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Risks to households and banks in the housing loan markets are increasing

The stock of housing loans continues to grow in the current cyclical and market situation. Banks are now making good profits and their capital adequacy is strong. Both net interest income and other income increased in the first half of 2005. Banks' interest rate risk has remained unchanged, but the strong growth in the stock of housing loans has increased their structural funding risk. The strong growth in the housing loan stock poses a risk both to households and banks.

Cyclical conditions keep loan markets active

US economic growth remained reasonably good, but economic uncertainties are still overshadowing growth prospects. International cyclical conditions keep domestic loan markets active.

Euro area interest rates still low, foreign exchange markets finding their bearings

Interest rates are still low in the euro area. In the Unites States, the increase in the policy rate have not increased long-term interest rates as the Federal Reserve Bank had hoped. In the foreign exchange markets, the euro has depreciated against the dollar.

Upward trend in the share market continues

The share market performance for 2005 is even better than for 2004. The share turnover on the Helsinki Stock Exchange has increased and most share prices have risen. Foreign investors have increased their interest in Finnish shares. Special securities market products such as hedge funds and exchange traded funds (ETF) are still unknown to the general public.

International investors in real estate still interested in Finland

International property investors no longer concentrate only on the Helsinki region but also aim for other urban growth centres. International investors' share of the 2005 trade has been as much as 43%. This means that the operating environment of our real estate market has become consistently internationalised. The total volume of the Finnish real estate market is estimated to be growing to EUR 2.5–3.0 billion in 2005.

Peaking growth in loans in tightening competition

Loan stocks continue to grow strongly as a result of the growth in the housing loan stock in particular. Competition is also intensifyiing as regards consumer credit. Large loans and lengthening loan repayment periods increase household risks.

Continued profit improvement in Finnish banks

Deposit banks' net interest income turned upwards in the first half of 2005 compared to the corresponding period in 2004, as an exceptionally large demand for loans compensated for the narrowed interest rate margin due to tight competition. At the same time, banks increasingly looked to fee income for support. Here the significance of securities-related products is growing. Staff costs brought about a modest increase in expenses.

Banks’ capital adequacy declined slightly but is still strong

The banking sector's capital adequacy has remained strong. While the sector's capital adequacy is burdened by rapid growth in the stock of lending, banks' increased profits and the issuing of equity instruments in the financial market have had a positive impact on their capital adequacy.

Income growth decelerated in investment services

Managed assets continued to grow and securities trading was brisk in spring and summer 2005. Despite favourable developments, income from investment services no longer grew at the previous pace. At the same time, new companies are entering the market. If turnover stagnates at the current level, competition for customers between investment firms will tighten and profitability will weaken.

Non-performing assets still at a low level

Finnish banking groups' non-performing assets contracted in respect of all sectors. Non-performing assets and impairment losses continue to account for a small proportion of total exposures. The quality of the banks' lending portfolio can, on average, be regarded as good.

Market-based funding on the increase

Deposits have not increased as fast as lending, and banks have funded their growing lending by issuing bonds. Bonds with mortgage collateral issued by mortgage credit banks are also used as a refunding channel.

No major changes in banks' interest rate risks

The banking sector's total income risk has remained at the same level as at the end of 2004. A 0.5 percentage point increase in interest rates would improve the banks' net interest income by EUR 133 million.

Risks to households and banks in the housing loan markets are increasing

The stock of housing loans granted by banks has almost doubled during the last five years. Demand for housing loans has been boosted by the exceptionally low level of market interest rates and lengthened loan repayment periods. It has also been boosted by the narrowing of interest rate margins as a result of strong competition among banks.

The debt servicing burden of households has nonetheless increased, since the size of housing loans has increased significantly. The current cyclical and market situation will foster growth in the stock of housing loans also in the future.

Narrowing of interest rate margins a risk to bank profitability in the future

The quality of banks' lending portfolio has been good for several years: loan losses and nonperforming assets have been very limited. There have been fewer bankruptcies than at any time since 1986. The number of payment defaults is relatively small, and unemployment developments have been favourable. According to economic forecasts, customers' payment capacity is not threatened in the short term.

Banks are competing for housing loan customers as eagerly as before the banking crisis at the end of the 1980s. Even though banks are not faced with major immediate risks, interest rate margins are narrow with respect to long-term risk management and profitability.

The profitability and capital adequacy of banks is now good. However, there are concerns over banks' ability to operate profitably, for instance with 0.5 percentage point interest rate margins 10 years from now. There is cause for concern especially if other financial services than housing loans do not bring as much earnings as at present. These services do not bind households as customers to banks for as long as housing loans do. Finnish banks are among the most efficient in the euro area, but it is worth considering whether it is, from the viewpoint of profitability, safe in the long run to grant housing loans that are the least expensive in the euro area.

Inexpensive and long-term housing loans a challenge for banks' funding

Banks have traditionally financed their lending through deposits, but the share of deposits in the financing of loans has fallen sharply already for several years. Banks have diversified their sources of funding. The demand for bank bonds has been ample and several banks have established mortgage credit banks. Financing loans with long repayment periods and very narrow margins poses a challenge for banks' funding.

Fall in housing prices a price risk to households and credit risk to banks

Bank competition for housing loan customers has started to demonstrate some worrisome characteristics. There are already some signs of banks relaxing their collateral requirements. Housing loans are considered to contain fairly low risks, since they are collateralised. However, housing prices have risen rapidly in recent years because housing demand has remained strong in urban growth centres in particular. There is a high risk that housing prices will start to fall at the same time as interest rates start to rise. Should this happen, banks' collateral for loans would also decrease in value. Households in turn carry a price risk, ie the risk that the value of the dwelling decreases from the value at the purchase time.

Risks greater to households than banks

In Finland, unlike in many other euro area countries, the majority of credit is fixed to floating interest rates, which means that the loan customer alone bears the risk arising from possible interest rate changes. If a household has measured its monthly debt service costs according to the current, exceptionally low level of interest rates, even the slightest rise in market interest rates could make it more difficult to repay the debt. For this reason, it is essential that customers prepare for interest rate rises and make calculations to determine how their debt service costs might increase.

When households take out a housing loan they usually buy other financial services as well. However, the pricing of other financial services is not as clear as that of housing loans. Therefore, in addition to interest rate margins on housing loans, customers should also compare carefully the prices of other financial services they buy.

The current possibility to get a long repayment period for a loan poses a substantial risk to a customer. If interest rates rise, the loan repayment programme cannot be adjusted by lengthening the repayment period. Hence, one important means of easing the repayment of loan is unavailable. Customers need to understand that it is quite possible that interest rates will double and that this is even likely during a long loan repayment period.

FIN-FSA supervises bank credit risk management but cannot intervene in loan pricing

The Finnish Financial Supervision Authority (FIN-FSA) cannot intervene in the pricing of loans in a free financial market situation, rather, the price is determined in the negotiations between the bank and the customer. Instead, the FIN-FSA supervises that banks observe the guidelines and regulations governing the sound management of credit risk and follow capital adequacy provisions. The FIN-FSA has also repeatedly reminded banks to carefully check a customer’s creditworthiness, and pointed out that it is vital to follow strict collateral policy and that narrow interest rate margins pose a threat to banks’ profitability. Furthermore, the FIN-FSA is currently examining the effects of housing loan competition on the basis of a survey made among banks. The results of the survey will be published during this autumn.

The FIN-FSA has frequently issued public warnings to households about the risks of long and sizeable housing loans. A rise in interest rates, unemployment, illness or some other event weakening households’ income can seriously shake household finances. A worrisome feature is that the stock of housing loans is concentrated among young families. The FIN-FSA has compiled useful information for borrowers on its website (Lainat ja vakuudet) (in Finnish only).

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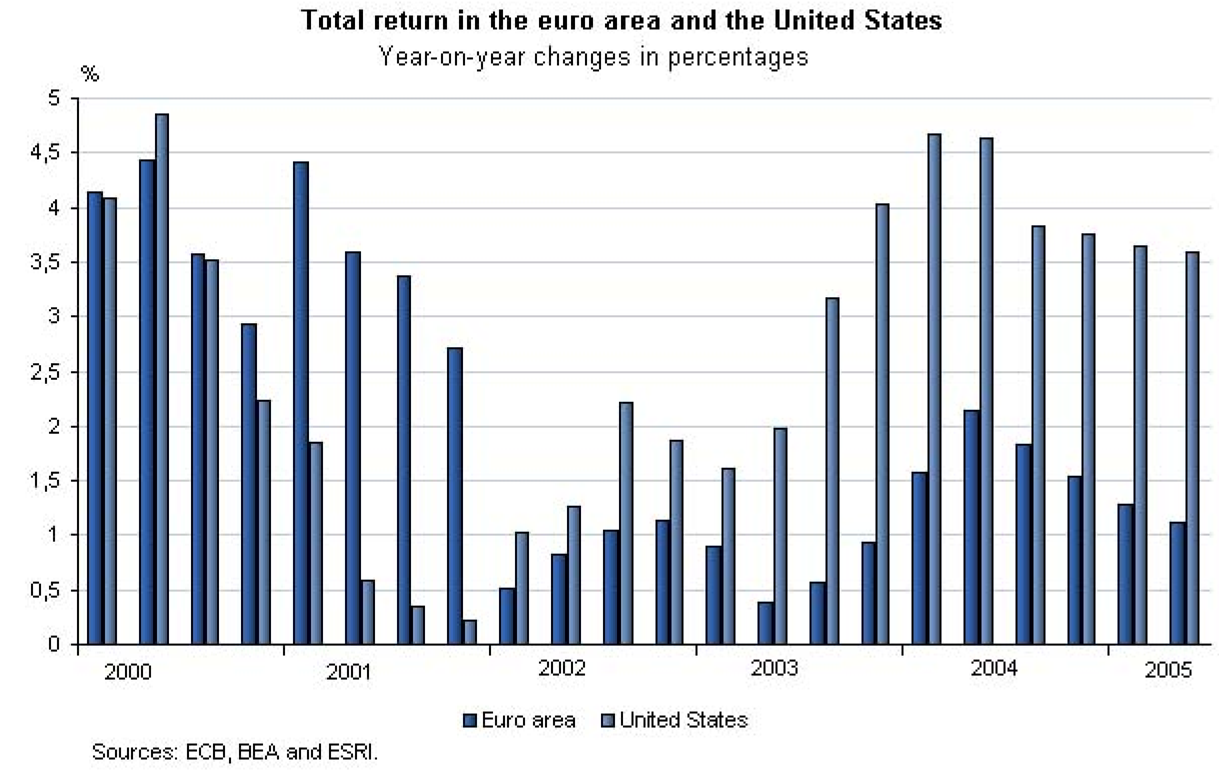
Cyclical conditions keep loan markets active

Econmic growth in the US continued at a clearly faster pace than in the euro area. The strongest contributor to demand continued to be private consumption, which grew by nearly 4% in annual terms during the year. Investment and exports also increased on 2004, while inventory run-downs weakened growth in the second quarter of 2005. Euro area economic growth was clearly slower than elsewhere in the world. Higher crude oil price, structural problems in the economic area and the strong euro will hold back euro area economic growth. In contrast, strong positive growth continued in the emerging economies of Asia, while Japan lagged behind similarly to the euro area.



Global economic risks unchanged

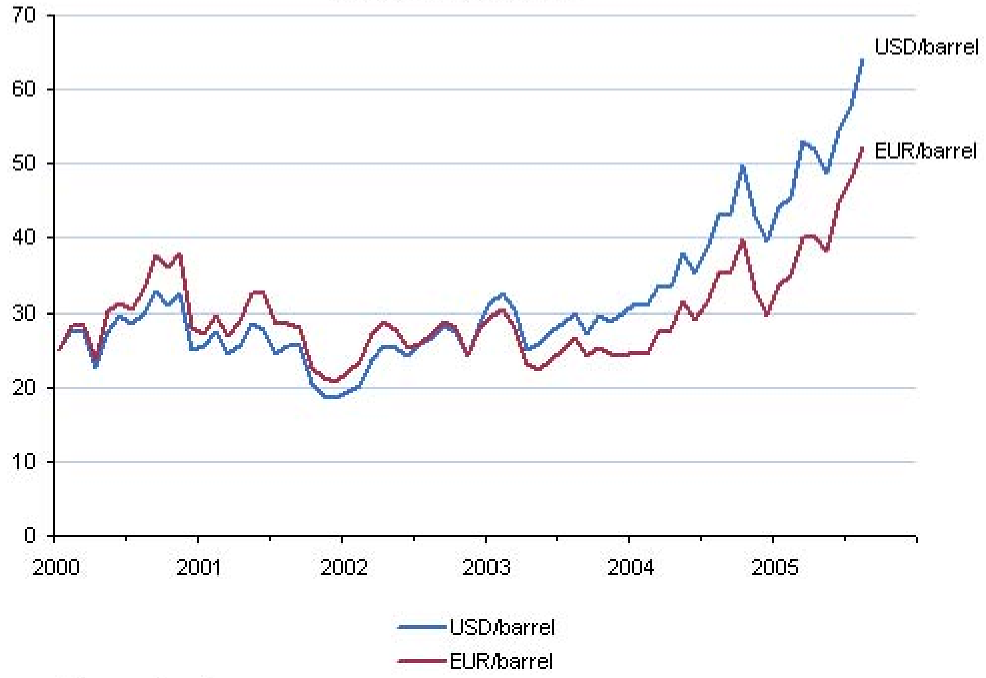
Despite relatively positive growth prospects for the world economy, prior uncertainty factors have not disappeared; instead, their risk has become more pronounced. The biggest risks continue to be deficits in the US public finances and foreign trade as well as crude oil price developments. The US current account defcit widened to more than USD 600 billion, accounting for some 6% of the GDP.

This deficit is at a recod high, and it is expected to reach nearly USD 800 billion by the end of the year. Sooner or later this will lead to a correcting of the economy, the speed and implications of which cannot be anticipated on the basis of past experience. A decrease in housing prices may also endanger the continuation of economic growth.

So far the US economy seems to have dealt with its problems surprisingly well, even with the damage caused by the hurricanes. Yet it must be borne in mind that because national accounts data is not real-time, the actual impact will become evident only over time. Recent estimates suggest that the direct and indirect damage caused by hurricane Katrina may clearly exceed preliminary projections.

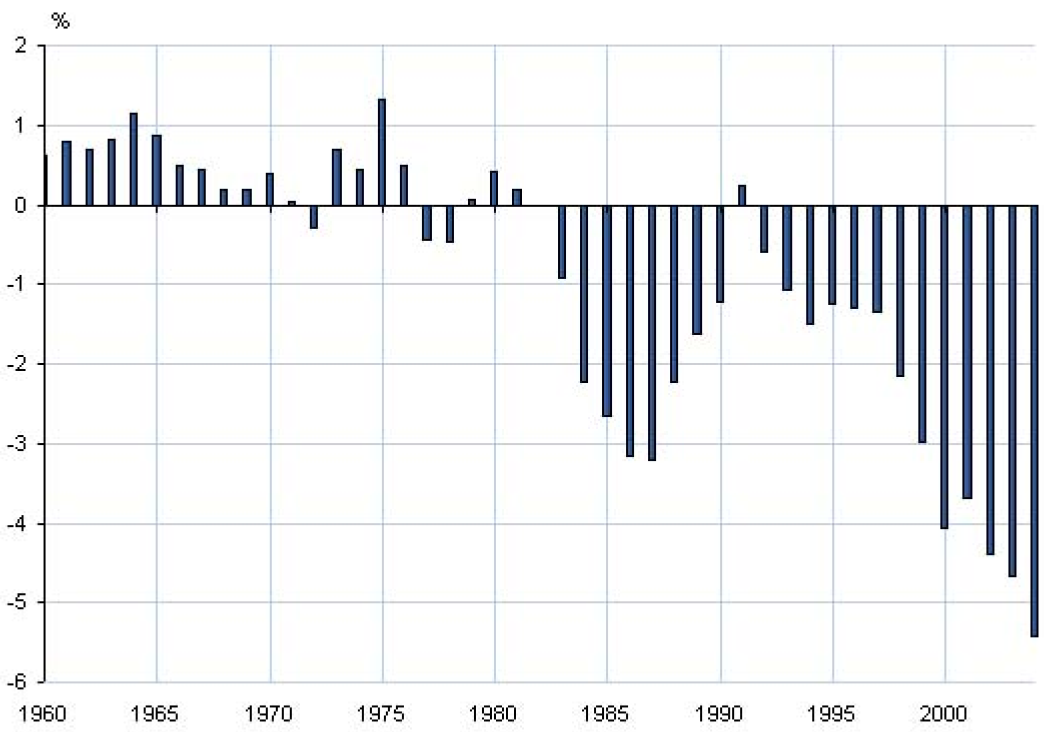
Recent euro area economic data has shown signs of more positive developments, which has prompted some forecasters to revise their euro area projections slightly upward. Positive news has also caused euro area interest rates to rise.

Crude oil price developments
North Sea Brent, spot



Source: Bloomberg.

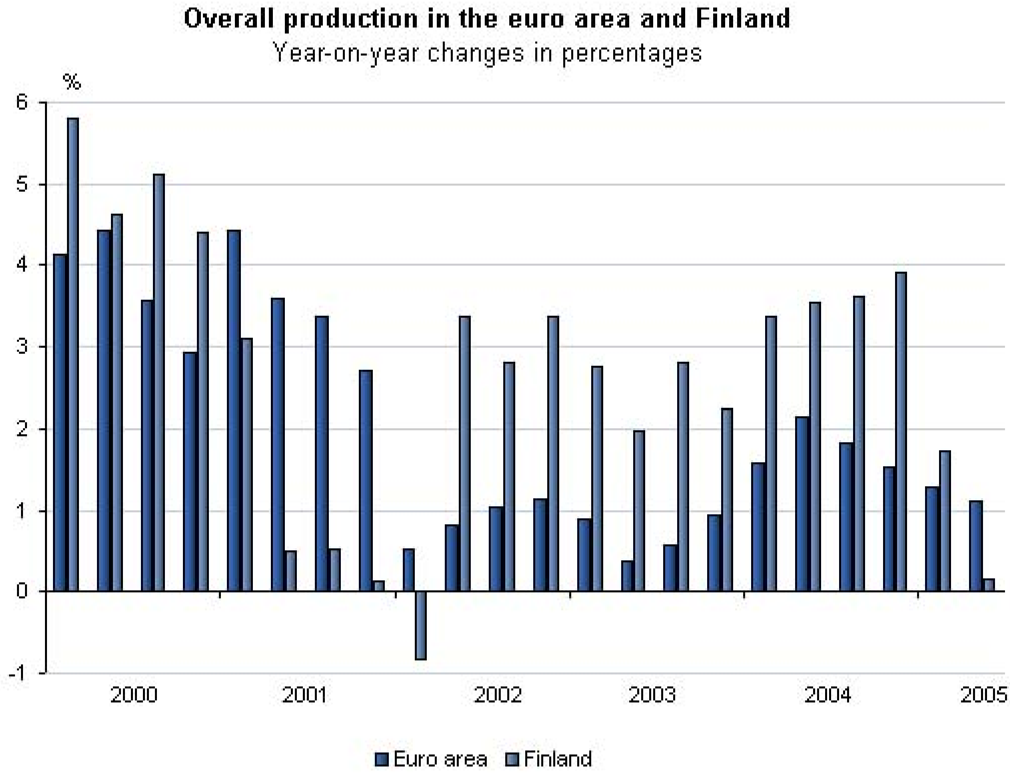
US current account as percentage of GDP



Source: Bank of Finland.

Finnish growth figures suffered from the paper industry labour dispute

Finland's economic growth exceeded that of the euro area up until the second quarter of the year. The figures for the second quarter were adversely affected by the paper industry labour dispute in spring 2005, which brought paper production to a standstill for months. The industrial dispute will also be reflected in next year's growth figures, as forecasters project a kind of technical dip in growth for 2005, which is expected to be compensated for by greater than expected output growth figures in 2006.



Sources: Eurostat, Bank of Finland and Statistics Finland.

More favourable outlook than elsewhere in the euro area

The transporation sector was adversely affected in 2005. The paper industry labour dispute nearly halted all export transports, and motor fuel prices increased due to the higher crude oil price. In other respects, Finland's economic environment continued to be favourable for practically all other sectors. Indicators of industrial and consumer confidence have also remained relatively strong. According to the banking survey of the Finnish Bankers' Association published in September, corporate and household demand for new loans is expected to continue to grow.

Current cyclical conditions keep loan markets active

The domestic operating environment for the FIN-FSA's supervised entities and for Finnish consumers appears still to be good. The pace of economic growth is reasonably good, consumer and industrial confidence is good, reductions in unemployment have been steady and borrowers' solvency has not deteriorated. However, consumer confidence in future economic conditions, coupled with low interest rates, has heated the Finnish market for household loans further. Given the long loan periods that extend over the industrial cycle, supervised entities and borrowers are encouraged to prepare, at the current stage of the business cycle, for a weaker operating environment in the future. Bad contracts are often made when times are good.

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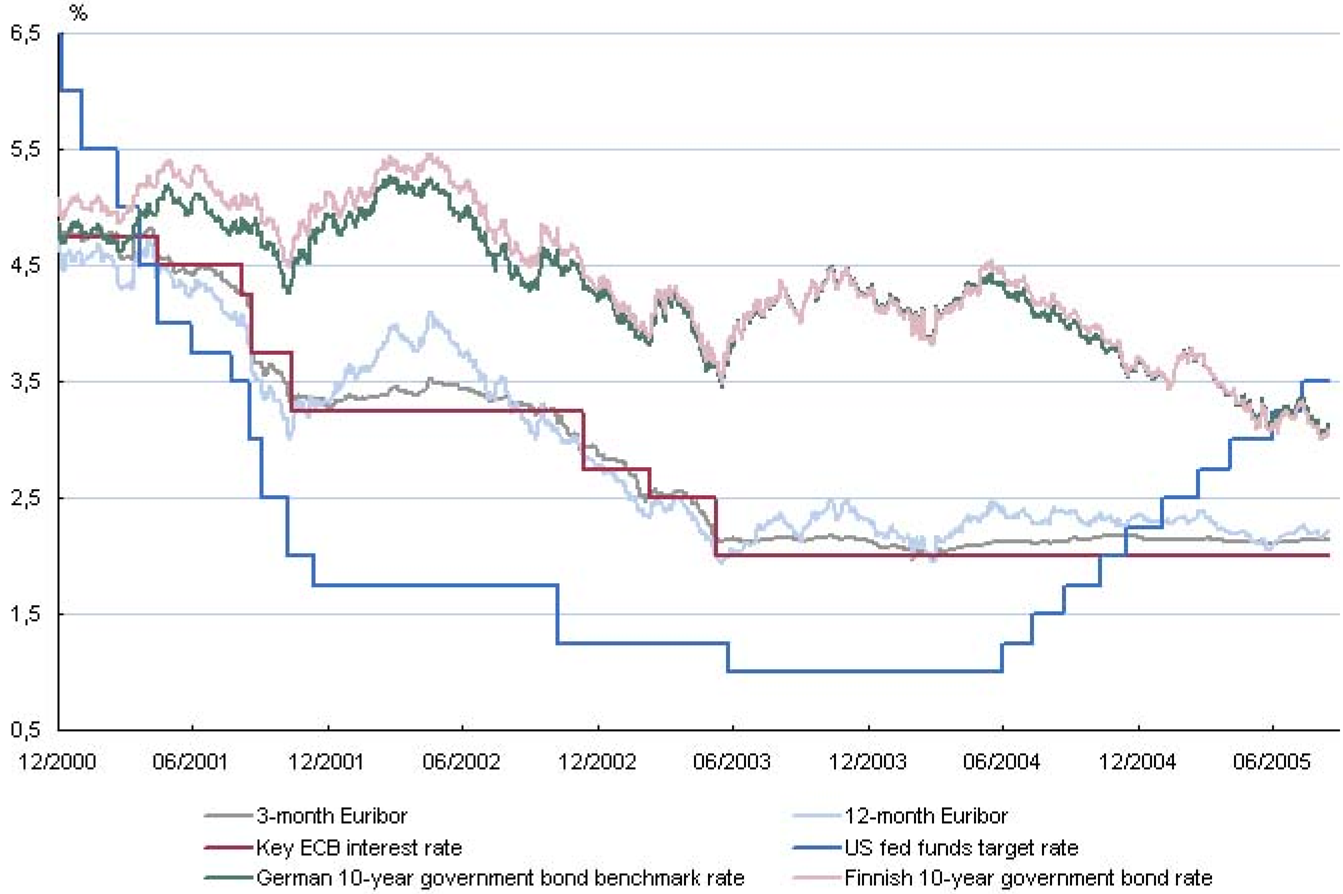
Euro area interest rates still low, foreign exchange markets finding their bearings

Households with an outstanding housing loan have benefited from historically very low market rates for several years now. The key ECB interest rate has stood at 2% since June 2003, and there are no signs of a rapid rise in the rate. This is reflected in short-term interbank market rates which have, even in recent months, remained at over 2%. These rates are important for households with an outstanding housing loan.

Euro area long-term interest rates are also exceptionally low by historical standards. In Germany and Finland, the 10-year government bond rate stood at about 3% at the beginning of September. The term structure of interest rates, ie the yield curve, slopes upward as usual, which means that long-term interest rates are higher than short-term interest rates. However, the yield curve moves continually in accordance with expectations. Only recently has the yield curve edged down again. This means that long-term interest rates have gone down owing to weakened future expectations.

Financial market rates, 29 Dec 2001–13 Sep 2005



Source: Financial Supervision Authority.

US long-term interest rate remains low despite policy rate increases

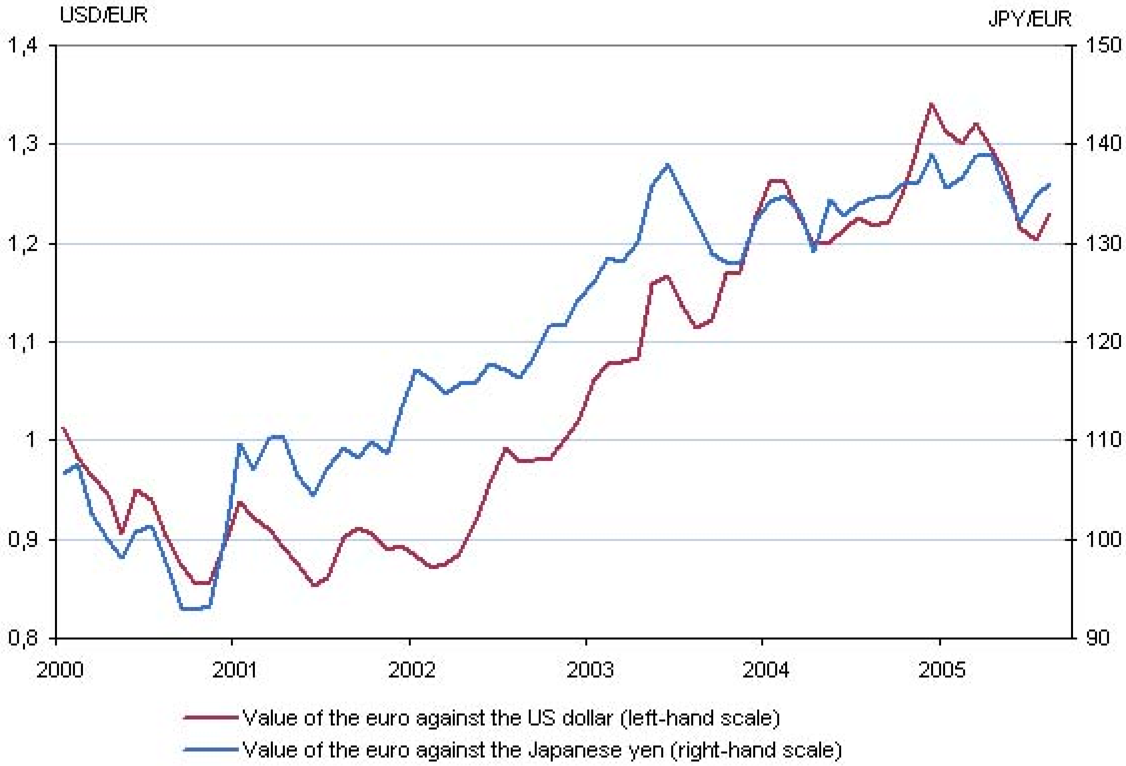
The US Federal Reserve System has increased its policy rate 11 times since June 2004, from 1.25% to the prevailing 3.75%. It is expected in the markets that these interest rate increases will continue. However, market expectations change almost daily, which reflects well the uncertainty linked to the world economy and economic developments in the US, in particular.

Despite interest rate increases, the US 10-year long-term interest rate has remained relatively unchanged at above 4%. Hence, changes in the policy rate have led to a flattening trend in the yield curve since June 2004. This could be explained by the concerns in the interest rate markets that US economic growth is slowing down and the economy is even heading towards a recession. Another explanation is more optimistic and suggests that strong demand in US interest-bearing paper is putting pressure on long-term interest rates.

Euro has depreciated from the turn of the year

The euro-dollar rate has experienced opposing developments in the course of 2005. After the record high at the turn of the year (EUR/USD 1.35) the euro depreciated against the US dollar until the beginning of July (EUR/USD 1.19), after which it in turn appreciated against the US currency. In September, the euro weakened again. There can be substantial fluctuations in exchange rates in the near future as exchange rate market participants reflect their views on economic developments in these economic areas.

Exchange rate of the euro against the US dollar and Japanese yen, monthly
The curve rises as the euro appreciates



Source: ECB and Reuters.

Interest rates will not stay low forever

It is probable that, at some point, the European Central Bank will also change its key interest rate to dampen the general price development, or when economic growth strengthens in the euro area again. Changes in the key interest rate, or even expectations of such changes, are immediately reflected in market rates and later in debt service costs. The shorter the rate fixation periods, the more quickly interest rate changes are reflected in the housing costs of households with an outstanding housing loan.

Changes in the key interest rate affect debt service costs more quickly in Finland than in many other euro area countries. The reason for this is that the majority of credit is fixed to short-term market rates in which the interest rate is usually adjusted yearly, in some cases even monthly.

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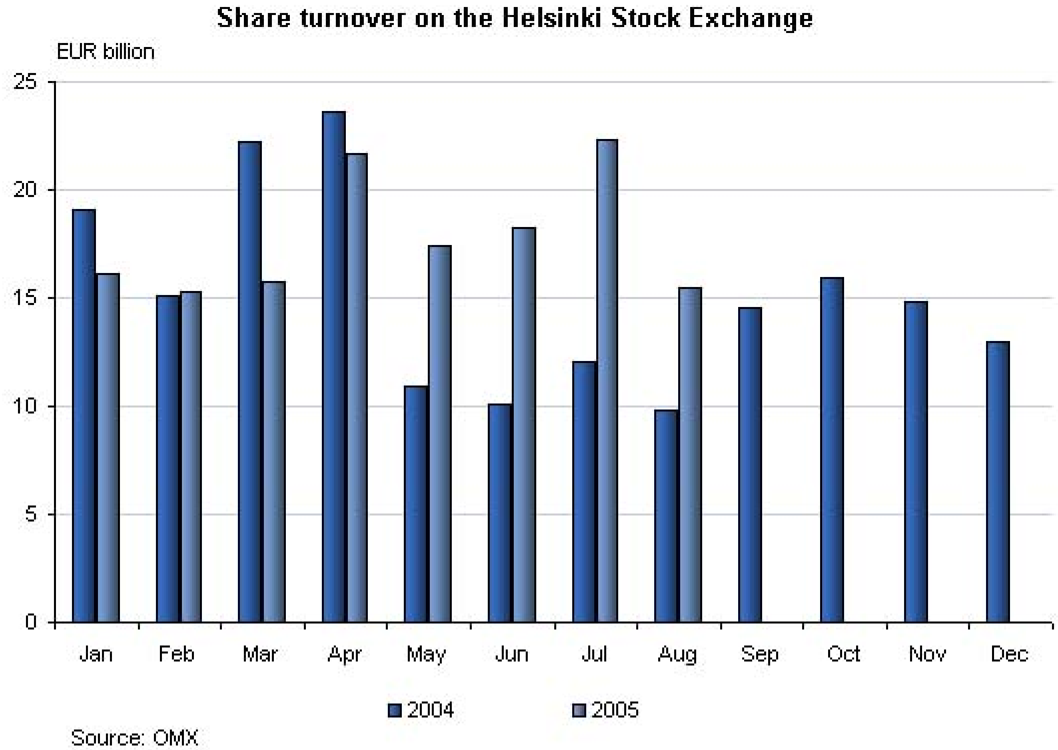
Upward trend in the share market continues

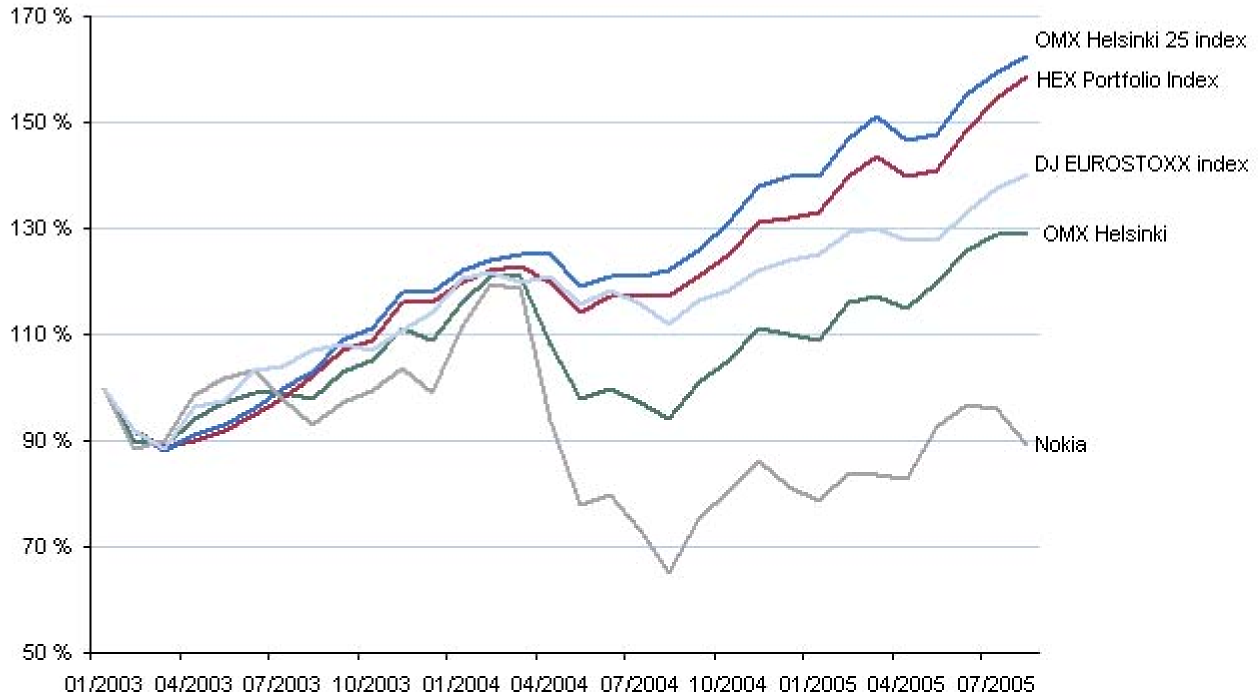
In January–August 2005, trading on the Helsinki Stock Exchange reached record levels. Turnover in the summer months especially was higher than normal. Foreign investors are again increasingly interested in Finnish shares, which was also reflected in the turnover of the summer months. In January–July 2005, net purchases of Finnish shares by foreign investors amounted to EUR 4 billion, in contrast to only EUR 85 million in the whole of 2004. What is more, the average for 2003 was clearly below than for 2004, due to foreign investors reducing their investment in Finnish shares by EUR 0.5 billion.1



Clear differences in the share performance of different sectors and companies

Share prices have continued to rise. In August 2005, the OMX Helsinki (OMXH) index was some 30% higher than ever before during the market upswing that has lasted for two and a half years. Measured by the performance of the OMXH index, the Helsinki Stock Exchange does not quite reach the average growth levels of other European stock exchanges. While the general index does illustrate the market performance of all shares listed on the stock exchange, it does not give any indication of the performance of single shares (Nokia excluding) or different sectors. However, the dominance of the index by Nokia has weakened slightly recently. In the summer, Nokia's index weight varied between 30% and 40%.

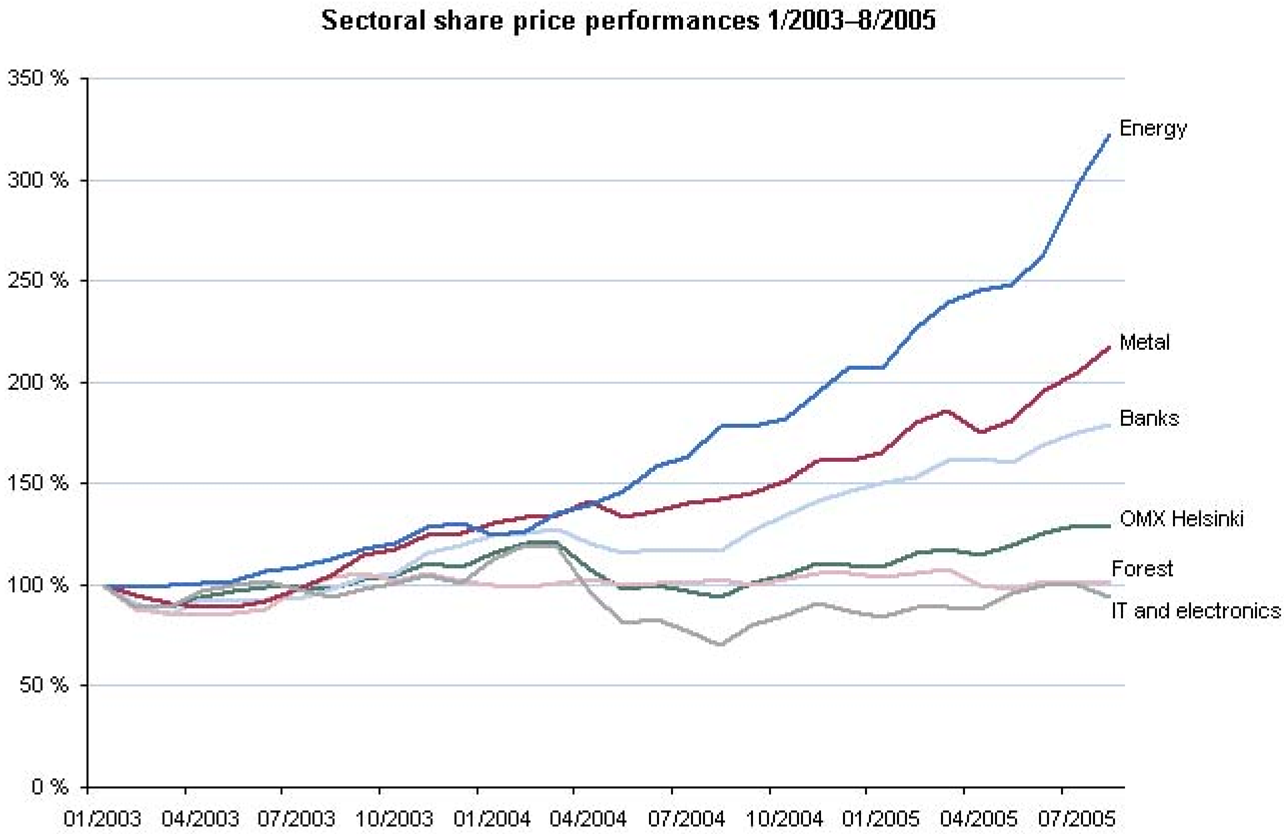
Share price performances on the Helsinki Stock Exchange 1/2003–8/2005



Change percentages have been calculated from price indices. Monthly data is the average of daily data.

Sources: OMX and Bloomberg.

Sectoral indices therefore give a better picture of the performance of different shares listed on the Helsinki Stock Exchange. The strong upswing of the energy, metal and banking sectors continues. Energy companies' share prices have performed particularly well, with shares tripling their market value during the economic upswing. Finnish banking sector shares also continue to attract investment. The banking sector index has risen more than the comparable European business index.



Change percentages have been calculated from price indices. Monthly data is the average of daily data.

Source: OMX.

Latest share market products still seeking a foothold

In addition to direct investment in shares and bonds, since the end of the 1980s investors have been able to invest in mutual funds and, more recently, in their special forms known as hedge funds as well as in exchange traded funds (ETF).

Of the 433 mutual funds registered in Finland, only 13 can be classified as hedge funds. In August 2005, these funds' net assets amounted to EUR 842 million, while the combined net assets of Finnish mutual funds was EUR 42 billion. Finland's hedge fund market is still at an early stage of development, with Sweden clearly occupying a dominant role in the Nordic markets. Sweden's share of the market is four fifths, with more or less equal shares being held by Norway, Denmark and Finland.[2]

Not only do characteristics of hedge funds vary, but it is also unambiguous whether a fund is being classified as a traditional or hedge fund. Some characteristics include short selling, use of derivatives and debt financing as well as aiming at a specified yield level. Hedge funds aim at a positive yield irrespective of the market situation. Traditional funds in turn seek to achieve a yield that is in line with or exceeds the index.

It is not permitted in Finland to set up funds targeted solely at professional investors; Finnish mutual funds are also always offered to the public. So far typical investors in hedge funds have been mainly insurance and pension companies. Foreign hedge funds also offer shares directly to Finnish institutional investors. The situation may change if those funds investing in hedge funds become more common. Shares in such funds will also be increasingly offered to private investors. There are currently two Finnish funds that invest in hedge funds.

It is nowadays also possible to invest in share markets via ETFs. They have been advertised to private investors as a cost-effective way of diversifying the portfolio. Helsinki Stock Exchange currently quotes only one fund that is connected to the OMX Helsinki 25 index. The trading volume on the Helsinki Stock Exchange has not been very high compared to the other Nordic countries. In January–August 2005, the turnover of ETFs on the OMX amounted to EUR 8.5 billion, of which the Helsinki Stock Exchange accounted for a mere 0.5%

1) Source: Bank of Finland.
2) Source: Hedgenordic.

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International investors in real estate still interested in Finland

The Finnish real estate market still continues to grow. The utilisation rates of high-quality properties have improved. Rents have mainly decreased in older, lower-quality buildings. In particular, international investors are interested in retail and logistics properties and office facilities in central locations.

Decrease of office rents slowing down

In its market bulletin of 10 May 2005, the Finnish KTI Institute for Real Estate Economics reports that the decline in office rents, which has now lasted for 4 years, seems to be slowing down in certain areas. However, the rental index for the Helsinki central business district still shows a decrease of almost 3% per annum. On the other hand, several areas of the Helsinki region show potential for a slight increase in office rents. Admittedly, the office market still struggles with high vacancies. However, the lively demand in the real estate market is still holding strong, and Finnish and international investors alike are interested in Finnish properties.

Raised requirements on office facilities

The excess supply of office facilities that has continued for some years has provided tenants with a choice in the market. The quality of the facilities is becoming an increasingly important basis for selection. Instead of a need for more space, the reason for moving is more and more often a need for a more efficient and flexible operating environment. As a result, a differentiation of the demand for facilities continues in the market: tenants are prepared to pay high rents for quality facilities, while in the present market situation tenants with money to spend are becoming harder to find for facilities considered old-fashioned. Requirements set by tenants seem to lead to increased renovation and alteration costs. Renovations and alterations of the facilities are necessary in order to keep them attractive.

Office rental market slow outside the Helsinki region

So far the slight pickup in the office rental market mainly seems to apply to the Helsinki region. The number of rental agreements in Helsinki and Espoo is growing, but in Vantaa office rents have decreased slowly, and the utility rates of facilities have deteriorated. Elsewhere in Finland new office rental agreements have been few.

Commercial facilities still fully utilised

The demand for commercial facilities has remained strong. The rent for well-located facilities has continued to grow based on the strong consumer demand, and the market hardly offers vacancies worth mentioning. However, an extensive supply of facilities in completion particularly in the Helsinki region has raised discussion on a threatening excess supply of commercial facilities. But continued growth in consumers' purchasing power should still uphold the belief, among property investors and in the retail trade, that the capacity for paying rent will be maintained.

Internationalisation of real estate market continues

The buoyancy of the real estate market continues in spite of problems in the market for office and commercial facilities. In the international market there is an abundance of capital investors looking for attractive investment objects. The large supply of capital and the low interest rates force down the yield requirements on real estate investments and force up the values.

Catella Property Group estimates that the total volume of Finnish real estate investments in 2005 will amount to EUR 2.7–3.0 billion. International investors' share of the 2005 trade has been 43% and will remain large also in future.

However, the largest single real estate transaction during the first half of 2005 was concluded among Finnish parties. CapMan Real Estate purchased 17 properties in the Helsinki region for a sum total of EUR 220 million. The second largest was London & Regional's company acquisition, the object of which was the entire business of Holiday Club Finland. The transaction comprises numerous spa and holiday resorts. Nordisk Renting also carried out large transactions, investing in 20 properties and acquiring a total of 108,000 sqm of primarily warehouse facilities. The value of the investments amounted to approximately EUR 100 million. There was also a significant sale leaseback transaction, in which Nokia sold 35,000 sqm of office facilities to LR Finland for EUR 95 million in order to lease it back.

More international capital entering Finland

According to the Finnish Property Barometer, a KTI survey directed at international property investors, more international capital will be entering Finland in the near future. More than 75% of the large international investors responding to the survey report that they quite likely will be making new property investments in Finland within the next 3 years. Investors are attracted to Finland due to its general stability and competitive yields in the real estate market. International investors are extending their interest to areas outside the Helsinki region and to all property types.

According to a report from Newsec, the volume of property transactions will continue to grow in the next 18 months. The proportion of transactions by international investors will also increase.

According to Newsec, also the demand for modern, centrally located operating facilities will increase, primarily in Helsinki. Industrial growth makes industrial facilities attractive. The retail sector has a large shortage of facilities, which makes the property market an interesting investment object. The interest in Finland is also stimulated by the fact that the country is part of the euro area.

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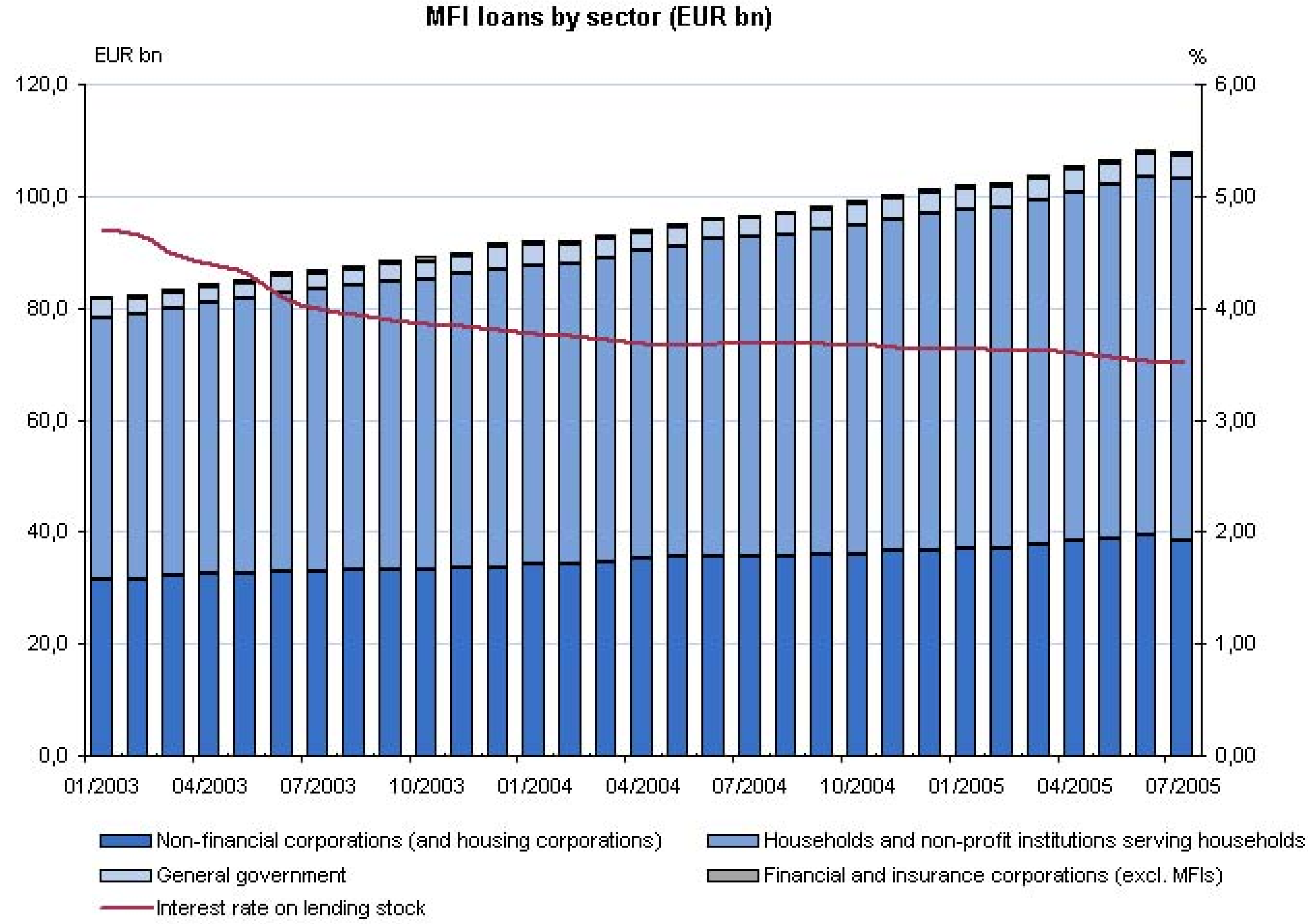
Peaking growth in loans in tightening competition

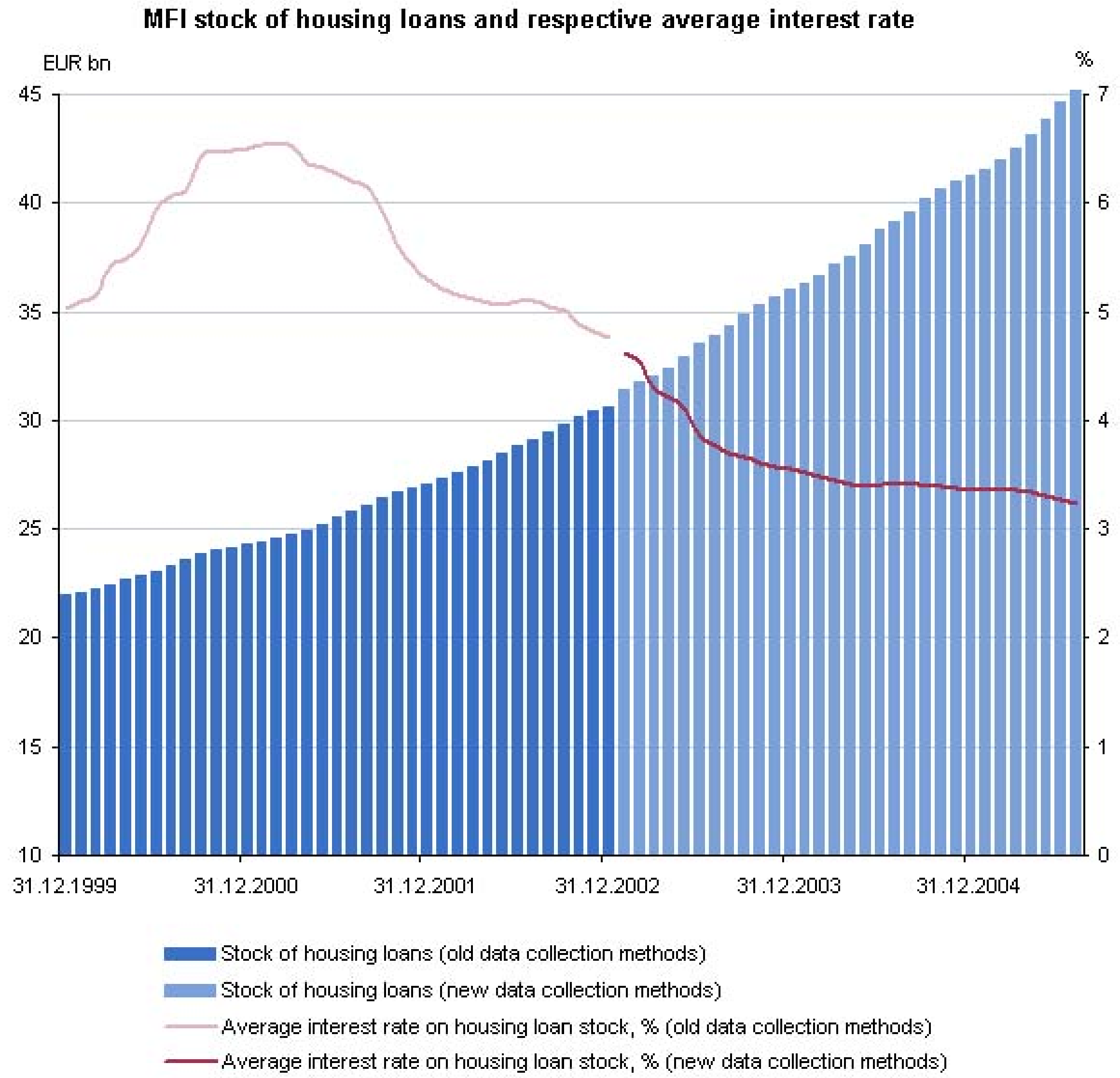
The stock of lending by Finnish monetary financial institutions (MFIs) grew strongly, ie by 11.9% between July 2004 and July 2005. This was mainly driven by strong growth in household loans, in particular housing loans. The stock of loans to non-financial corporations grew at an annual rate of 7.8%, whereas household loans grew by 14%. In recent years, households have become an increasingly important customer group for banks, as almost 60% of the stock of lending, ie EUR 69.4 billion, consists at present of loans to households. Loans to non-financial corporations accounted for about 35%, ie EUR 38.2 billion, of the total lending stock of EUR 107.6 billion.



Source: Bank of Finland.

Households taking out housing loans and consumer credit at record pace

At the end of July 2005 the total amount of loans to households totalled EUR 64.9 billion. Of this total, housing loans already exceeded EUR 45 billion. The stock of housing loans has doubled in five years, and there are no signs of growth slowing down. According to the latest statistical data, households are still very eagerly taking out housing loans, as the annual growth of housing loans was exceptionally robust at 16.2%. Consumer credit totalled EUR 8.9 billion in July 2005. At the same time, other loans to households, such as loans to entrepreneurs, holiday home loans and student loans, amounted to EUR 10.5 billion.



Source: Bank of Finland.

Housing prices showing some signs of levelling off

The unencumbered square metre price of old apartment flats, published by the Statistics Finland, is the most frequently used measure of housing prices. The annual growth of this index was 5.6% (June 2004–June 2005). A year earlier, the corresponding figure was 8.3%. The figure does not comprise new housing construction and it also excludes square metre prices of terrace and detached houses. Prices of lots for housing construction continue to rise quickly, at an annual rate of 13.0%.

Interest rate margins exceptionally narrow owing to competition

Competition among banks has narrowed interest rate margins on housing loans. In Finland, lending margins are among the lowest in the euro area. At the end of July, the interest rate margin on new Finnish housing loans averaged at about 0.72%, whereas in the euro area it was a few tens of percentage points higher.

As for banks, it is significant that the narrowing of lending margins in the euro area came to a halt in spring and turned upward, but in Finland it has continued. Indeed, the spread between lending margins in Finland and other euro area countries has increased in the course of 2005. On the other hand, statistical practices and collateral policies vary across countries, and therefore no far-reaching conclusions should be drawn about the competitive situation on the basis of interest rate margins.

Competition tightening also as regards consumer credit

In 2005, competition also seems to have reached consumer credit in Finland. Interest rate margins on consumer credit have narrowed strongly since the beginning of 2005, whereas in other euro area countries they have developed more evenly. Banks and other MFIs should ensure that, despite the total pricing of the customer relationship, also the pricing of an individual product is in line with the product-related risks.

Finnish loan customers vulnerable to interest rate changes

New housing loans are mainly fixed to short-term (up to 12-month) market rates in Finland. Hence, in contrast to many euro area countries where the majority of loans are fixed to longer-term reference rates, Finnish customers bear the risk arising from interest rate changes themselves. Changes in short-term market rates can therefore be reflected in the housing market more rapidly in Finland than in other euro area countries.

Other loans to households, such as consumer credit, are also mainly fixed to short-term market rates. For this reason, a possible rise in market rates could weaken the debt servicing ability of over-indebted customers.

Larger loans and longer maturities

According to the Survey on Household Saving and Use of Credit published by the Finnish Bankers' Association in spring 2005, the average size of housing loans has increased by 12% in a year, and almost 10% of housing loans exceeds EUR 150,000. A typical repayment period for a new housing loan is 20 years. Already more than one third of new loans are granted with a repayment period of over 20 years.

The greater risks pertaining to long-term housing loans as compared to short-term loans are borne by borrowers in particular. Long-term, over 30-year annuity or fixed-amortisation loans shorten very slowly, and the effects of interest rate increases can be significant even after years, at worst even after decades.

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Continued profit improvement in Finnish banks

At the beginning of 2005 listed banking groups started to apply IFRS recognition and measurement principles in their financial reporting. At the same time also the financial reporting of other banks has been made more compliant with the IFRS praxis through a change in the Credit Institutions Act. The figures of this report are based on banks' interim reports of January–June 2005 with comparable information on operations in January–June 2004.

Net interest income turned upwards

In January–June 2005 the income of deposit banks (Nordea excluded)[1] increased by 4% compared to January–June 2004. Of the income items, net interest income in the first half of 2005 was 5% larger than during the comparable period in 2004. Behind the growth lies the very steep rise in the stock of lending (which increased by more than 16% between July 2004 and July 2005). During the same time banks' interest rate margin (average interest on stock of lending - average interest on stock of deposits) shrank from 2.5% to 2.4%.

The situation differs compared to recent years. Although the rapid growth in the stock of lending in the two previous years compensated for lowered interest rate margins due to tightening competition, the total net interest income during both years nonetheless shrank by about 4% compared to the first half of the previous year.

Fee income continues as driver of growth, securities-related fees increasingly important

Banks' other income apart from net interest income increased by 3% on average. Fee income represented the largest increase compared to the corresponding period in 2004. Net fee income (fee and commission income - fee and commission expense) increased by 8% compared to January–June 2004. However, the increase of fee income is levelling out, as in the previous year the increase in net fee income was as much as 14%.

The distribution of fee income is changing. Securities-related fees, such as fees for fund investment and asset management services, constituted a 29% proportion of fee income in January–June 2005, while in the previous year it was still 24% and in January–June 2003 19%. At the same time, lending-related fees reached only 20% (22% in January–June 2004 and 23% in January–June 2003).

The increased importance of securities-related fees and the decreased proportion of lending-related fees is a result of banks' tightening competition for customers in the credit market and a buoyant trade in securities-related services. Banks have extended their income base to other products as sinking interest rates and narrowing margins due to the competition have tended to shrink the net interest income.

In future, bank competition may more clearly be extended to securities-related products. In that case, the raising of fee income will become more difficult.

Staff costs went up

After remaining unchanged in the first half of the two previous financial years, total expenses began to show modest growth, most importantly due to increases in staff costs. This suggests that the room for cost cutting has been exhausted.

In total, bank expenses increased by 3% compared to the corresponding period in 2004. Primarily the rise in expenses is due to a 7% increase in staff costs. Behind the growth lies an increased labour demand caused by business volumes and a rise in wage levels. Banks succeeded in keeping other costs than staff costs at the same level as in the comparison period.

The cost to income ratio calculated for the banking sector was 58% in January–June, while it was 62% in January–June 2004.

Net operating profit increased, return on equity unchanged

The quality of the stock of lending is still exceptionally good, although impairment losses on loans have increased compared to the first half of the previous year. Taking impairment losses on loans into account, banks' net operating profit increased by 5% compared to the first half of 2004.

Equity increased as much as the net operating profit and the return on equity (ROE) calculated for deposit banks was 12% in January–June, or the same as last year.

1) The profit development of Nordea Bank Finland Group clearly differs from that of the other Finnish deposit banks, because the derivatives business of Nordea Markets is based in Finland. As, in addition, the market share of NBF is very significant, Nordea has not been included in the analysis of the profit development of Finnish deposit banks. For June 2005 financial information on Nordea Bank Finland Group, see the table below. The analysis comprises OP Bank Group, Sampo Group's credit institution and investment firm operations, savings banks (apart from Aktia), Aktia Group, local cooperative banks, Bank of Åland Group, Evli Group, eQ Group, Gyllenberg Private Bank, Tapiola Bank, Kaupthing Bank and Suomen AsuntoHypoPankki.

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Banks' capital adequacy declined slightly but is still strong

In the first half of 2005 the capital adequacy of the Finnish banking sector remained good in spite of a slight decline in the capital adequacy percentages. The capital adequacy is burdened by rapid growth in the stock of lending, but increasing profits, the issuing of equity instruments in the financial market and the measurement of financial assets at fair value have increased banks' capital and thus kept their capital adequacy percentages high. At the end of June 2005 the overall capital adequacy of the banking sector apart from Nordea Bank Finland Group (NBF) was 14.1 % (14.6 % on 31 December 2004) and the Tier 1 capital adequacy calculated on the basis of original own funds 11.9 % (12.4 %).

The present restructuring of Nordea has raised NBF's capital adequacy beyond 20%[1]. Because the seemingly high capital adequacy of NBF distorts the figures for the Finnish banking sector, NBF figures have not been considered in the aggregates.

Own funds increased not only through income financing but also through issuing of equity instruments and measurement of financial assets at fair value

Banks' total own funds increased by 7% in the first half of the year. The income financing was still good and comprised one third of the capital increase. Due to the low interest rates, banks have also increased their use of equity instruments to raise capital for their operations. In the first half of 2005 the total amount of equity instruments eligible as banks' original or additional own funds increased by EUR 105 million, which constitutes one fifth of the capital growth.

The transition to IFRS at the beginning of 2005 and an updating of the Credit Institutions Act have affected banks' own funds. In particular, additional own funds have been increased by unrealised gains from the measurement of available-for-sale financial assets at fair value, after deferred tax under the corporate tax base has been deducted from those gains.

Quality of capital still good

The core original own funds must represent at least half of the total amount of own funds. It is important that the original own funds are composed of equity and retained earnings from previous financial years, which are available on request to cover losses in operations.

Original own funds can also comprise capital loans, but the Financial Supervision Authority has limited their proportion in a statement, which is based on a corresponding opinion of the Basel Committee on Banking Supervision. The proportion of capital loans in the total amount of original own funds may not exceed 15%, if the terms of the debt security agreements contain an option of premature repayment and a possible interest rate rise before maturity. Under normal conditions the proportion of all capital loans should be limited to one third of original own funds.[2]

Even after consideration of the limitations pertaining to own funds, the quality of capital in the banks is still good. Original own funds constitute 84 % of the banking sector's total own funds and they are mainly made up of equity and retained earnings from previous financial years. Capital loans' proportion of original own funds is 5.6%. However, capital loans have clearly grown in popularity. In the aggregate figure at the end of 2003, banks' capital loan proportion of original own funds was 0.2%.

1) At the end of June, NBF's capital adequacy was 20.1%, while Nordea Group's capital adequacy at the same point in time was 9.4%.

2) Capital loans are not as permanent as other capital items eligible as original own funds. In addition, they are in practice available for covering losses only in cases of liquidation.

Banking sector's[1] capital adequacy 12/2004–6/2005, EUR million

	30.6.2005	31.12.2004
Total own funds	7 391	6 921
Original own funds	6 203	5 890
Total risk-weighted items	52 281	47 515
Capital adequacy	14,1 %	14,6 %
Tier 1 capital adequacy	11,9 %	12,4 %

1) Apart from Nordea Bank Finland Group

Source: Financial Supervision Authority.

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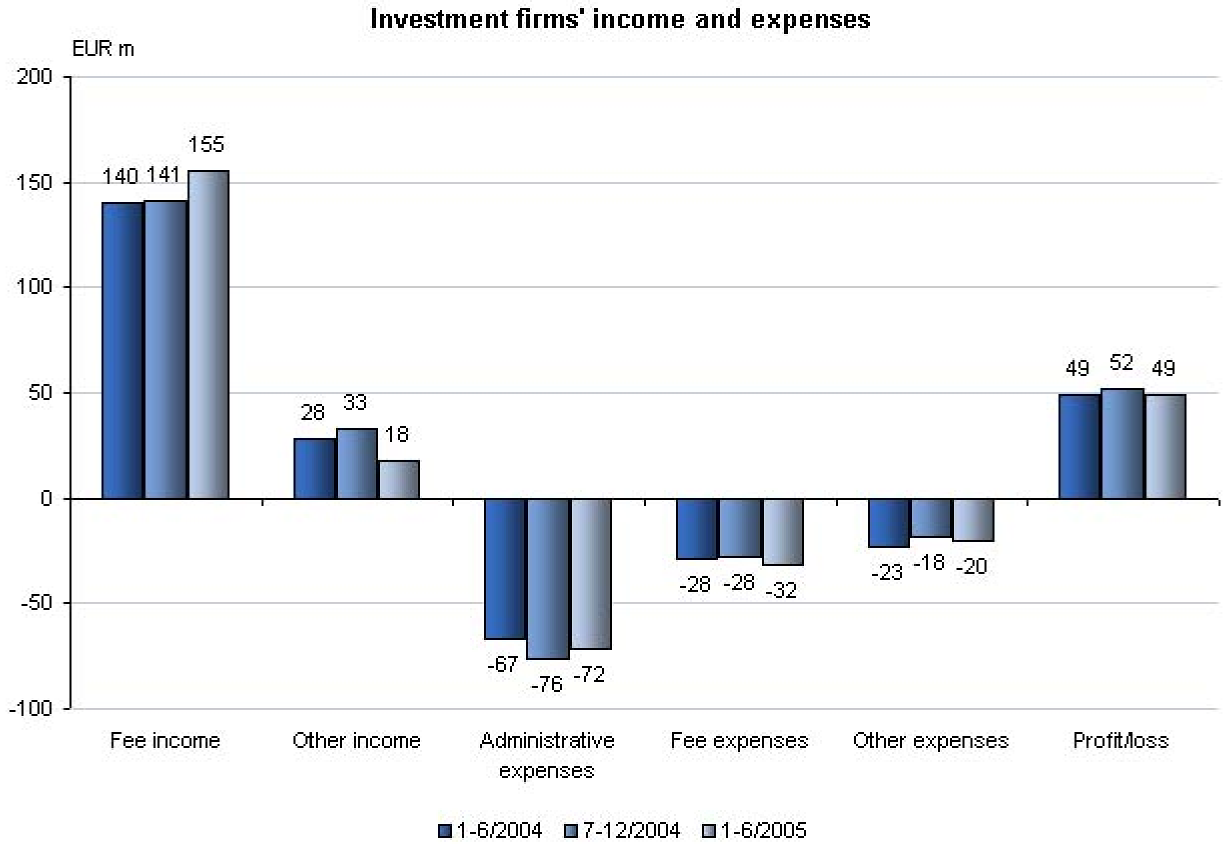
Income growth decelerated in investment services

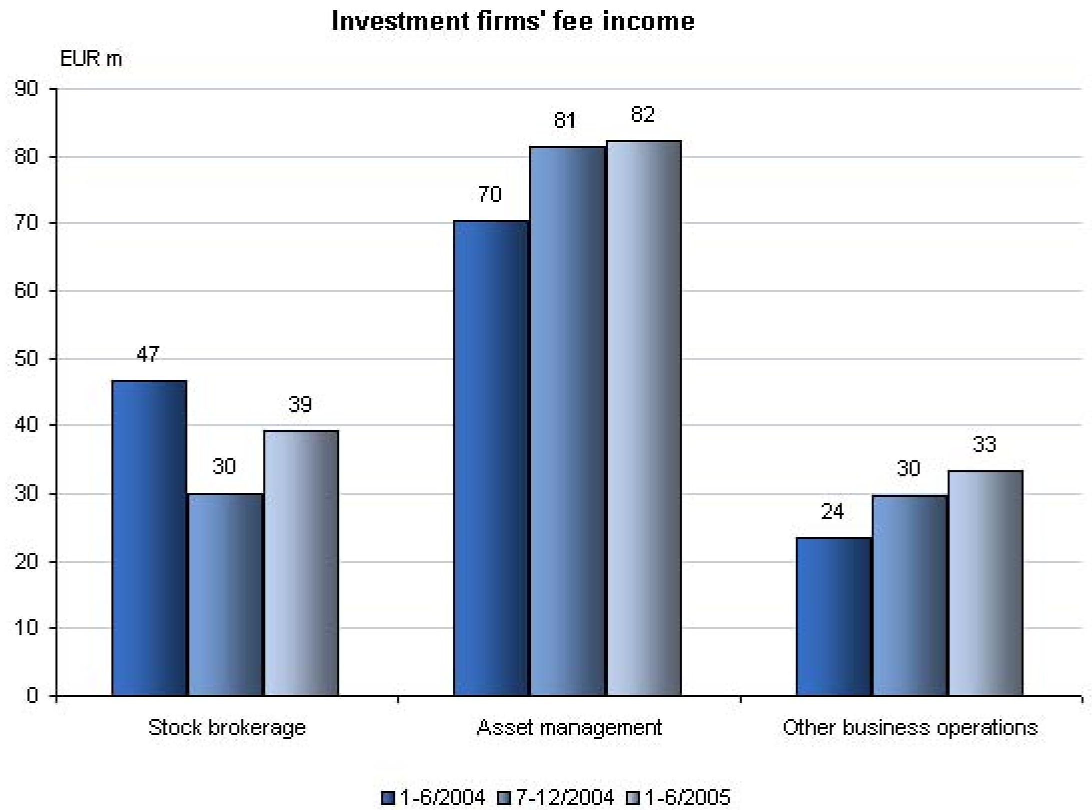
Investment firms operating in the Finnish market recorded a total of EUR 155 million in fee income in June 2005, about 10% more than in spring or autumn 2004. However, growth in fee income used to be considerably faster in earlier periods. In 2004, for instance, fee income increased by as much as 32% from the previous year.



Other income includes net income from securities trading and foreign exchange dealing, income from equity investments, interest income and other income from business operations.

Source: Financial Supervision Authority.

Contrary to previous developments, fee income from asset management in the first half of 2005 scarcely grew compared with the latter part of 2004, although managed assets increased by 15% during the same period. In contrast, income from stock brokerage was higher in spring 2005 than in autumn 2004. Income from stock brokerage was however lower in spring 2005 than in spring 2004 despite the fact that turnover on the Helsinki Exchanges has been more buoyant in the course of this year. As foreign investors have increased their purchases of Finnish shares, turnover growth is not reflected in income recorded by Finnish investment firms or banks. In contrast, remote brokers have continued to increase their market share. In the period from January to August, they already accounted for 62% of turnover on the Helsinki Exchanges, compared with 56% in 2004.

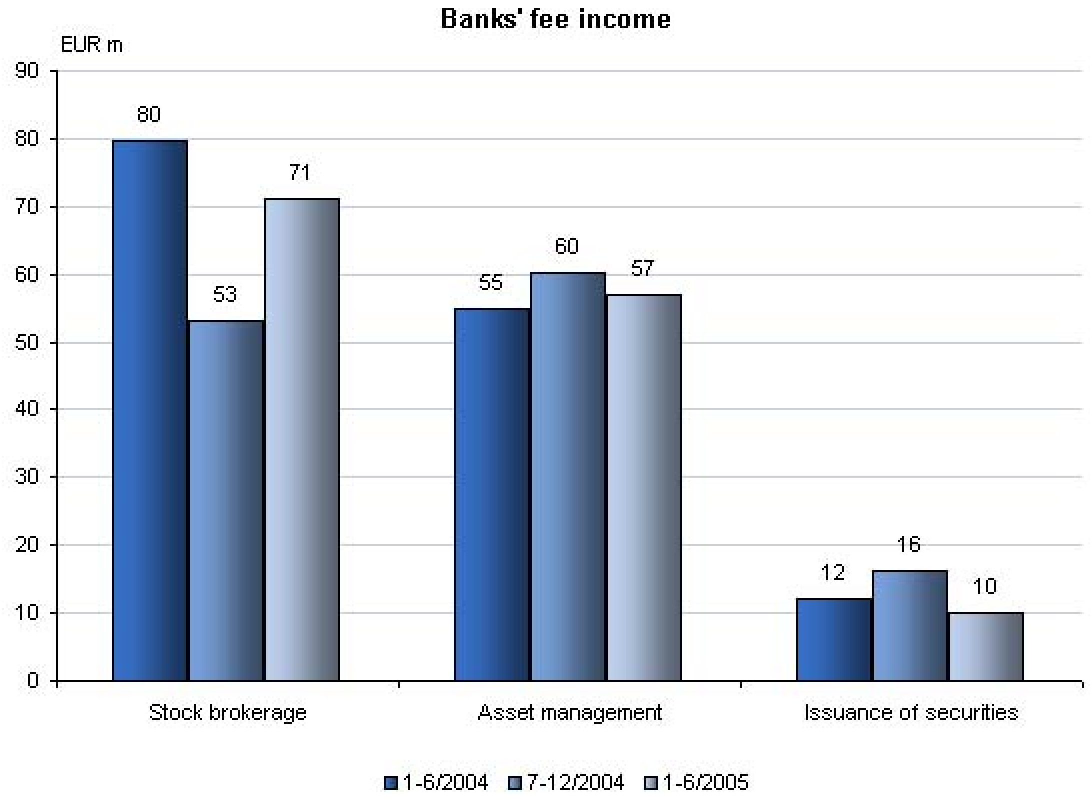


Other business operations include market making, issuance and underwriting, lending and funding arrangements, securities depository services, etc.

Source: Financial Supervision Authority.

Banks' fee income provides a similar picture of developments in investment services

In addition to investment firms, investment services are also provided by banks. Investment firms and banks are in the same situation in that fee income from the provision of investment services does not appear to be growing for either of them as fast as earlier. Fee income from asset management, for example, was lower in spring 2005 than in autumn 2004. Banks' fee income from stock brokerage follows a pattern similar to that of fee income recorded by investment firms.



The breakdown of banks' fee income deviates from that of investment firms. The chart shows fee income related to the provision of investment services

Source: Financial Supervision Authority.

Increase in managed assets stems from mutual funds

Managed assets have continued to increase. Growth for the first six months of this year has mostly stemmed from the management of mutual fund assets. Domestic mutual fund assets managed by investment firms increased in the first six months in euro terms by as much as during the last year as a whole. Assets managed by banks are mainly composed of assets managed under consultative asset management agreements, in respect of which final decision-making lies with the customer.

Table 1. Assets managed by investment firms: June 2005, December 2004

	6/2005 EUR bn	12/2005 EUR bn	Change EUR bn	Change %
Assets managed with full powers of attorney	71.7	62.0	9.6	15.5
of which Finnish mutual fund assets	35.2	27.1	8.2	30.2
Assets managed under consultative asset management agreements	14.6	12.6	1.9	15.4

Source: Financial Supervision Authority.

Table 2. Assets managed by banks: June 2005, December 2004

	6/2005 EUR bn	12/2005 EUR bn	Change EUR bn	Change %
Assets managed with full powers of attorney	2.5	2.1	0.4	17.9
of which Finnish mutual fund assets	0.2	0.1	0.1	63.9
Assets managed under consultative asset management agreements	13.9	12.0	1.9	16.0

Source: Financial Supervision Authority.

Three largest banking groups dominate markets Provision of investment services has recently undergone major structural changes. Part of investment firms have been merged with banking groups and one investment firm expanded its business into banking. While companies have left the sector, there are also new entrants, which will add to competition in the sector. The three largest banking groups' market share is considerable, measured in terms of fee income, if their investment firms are also included. The closest competitors are FIM Group Oy, providing only investment services, and the Swedish Skandinaviska Enskilda Banken AB with its Finland-based branches and subsidiaries.

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Non-performing assets still at a low level

Finnish banking groups continue to report small amounts of non-performing assets. In June 2005, non-performing assets amounted to EUR 408 million[1], which is 12.4 % less than in June of the previous year. The share of non-performing assets of total exposures has contracted to 0.4% in a year (0.5% in June 2004).

This contraction in non-performing assets occurred in all sectors. The strongest decline was recorded for non-performing assets in the non-resident sector, which accounted for 0.23% of total exposures in June, compared with 0.83% a year earlier.

Non-performing assets in the corporate and household sectors also saw their respective shares of total exposures diminish; however, by less than the non-resident sector. While there has been a steep rise in the lending stock to the household sector, the share of non-performing assets of total exposures has continued to go down. Non-performing assets in the household sector have been falling since 1993, when 7% of claims on the household sector were non–performing. Currently, the corresponding figure is 0.4%. The share of non-performing assets of total exposures in the corporate sector is also 0.4%.

Impairment losses increased slightly during the year

Impairment losses recorded by Finnish banking groups in June amounted to about EUR 13 million in net terms. However, while impairment losses in net terms did increase by 18% from the previous year, they continued to be at a low level. Impairment losses in gross terms also registered a slight increase, accounting for 0.1% of total exposures. The corresponding ratio for June of the previous year was 0.08%.

The threat of impairment losses in individual sectors may grow if companies' propensity to invest picks up after the sluggishness of recent years.

Finnish banking groups' credit risk ratios have already been low for a long time. At the same time, banks are fiercely competing with each other in the housing loan market. The strong increase in the lending stock, in turn, sets strict requirements on credit risk management by banks. Effective risk management, careful compliance with guidelines for credit granting and collateral, together with avoidance of undue flexibility, are means of preventing occurrences of both impairment and loan losses now and in the future.

1) This figure does not show impairment losses on assets collectively assessed. If such losses are taken into account, non-performing assets amount to EUR 323 million.

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Market-based funding on the increase

Banks' balance sheets have continued to grow at the same time as there has also been a rapid increase in lending. As at the end of June, deposits were at levels seen at the end of 2004 and the beginning of 2005; thus, 75% of lending could be covered. Increased lending was funded by bond issues, for which there has been sufficient demand. Stocks of bonds issued by banks grew by one fifth, ie to EUR 8.3 billion. The stock of short-term certificates of deposit, in turn, experienced a slight fall, to EUR 23 billion.

Banks are increasingly more dependent on market-based funding, which has led to higher structural funding risk. However, banks are prepared for price and availability risks in funding: they have added diversity to their funding programmes and increased their mortgage credit bank business. Market-based funding is more expensive than funding accessed via deposits, and banks have used fee income to cover higher costs in market-based funding.

Funding through bonds with mortgage collateral

Bonds with mortgage collateral may be issued exclusively by mortgage credit banks. To reduce the risks inherent in these bonds, the relevant legislation restricts the operations of mortgage credit banks and regulates the quality and adequacy of collateral used, as well as the preferred status of the bonds. Such limitation of risks and transparency in the operations of mortgage credit banks enable a more favourable pricing of issued bonds than in the case of other bonds. The legislation is in line with corresponding laws in other European countries, which makes it easier to market these bonds internationally.

As demand for housing loans continues to grow and deposits do not suffice to cover lending growth, banks have enhanced the operations of mortgage credit banks established by them. Housing loans have been transferred from deposit banks to mortgage credit banks, and funds are raised by the issuance of bonds with mortgage collateral in international markets. The coupon on bonds with mortgage collateral issued in 2005 has been around 2.4–2.5%. There has been adequate demand for the bonds, and they have been oversubscribed many times. Funding costs have therefore been small. There are currently three mortgage credit banks operating in Finland: Aktia Hypoteksbank Abp, OP Asuntoluottopankki Oyj and Sampo Asuntoluottopankki Oyj.

Short-term liquidity risk higher than at year-end 2004

Deposit banks' aggregate short-term one-month funding deficit increased at a brisk pace from the end of 2004. The combined deficit grew to EUR 7 billion, compared with a surplus of EUR 1.7 billion at the end of 2004. Maturities of large bond loans and issues of certificates of deposit have caused strong volatility in the combined funding deficit. However, funding deficits in most banks have changed only slightly from what was registered at the end of 2004.

At the end of June, banks held certificates of deposit eligible for central bank financing in the amount of EUR 7.8 billion, which banks may use to obtain funding from the central bank. There was EUR 3 billion worth of available-for-sale certificates of deposit. The amount of all these investments has remained almost unchanged. Banks may acquire funding by selling their investments if they are unable to renew maturing funds raised in money and capital markets. Banks' short-term liquidity has continued to remain fairly strong.

Funding risk

Funding risks are divided into long-term, structural funding risks and liquidity risks related to short-term cash flow imbalances.

Structural funding risks are monitored by assessing the funding of balance sheet assets and in particular lending through deposits and market-term sources of debt capital.

The measurement of short-term liquidity risk is based on the cash flow difference between income and expenditure, in each maturity class. Cash flow calculations also account for off-balance sheet items. The difference resulting from maturity imbalance shows the amount the bank has to invest or finance at the expiration of assets and liabilities in each maturity class.

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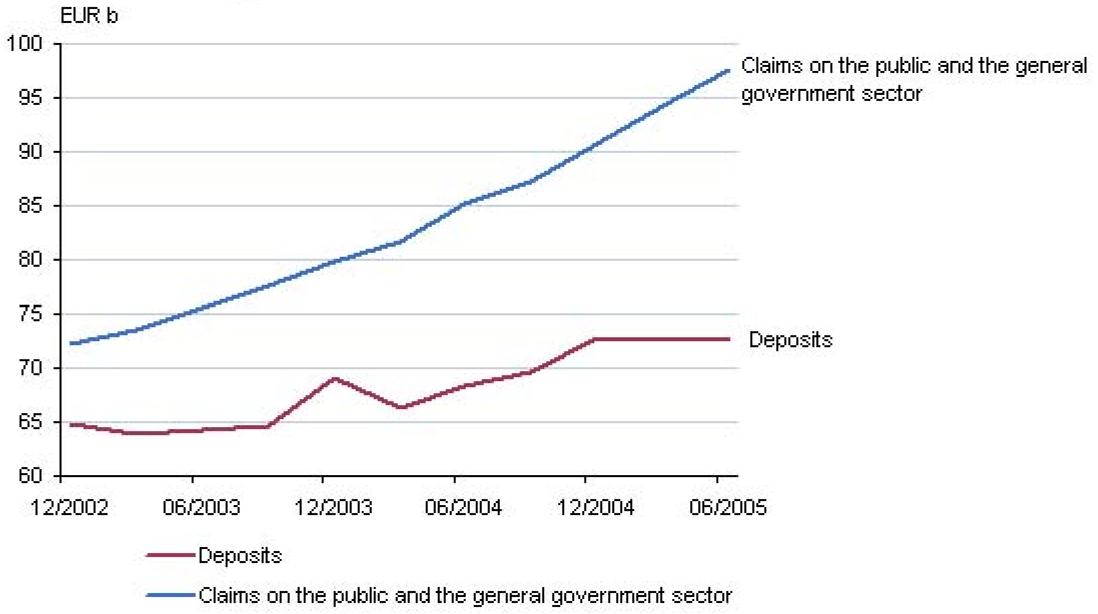
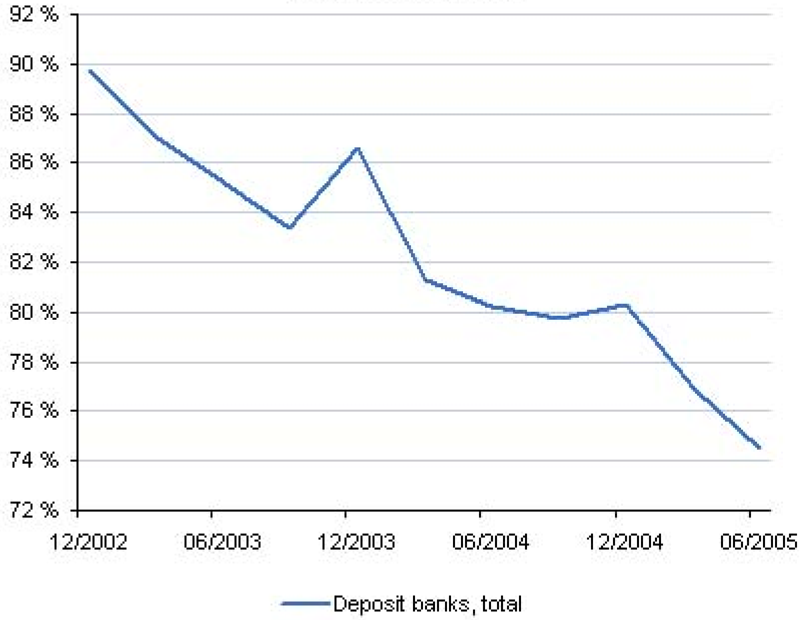
Deposits from and claims on the public and the general government sector, EUR billion



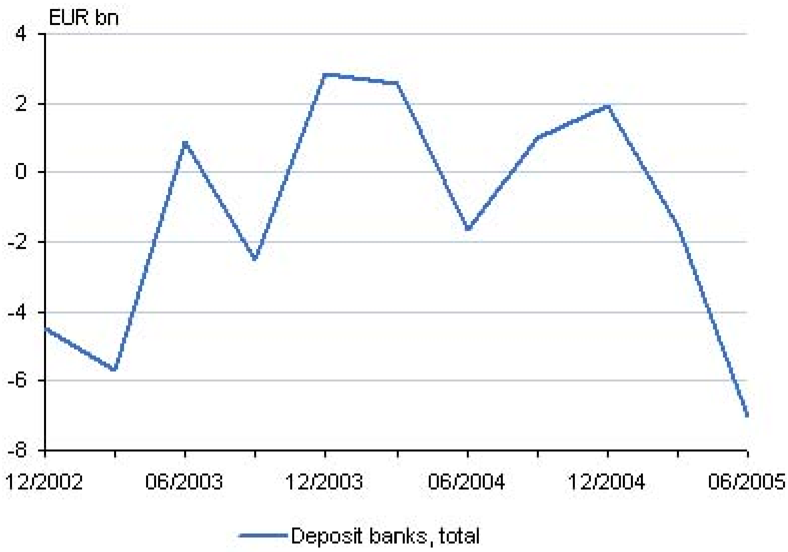
Source: Financial Supervision Authority.

Deposits in % of claims on the public and the general government sector

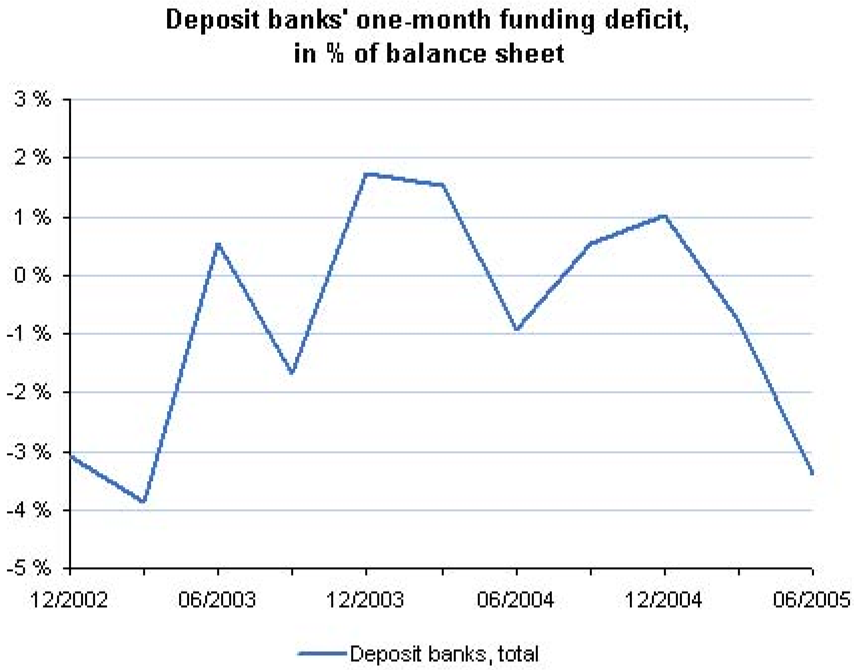


Source: Financial Supervision Authority.

Deposit banks' one-month funding deficit



Source: Financial Supervision Authority.



Source: Financial Supervision Authority.

No major changes in banks' interest rate risks

Income risk in banks' financial account lower than in previous years

Finnish deposit banks' income risk (all currencies included, after impact from derivatives) has remained unchanged since the end of 2004, both in euro terms and in terms of a measure of interest rate risk relative to net interest income in 2004. Income risk arising from a 0.5 percentage point increase in interest rates amounted to EUR 133 million at the end of June 2005, accounting for 5.6% of net interest income. The income risk figure shows the amount of profits to be gained by banks from an interest rate rise in the following year. In 2003–2004, banks' combined income risk was on average 7.5%; compared with this figure, income risk at the end of June 2005 is clearly lower.

Although banks have slightly increased the use of derivatives in hedging against income risk, hedging is still largely ensured by opposite balance sheet items.

Income risk for euro-denominated items (after impact from derivatives) has increased by 52% from the end of 2004. At the end of June, income risk for euro-denominated items amounted to EUR 147 million. However, while derivatives have considerably increased their share in euro-denominated items, their hedging impact against income risk has diminished. It is precisely this weaker hedging impact that explains most of the increase in income risk for euro-denominated items. One potential reason for reduced hedging is that banks do not consider a major change in interest rates as probable, although a small rate cut is expected.

The share of currencies other than the euro in the combined income risk has clearly become lower from what was recorded at the end of 2004. Income risk for other currencies stood at EUR 37 million at the end of 2004, and was EUR -14 million at the end of June 2005. Accordingly, a 0.5 percentage point increase in interest rates would lead to a decline of EUR 14 million in banks' net interest income. The change from end-2004 to mid-2005 is mainly explained by a decrease in foreign-currency-denominated derivative assets and an increase in banks' foreign-currency-denominated liabilities.

Investment risk in the financial account increased slightly

Euro-denominated investment risk in the financial account (including derivatives held in the financial account) has increased from the end of 2004. A 0.5 percentage point increase in interest rates would have led to a loss of EUR 94 million to banks at the end of June 2005, whereas a corresponding interest rate change would have caused a loss of EUR 82 million at the end of the previous year.

Derivatives held in the financial account would cause losses to banks if interest rates rose, as would bonds held in the financial account. This means that derivatives held in the financial account, and thus taken into account in the calculation of both income risk and investment risk in the financial account, are designed to hedge banks against the impact that an interest rate rise may have on net interest income (macro hedging) rather than against the downward impact that an interest rate rise may have on market values of bonds held in the financial account.

Investment risk in the trading book also increased

Investment risk in the trading book has increased from the end of 2004. A decline in market values as a result of a 0.5 percentage point increase in interest rates would now amount to EUR 80 million (of which certificates of deposit would account for EUR 48 million and derivatives for EUR 32 million), compared with EUR 62 million at the end of 2004.

The combined investment risk for bonds and derivatives included in the trading book has also increased in relation to operating profit. Investment risk in the trading book in June 2005 accounted for 5.0% of operating profit, compared with 3.8% at the end of 2004. Both calculations are based on operating profit in 2004.

As in the case of the financial account, derivatives included in the trading book would also cause losses on the basis of June 2005 positions if interest rates rose. Positions taken in derivatives are not intended for hedging against the impact that an interest rate change may have on the market value of the trading book; rather, the aim is to benefit from a potential interest rate fall, also through derivatives.

What is interest rate risk?

Income risk is a measure of the impact that a maturity mismatch between a bank's assets and liabilities may have on net interest income accrued during a year, in the case of a rise in market interest rates. Investment risk is a measure of an immediate change in the market values of bonds and derivatives included in the financial account or trading book if interest rates rise. In other words, investment risk measures the sensitivity of current market values of securities portfolios to changes in interest rates.

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Table 1. Combined interest rate risk of the Finnish banking sector (euro and other currencies)
(EUR million in the case of a 0.5 percentage point increase in interest rates)

	30 June 2005	31 Dec 2004	Change
Interest rate risk of financial account (incl. derivatives)			
Income risk, total	133.1	133.4	-0.3%
Net interest income (in both cases 31 Dec 2004)	2,378.3	2,378.3	
Relative income risk, % of net interest income	5.6%	5.6 %	
Stress test 1; sight deposits < 1 month	-104.7	-98.9	5.9%
Stress test 2; currencies, absolute values, total	341.8	233.6	46.3%
Investment risk of financial account	-94.4	-82.8	14.0%
Interest rate risk of trading portfolio (incl. derivatives)			
Investment risk of trading portfolio	-79.9	-62.3	28.3%
Market value of trading portfolio *)	8,791.2	10,414.4	-15.6%
Relative investment risk, % of market value of trading p	-0,90 %	-0,60 %	
Stress test 3; currencies, absolute values, total	112.6	140.2	-19.7%

* The fall in the market value is partly due to an IFRS-related change in the portfolio allocation.