the Finnish Financial Supervision Authority (FIN-FSA) also include the supervision of financial statements that have been prepared in accordance with international financial reporting standards. The supervisory responsibility of the application of standards concerning only insurance business lies with the Insurance Supervision Authority.

The Act on Supervision Fees of the Financial Supervision Authority entered into force on 1 January 2005. The new act lays down detailed provisions on the basis for the supervision fee, enabling each entity liable for payments to calculate and estimate its supervision fee in advance. The purpose of the new act is to fulfil the constitutional requirements on fiscal fees and ensure the financing of FIN-FSA operations.

The act on the imputation system of corporation tax (avoir fiscal) was repealed on 1 January 2005. The other legislative amendments made in connection with the reform of corporate and capital taxation took effect already in August 2004.

Amendments to the restrictions on the acquisition of own shares included in the Companies Act took effect on 9 March 2005. From now on, a public limited company can acquire an amount of own shares that does not exceed 10% of its share capital or total voting rights attached to its shares. The new limit is in accordance with the limit laid down in the so-called capital directive. The objective of the legislative amendment is eg to ensure that Finnish companies have the same opportunities for implementing corporate restructuring as the public limited companies in other EU countries. An increase in the acquisition limit from 5% also provides increased flexibility in the distribution of profits and capital structure management. Preparations on the Companies Act reform continue in a working group set up by the Ministry of Justice.

Ongoing legislative projects

The purpose of the key ongoing projects is to prepare legislation for the national implementation of directives of the European Parliament and of the Council and provisions of the European Commission that complement these. The legislative amendments are being prepared in working groups set up by the Ministry of Finance.

The deadline for implementing directive 2003/6/EC on insider dealing and market manipulation (market abuse) in national legislation was 12 October 2004. Eight of the nine legislative proposals (Government bill HE 137/2004) issued in September 2004 on the amendment of the Securities Markets Act and certain related acts were accepted by the Parliament in March 2005. One objective was to include in the Securities Markets Act the provisions on market abuse and, in the Act on the Financial Supervision Authority, provisions on two new administrative sanctions: an administrative fixed penalty and a penalty payment.

Directive 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading must be implemented in national legislation not later than 1 July 2005. The aim of this so-called prospectus directive is to improve the quality of information provided to investors by companies raising capital in the EU. The first report of the working group preparing the legislative amendments was completed in December 2004. The working group's mandate should have expired at the end of January 2005, but it was extended until the end of August to enable the working group to continue examining the division of responsibilities in connection with the prospectus. In March, the FIN-FSA published its interpretation of the purpose and contents of the directive and regulations issued in accordance with it.

Member states must bring into force the laws, regulations and administrative provisions necessary to comply with the directive 2004/25/EC on takeover bids no later than 20 May 2006. The purpose of the directive is to promote acquisitions in the EU by harmonising rules on takeovers. The legislative amendments required by the directive are being prepared in a working group whose mandate expires at the end of March 2005.

Directive 2004/39/EC on markets in financial instruments should be implemented in national legislation no later than 30 April 2006. The mandate of the working group preparing the legislation expires at the end of October 2005.

The capital adequacy reform on investment firms and credit institutions (see Section 5.1) should be implemented in national legislation on 31 December 2006 at the latest. The powers of the authorities proposed in the directive will be applied in Finland in line with the limits defined in the general principles of the national legal system. The working group preparing the necessary legislative amendments completed its assessment on the economic impact of the reform in September 2004.

In March, the Finnish Government issued a bill for amending the Insurance Companies Act and certain related acts. The Government bill proposed that insurance corporations could, instead of the earlier 5%, cover a maximum of 10% of their gross technical provisions included in the insurance risks located in an EEA country with certain debt instruments, shares and other equity, and other commitments located in other OECD member states. The amendment would enable insurance corporations to improve their risk management as a result of more efficient allocation of funds covering technical provisions.

6 Key corporate arrangements and events in the financial sector

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.

Date	***Event and description***
	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.
	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.

Date	Event and description
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.
Dec 2004	*Danske Bank announced that it will acquire from National Australia Bank the National Irish Bank operating in Ireland and the Northern Bank operating in Northern Ireland at a price of EUR 1.4 billion.*
	Derivatives trading ended at the Helsinki Stock Exchange and was transferred to Stockholm.
	Kaupthing Sofi Oyj was granted a banking licence. The new name of the bank is Kaupthing Bank Oyj, and it started operating at the beginning of 2005.

Date	*Event and description*
	Aktia Savings Bank and Veritas Life Insurance Company signed an agreement according to which Aktia Life Assurance will become a subsidiary of Veritas Life Insurance Company at the turn of the year. At the same time, the operations of the company Hiisi are transferred to Aktia Asset Management Ltd and Veritas' mutual fund management to Aktia Fund Management Company Ltd.
Jan 2005	*Pohjola Life Insurance Company Ltd started operations. Suomi Mutual Life Assurance Company transferred a EUR 1.2 billion life insurance portfolio to Pohjola Life Insurance Company Ltd. Suomi Mutual stopped selling new life insurance policies.*
	Aon Finland Oy, one of the largest insurance brokers in Finland, sold its life and investment insurance brokerage operations to Bon Life Oy.
	Standard Chartered Bank acquired Korea First Bank for USD 3.3 billion.
	Citigroup announced that it will sell its insurance company, Travellers Life & Annuity, to MetLife for USD 11.5 billion.
Feb 2005	*The government sold 7.1% of its A shares of Sampo plc at EUR 10.75 per share. The State now holds 14% of Sampo's shares and 13.9% of its voting rights.*
	Mitsubishi Tokyo Financial Group, Japan's second largest financial group, announced that it will acquire UFJ Holdingin, the country's fourth largest financial group.
Mar 2005	*Amendments to the restrictions on the acquisition of own shares included in the Companies Act took effect. Consequently a public limited company can acquire an amount of own shares that does not exceed 10% of its share capital or total voting rights attached to its shares.*
	The Spanish bank Banco Bilbao Vizcaya Argentaria made a EUR 7.6 billion bid for the Italian bank Banca Nazionale del Lavoro.
	ABN AMRO announced that it will acquire Bank Corluy, a Belgian private bank.