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Supervised entities' condition positive

The economic environment in which Finland's banks find themselves is currently a favourable one. On the other hand, the regulatory environment has been highly challenging and looks set to continue being so in the future. Credit institutions' and investment firms' profitability improved and capital adequacy strengthened. Credit and market risks appear to be under control, but banks are increasingly exposed to operational risk. The fact that housing loan margins are narrowing at the same time that loan repayment periods are lengthening may, however, bring banks its own set of problems in the future. Banks must ensure that the collateral used adequately maintains its value throughout the lifetime of the loan.

Upward trend in share markets

Overall, year 2004 was good for stock markets, which was also reflected in increased income for securities brokers and growth in assets for those who invested in share markets. After the dip in share prices in spring 2004, share markets were dominated by mainly an upward trend. In contrast with previous periods of economic upswing, there wasn't the same level of listings made on the Helsinki Stock Exchange's main list.

Buoyant housing loan market maintained lending growth

Lending by monetary financial institutions (MFIs) continues to grow rapidly. The stock of housing loans in particular continued to grow strongly in 2004, at an annual rate of more than 15%. Competition has also increased in active housing loan markets. Interest rate margins on housing loans have narrowed, varying between 0.5 and 1 percentage points.

Common currency has increased corporate bond financing from abroad

Finnish companies are increasingly raising financing from abroad. Foreign markets are an important source of financing also to banks. Bonds are issued in Finland as well, but the stock of bonds has gradually decreased.

Profits of Finnish banks improved

Bank profits increased in 2004 compared to 2003. The improved profits were due to growing income and continued strict expense policies. Bank competition stayed tight, which together with the low interest rate level decreased the interest rate margins between lending and funding.

Banks' capital adequacy solid

Banks' capital adequacy is still solid. Capital adequacy was strengthened by increased own funds resulting from a rising profit trend and new capital loans. Low interest rates kept lending, and thus also growth in risk-weighted claims buoyant. Nevertheless, the increase of banks' total own funds was still stronger than the growth of risk-weighted items.

Improved profitability of Finnish investment firms

The profitability of Finnish investment firms has improved as a result of the stock market upswing and asset management services growth. A very rapid growth of income has been recorded for both the asset management and mutual fund sectors. It is more doubtful, however, whether the rate of growth will keep up. Economic forecasts suggest that the fastest stage of growth was reached in 2004.

Management companies' income up by 39%

Mutual fund investment is expanding quickly: fund assets grew by 36% in 2004 compared to 40% in 2003. The share of equity fund assets in total fund assets increased. However, their relative share of total fund assets still remains smaller than that of fixed income funds.

Low credit risks for Finnish banking groups

Non-performing assets for Finnish banking groups declined in all sectors. Loan losses grew slightly, but their proportion in the stock of lending and guarantees remained broadly unchanged from 2003. The quality of the credit portfolio can thus be considered to be good on average. Finnish banks' claims on countries with low risk ratings continue to be small.

Banks' liquidity remained strong

The aggregate liquidity position of deposit banks remained strong. The proportion of deposits in the funding of lending declined, but banks were successful in raising financing from the market.

Banks' interest rate risks remained moderate

Banks' net interest income risk, ie the effect of market rate changes on net interest income, has declined compared with the end of 2003. A 0.5 percentage point interest rate rise would now cause a resulting improvement of EUR 133 million. The effect of the investment risk, ie the change in the market value of bonds and derivatives following an interest rate rise, is the opposite, thus reducing banks' aggregate interest rate risk.

Supervised entities' condition positive

The operating environment in which the FIN-FSA's supervised entities function has been simultaneously both favourable and challenging. The economic environment has been extremely beneficial, in that growth at global economy level has been robust and the Finnish economy has grown faster than the euro area average.

On the other hand, the same economic environment has proved to be highly challenging. The International Financial Reporting Standards (IFRSs) concerning listed companies, that came into force at the beginning of 2005, as well as the upcoming renewed capital adequacy framework (Basel II) have posed and continue to pose major challenges to the competencies, methodological development and information systems of the supervised entities

Credit institutions improve their performance – competition tightens

Credit institutions' profitability has continued to improve, due to the favourable economic environment. Income increased and a tight rein was held on expenditure. Low interest rates and economic stability experienced by households have boosted the demand for housing loans. Although intense competition between banks further narrowed their margins, it has been counterbalanced by an increasing volume in the demand for loans leading, thereby causing a slight increase in net income on the previous year

The share of fee income in overall net income over the last few years has clearly grown. Fee income on lending, brokerage and asset management shown particular signs of growth in 2004 The positive results brought in by the banks have served to strengthen capital adequacy further, which also stands up well in international comparisons.

Banks' credit and market risks under control

The banks' lending stock has grown robustly over the last several years, despite which their credit portfolios have remained sound. The steep growth in lending has been financed, mainly, through deposits and bonds. Approximately 80% of lending requirements have been covered by deposits, but this proportion is dropping and the banking sector's dependency on market-based financing is increasing. The liquidity of the deposit banking sector has weakened slightly, but still remains sound.

The banks have their market risks well under control. The banks' positions in relation to interest risk have long been stable. There are signs of increased activity in foreign exchange trading, however banks have been cautious regarding foreign exchange risks. The relative equity risks have risen slightly, in that the market value of shareholdings has grown. The sale of property owned by banks has reduced property risk levels. Banks tend to be more susceptible to operational risk as a process-orientated management approach becomes more common and increasingly banks' various functions are either outsourced or incorporated. On top of which, the continuously prevalence of malicious code incidents (viruses, worms etc) pose increasingly serious information technology risks.

Robust growth in fund savings

The strong growth that has been seen in mutual fund capital for the last couple of years continues still. In terms of international comparisons, however, fund savings levels in Finland are still relatively low. Mutual fund assets, over all, already total approximately 44% of all deposits. The number of mutual fund has grown rapidly in the last few years, and selection of funds available for investors to choose from has broadened. Product development has been focused on developing markets and listed real estate corporations' mutual funds.

Improved position for investment firms

Investment firms found themselves in an improved operating environment in 2004, which led to clear improvements in profitability. The investment firm sector has, on average, done well, but the situation varies between individual firms.

Of the services provided in the sector, asset management was the one that showed the strongest growth. There were clear trends seen in interest in absolute return funds, evidence of focus on developing markets and the increased use of mutual funds in portfolio management. Over half of investment firms' income was generated specifically by asset management.

Commission from securities brokerage grew at a rate commensurate to share turnover on the Helsinki Stock Exchange. Competition in the sector is tough and fees have remained at a low level for several years. The share accounted for by domestic brokerage firms has been shrinking for a long period, already. Last year it totalled only 33% of share turnover at the stock exchange. Over half of the turnover was brokered by remote brokers. On top of which, electronic channels offer customers cost effective means of carrying out their transactions themselves.

Banking sector capable of withstanding bigger shocks

According to stress tests undertaken on the banking sector, the sector's risk-bearing capacity is capable of withstanding fairly considerable drops in asset prices, write downs and a rise in long-term interest rates. Economic forecasts always, however, contain risk factors which, were they to be achieved, could rapidly have an adverse effect on the supervised entities' operating environment. The strong growth in housing loans, low interest margins and the lengthening of loan periods call all serve to cause problems for banks in the future. Banks must ensure that the collateral used adequately maintains its value throughout the lifetime of the loan.

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Upward trend in share markets

Development in the Finnish stock markets was varied in 2004. The year was characterised by exceptionally high dividends and bonus issues, buoyant trading at the beginning of the year and a fall in share prices of Nokia, the largest company in Finland. On the whole, year 2004 was good for stock markets, which was also reflected in increased income for securities brokers and growth in assets for those who invested in share markets. Economic growth in Finland is expected to continue at a favourable pace and faster than in the euro area on average, thereby lending support to share market growth in the near future.

During 2004 listed companies paid out unusually high dividends, totalling EUR 6.4 billion (EUR 4.9 billion in 2003). This was the result of a change in the taxation of dividend income, as of the beginning of 2005.[1]

1) The taxation of dividend income was tightened by shifting from the imputation system of corporation tax to the partial double taxation of dividend income. 70% of dividends paid by listed companies is taxed as capital income.

Stock exchange listing minimal

Despite the upward trend in share markets no entirely new companies listed on the Helsinki Stock Exchange. The situation has remained unchanged for several years. Three new companies were accepted in the main list during autumn 2004, but two of them had already been admitted to the Exchange’s other lists, and the third listing was related to the segmentation of a listed company. As an alternative to stock exchange listing, companies have sought funding from capital funds that invest in companies intending to list on the Helsinki Stock Exchange. Finnish companies have also listed directly on stock exchanges abroad.

Stock exchange merger to be reflected in list structure

The merger between the Nordic and Baltic stock exchanges continued in 2004. As a natural continuation to the merger between the Stockholm Stock Exchange and the Helsinki Stock exchange, the Copenhagen Stock Exchange and OMX informed of their merger plans at the end of autumn.

The merger between stock exchanges will also be reflected in the structure of stock exchange lists in the future. According to current plans the lists will differentiate; along with the main list containing shares of large companies (prime list) there will be a list containing shares of small and medium-sized companies (Nordic list), with less strict listing criteria than those pertaining to the main list. A pan-Nordic list would naturally provide for the visibility of large companies, but at the same time it could also impair the position of SME companies. On the other hand, investors' and analysts' interest in SME companies could increase if they could compare several companies operating in the same field within one list.

Mainly upward trend in share prices

Share price developments in Finland were very similar to developments in the whole euro area. The integration of European stock markets has been reflected in the narrowing of return differentials between share markets in different countries.

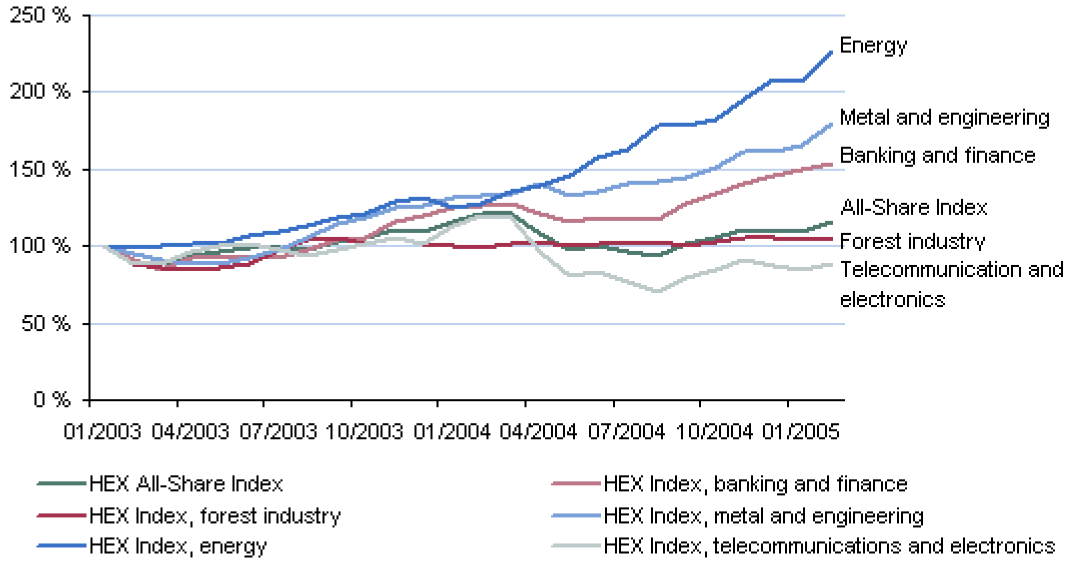
The rise in share prices lasted about a year and came to a halt in March 2004, as share prices in the telecommunications and electronics sector in particular began to fall along with a fall in Nokia share prices. Share prices fell or remained unchanged until late June, but caught an upward trend again in autumn. The HEX All-Share Index was still lower than in March, however, but other share indices, namely the OMX Helsinki 25 and the HEX portfolio index[2], exceeded the high levels of the early 2004.

2) OMX Helsinki 25 includes the 25 most traded shares on the Helsinki Stock Exchange's main list. In the HEX portfolio index, each company's weight is restricted to 10% at maximum of the market value of the whole index.

The telecommunications and electronics sector has not yet recovered from the downward turn in spring 2004. In fact, the performance of the index for this sector has been weaker than that of other sectoral indices. Nokia accounted for 85% of the telecommunications and electronics index and 39% of the HEX All-Share Index at the end of 2004.

From sectoral indices, the indices for energy and metal in particular rose strongly, but the share index for banking sector also performed well. At the beginning of 2005 the share index for banking sector was 50% higher than at the beginning of 2003.

Performance of sector share indices, 1/2003–2/2005



Percentage changes are calculated from price indices. Monthly data is the average of daily data collected during each mont.
Source:OMX.

Nordea's share prices have risen most in relative terms, ie by 80%, of bank shares during the upward trend of past two years. OKO Bank's share prices have also risen strongly. Sampo Bank's share prices have in turn risen more slowly than those of its rivals, yet considerable 40%. Of all listed banks, the Bank of Åland's shares have shown the weakest performance.

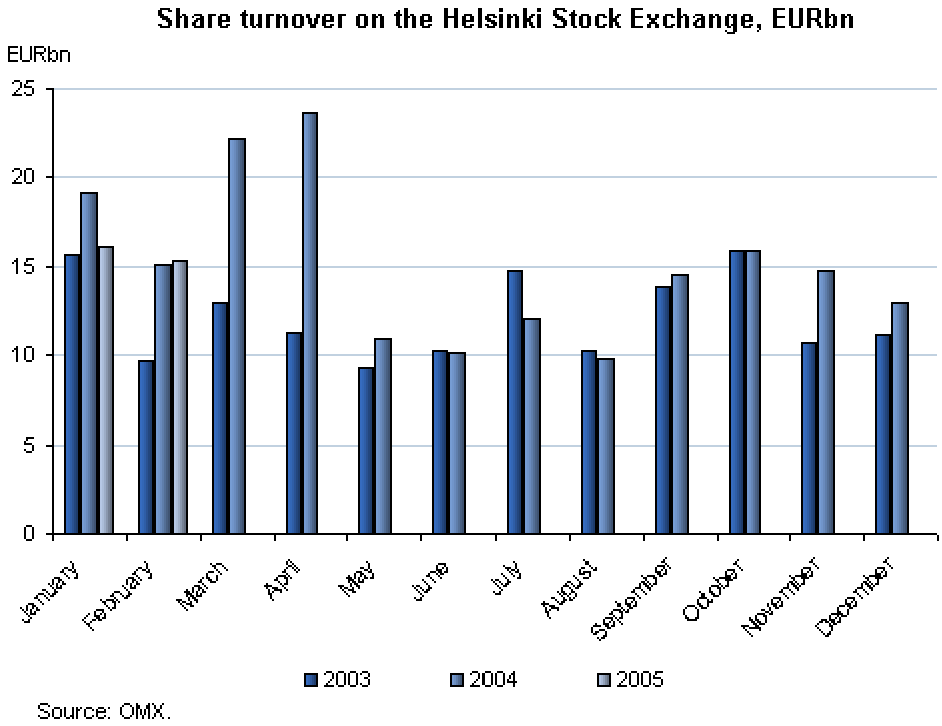
Market value of the exchange at year-2003 level

The market value of shares on the Helsinki Stock Exchange was the highest in early March 2004, totalling EUR 185 billion. At the end of 2004 it was only EUR 159 billion, which was still equal to the level observed at the end of 2003.

Share trading brisk at early 2004

Share trading was very active during the first four months of 2004. Trading was exceptionally buoyant in April, when it amounted to EUR 24 billion. Relative to market value, share trading was then even higher than in January 2001, when the value of euro-denominated trading on the Helsinki Stock Exchange reached an all-time high, EUR 25 billion.

Share trading levelled off at the end of the year, however, and returned to the 2003 level. Share turnover for the whole 2004 was EUR 180 billion (EUR 145 billion in 2003).



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Buoyant housing loan market maintained lending growth

Low interest rates and favourable economic developments were reflected in the financial sector in buoyant demand for loans in 2004. The growth rate of loans granted by monetary financial institutions (MFIs) was very high at the beginning of 2004, but levelled off towards the end of the year. Growth in the stock of loans granted by Finnish MFIs within euro area decreased during 2004 from 12.2% to 10.6%. At the end of January 2005 the stock of loans amounted to EUR 101.9 billion, increasing by 11% annually.[1]

Growth in lending is maintained by the continued strong growth in the stock of housing loans. Low interest rates and consumers' exceptionally high confidence in their own financial situation support the demand for housing loans.[2] At the end of January 2005 the annual growth rate of the stock of housing loans was 15.2%. Consumer loans and other lending to households are increasing at a clearly slower pace.

The demand for corporate loans increased as a result of growing corporate investments in 2004. However, investment intentions seem more subdued after the peak of the cycle.[3] Corporate loan stock growth will probably level off during 2005.

Increase in household indebtedness

Household indebtedness has increased clearly in recent years, increasing household exposure to financial problems. From 1998 to 2004 the ratio of household indebtedness rose from 60% to 75%.4 For individual households, the situation could become critical if interest rates were to increase strongly and unemployment were to weaken income levels at the same time as housing prices falling and collateral values dropping from their current high levels. However, indebtedness in Finland is still low by international standards.

Finnish households bear interest rate risk themselves

Households' confidence in the stability of short-term interest rates has remained unchanged although the level of interest rates has for long been predicted to rise. Interest in fixed-rate loans at longer term and higher cost is negligible. In 2004, only 3.5% of new housing loans were fixed to over-one-year interest rates. Households bear the interest rate risk themselves.

Changes in short-term market rates swiftly affect the debt servicing costs of households. The primary criterion for the granting of a housing loan must be whether the customer would be able to service his debt if, for example, interest rates increased significantly.

Tightened competition in housing loan markets

Tightening of competition in housing loan markets is reflected in narrowing interest rate margins and longer repayment periods for new loans. Interest rate margins on housing loans have narrowed, varying between 0.5 and 1 percentage points. Banks should make sure that their margins cover the risks attached to lending.

Banks also attract new loan customers by granting housing loans with longer repayment periods. These have been lengthening for several years now. A longer repayment period poses a greater risk to the customer than to the bank. If the repayment period is long, there is no room for flexibility in the customer's loan repayment programme, since it cannot be eased markedly by extending the repayment period.

A housing loan is usually collateralised through the house purchased with the loan. Housing prices are currently at high levels. However, they are subject to considerable fluctuation. Also when granting longer-term housing loans, banks should make sure that the collateral remains adequate throughout the whole repayment period.

1) Information is based on the data of the Bank of Finland statistical review Financial Markets. The data covers resident monetary financial institutions' (MFIs) euro-denominated loans within euro area.
2) Statistics Finland, consumer confidence indicator 2/2005.
3) The Confederation of Finnish Industries, Ministry of Trade and Industry and Bank of Finland: Manufacturing and service companies financial survey 2004 (in Finnish only).4) The ratio of indebtedness has been calculated as the relation of the loan stock as at year end to annual disposable income.

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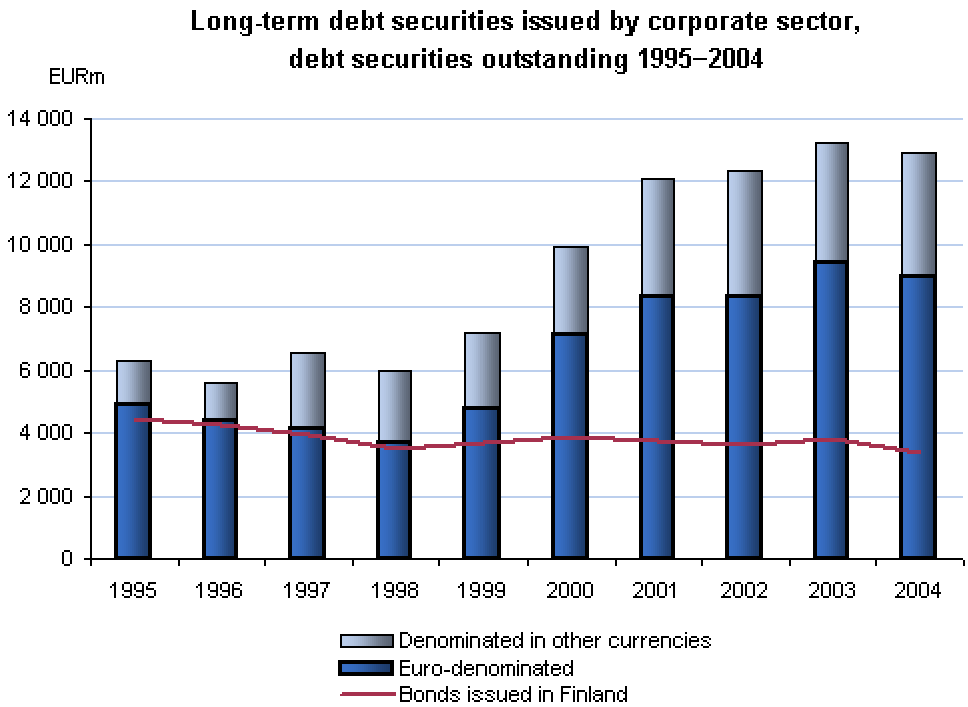
Common currency has increased corporate bond financing from abroad

The growing importance of the euro as an international investment currency has made the market for euro-denominated issues more attractive for both investors and issuers. Thus the euro bond market has continued increasing since 2000: at the end of 2003 the share of euro bonds in the international bond market was already a little larger than the share of dollar bonds, ie 43.5% as compared to 40.5%.[1] In particular, euro market integration, improved liquidity and diversification of products have fostered the attractiveness of the euro.

European financing structures are still strongly bank-based, and governments and banks also dominate the bond market. However, there is a growing bond market segment of private issuers. As corporate bonds formed a 9% share of outstanding bonds at the beginning of European monetary union at the turn of the century, this share was nearly 15% already by the end of 2004.[2]

Companies are increasing their bond financing from abroad

Finland has also seen the corporate sector increase its long-term bond financing since 2000. However, the increased financing has been attained from abroad, whereas the stock of bonds issued in Finland has decreased. In recent years the euro-denominated share of long-term debt security financing has been about 70%.

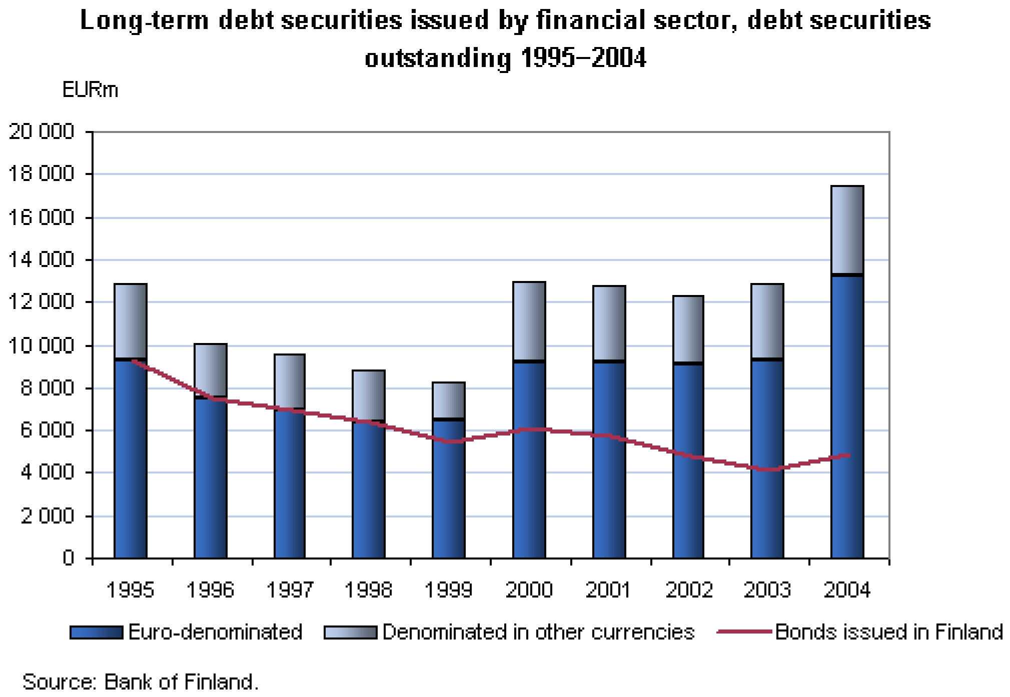


Source: Bank of Finland.

The growth in long-term financing that had continued for several years stopped in 2004. It is likely that both the Finnish financing and financing from abroad will go on shrinking in 2005. According to a survey on business finances, an exceptionally small portion of the companies is going to raise external financing in 2005.[3] For example only 23% of large companies aim to raise external financing, when 33% of them still attained such financing in 2004.

Also financial institutions have decreased their Finnish bond financing

Also the financial sector[4] has increased its long-term financing from abroad after the third stage of the monetary union, when the euro was introduced as common currency. By contrast, financial institutions have significantly decreased their Finnish bond financing. The stock of bonds has fallen by half in ten years.



According to the European Central Bank, Finnish companies more frequently, in relative terms, raise euro-denominated financing directly on the market than other companies in the euro area. Only in France is the share of corporate euro-denominated long-term debt securities a little larger than in Finland. In Germany, the role of banks as financial intermediaries is still strong, and companies raise financing through banks and not directly on the market.

Table: Euro-denominated long-term debt securities by sector of issuer and country on 31 December 2004, EURbn

	Total, EURbn	%	Government	%	MFIs	%	Other financial institutions	%	Companies	%
Euro area	7739	100	3895	50	2715	35	687	9	442	6
Belgium	306	100	226	74	52	17	4	1	24	8
Germany	2429	100	971	40	1390	57	0	0	68	3
Greece	159	100	156	98	0	0	1	1	2	1
Spain	570	100	293	51	136	24	132	23	8	1
France	1390	100	782	56	352	25	31	2	225	16
Ireland	31	100	31	100	0	0	-	-	-	-
Italy	1645	100	1018	62	438	27	141	9	48	3
Luxembourg	35	100	0	1	34	99	-	-	-	-
Netherlands	766	100	198	26	166	22	368	48	35	5

Austria	243	100	114	47	109	45	4	2	15	6
Portugal	97	100	60	62	26	27	4	4	7	7
Finland	69	100	47	68	12	17	1	1	9	14

- = data not available

Source: ECB Securities Issues Statistics.

1) ECB: The Euro Bond Market Study, Dec 2004. In the study, bond is used as a general term, which in addition to bonds also includes other above one year notes.
2) Here the corporate sector comprises not only companies but also other financial institutions than monetary financial institutions (MFIs).
3) Confederation of Finnish Industries, Ministry of Trade and Industry and Bank of Finland: Teollisuus- ja palveluyritysten rahoituskysely 2004 (Survey on Business Finances 2004).
4) Here the financial sector includes MFIs and other financial institutions.

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Profits of Finnish banks improved

Finnish banks' profits increased in 2004 compared to 2003. The improved profits were due to growing income and continued strict expense policies. Banks' operational environment was favourable, as economic growth picked up compared to 2003 and no signs of materialised credit risks appeared. Bank competition was still tight, which together with the low interest rate level decreased the interest rate margins between lending and funding. At the turn of the year the interest rate margin between lending and funding was exceptionally narrow, 2.45%, as compared to 2.60% in 2003.

Net income from financial operations resisted downward pressure

In spite of tight competition and low interest rates, banks' net income from financial operations stayed more or less at the 2003 level. Net income resisted the downward pressure, as the continued strong growth in lending made up for the impact of shrinking margins. The low interest rate level maintained a strong demand for credit, although the growth in euro-denominated loans granted to the euro area by Finnish monetary financial institutions slowed slightly compared to 2003. In 2004 the stock of housing loans still increased strongly, by more than 15%.

Other income increased in line with increased fee income

Other income increased in line with increased fee income. In particular there was an increase in securities-related fee income, ie income from fees related to trading and asset management. Also fees from lending operations increased strongly due to the growth of lending. The significance of fee income has increased in the last three years: in 2004 the relation of net fee income to net income from financial operations was 39%, as compared to 35% in 2003 and 31% in 2002.

The significance of other income items was smaller. Other operating income, such as income from real estate and dividends, remained more or less at the 2003 level. Also net income from securities and foreign exchange transactions remained unchanged compared to 2003.

Expenses were kept low

Strict control of expenses was continued in the banks. Expenses did not increase compared to 2003, particularly when the cost impact of new banks is disregarded. Staff expenses decreased slightly, whereas other administrative expenses increased by almost 3% on 2003. Depreciations and write-downs were recognised to the same extent as in 2003, so there was no significant increase of investments.

Increased income improved profitability figures

The increased income and successful control of expenses increased bank profits. The profit impact of loan loss recognitions stayed very low. The total return on assets (ROA %) for the whole banking sector remained at the 2003 level of 0.9%. The average imputed return on regulatory capital (RORC %) was slightly below 20%, which must be considered very high.

Favourable prospects for 2005

The prospects for 2005 are bright. Banks' operating profits are expected to stay unchanged or even slightly improve due to a rise in interest rates and continued brisk lending. Fee income is expected to grow as a result of favourable economic growth. In addition, the growth of expenses is expected to stay moderate.

Risks to favourable outlook

Although the outlook for 2005 is still favourable, there are still risks to the profitability developments. Short-term interest rates may stay at the present, exceptionally low level or even fall, and as a result banks' present narrow interest rate margins would shrink even further. Nor can the strong growth of lending endlessly continue at a faster rate than the total economic growth. The amount of loan losses will increase from the present exceptionally low level sooner or later. The changes will have to be measured in a new accounting environment, as the IFRS reform that entered into force at the beginning of 2005 together with the revision of the Credit Institutions Act changes the structure, item contents and accounting practices in banks' income statements and balance sheets.

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Table: Profit or loss and capital adequacy of Finnish banks, 12/2004
(EURm)

	Nordea Bank Finland Group	Amalgamation of cooperative banks	Sampo(credit institution and investment firm operations)	Savings bank total	Aktia Group	Local cooperative banks total	Bank of Åland Group	Evli Bank Group	eQ Bank Group	Tapiola Bank Ltd.	Gyllenberg Private Bank Ltd.	Suomen Asunto-hypopankki
Net income from financial operations	1 121	783	394	109	73	74	29	1	2	1	1	0
Other income	717	504	264	49	47	27	20	54	19	1	2	0
Total income	1 838	1 286	658	158	120	101	49	55	21	2	2	0
Administrative expenses	716	563	319	81	58	53	26	40	12	12	2	0
Other expenses	335	240	78	32	24	20	7	11	7	1	1	0
Total expenses	1 051	803	397	113	82	73	33	50	19	13	2	0
Profit/loss before loan losses	787	483	261	45	38	28	16	4	2	-11	0	0
Loan losses	18	7	-14	1	2	1	1	0	0	0	0	0
Proportion of profit/loss of companies consolidated through capital participation	18	27	13		0		0	0	0			
Operating	786	504		43	36	27	15	4	2	-11	0	0

profit/loss												
Income/expenses	1,7	1,6	1,6	1,4	1,5	1,4	1,5	1,1	1,1	0,2	1,1	0,6
Cost/Income %	57	62	64	72	69	72	67	92	92	567	88	172
Balance sheet total	110 876	38 229	19 738	4 894	4 076	2 968	1 834	546	258	228	123	17
Own funds total	12 788	4 050	2 254	500	293	368	120	46	31	25	8	5
Original own funds (Tier 1)	11 136	3 686	2 123	446	195	360	87	47	31	25	8	5
Risk-weighted items total	55 839	25 577	14 678	2 704	2 082	1 808	1 052	230	135	94	74	3
Capital adequacy ratio	22,90 %	15,80 %	15,40 %	18,50 %	14,10 %	20,40 %	11,40 %	20,00 %	23,10 %	26,9 %	10,20 %	156,50 %
Tier 1 capital adequacy ratio	19,90 %	14,40 %	14,50 %	16,50 %	9,40 %	19,90 %	8,20 %	20,30 %	23,1 %	26,9 %	10,20 %	156,50 %

Banks' capital adequacy solid

Capital adequacy of the Finnish banking sector remained solid. At the end of 2004, the total capital adequacy of the sector was 19.6% (18.9 % in 2003) and the Tier 1 capital adequacy calculated on the basis of original own funds 17.4% (16.9 %).

As a rule, banks' capital adequacy is good. One reason for the exceptionally high capital adequacy is the present restructuring of Nordea, which has raised Nordea Bank Finland Group's capital adequacy above 20%.

Banks' own funds increased in line with positive results

Banks' total own funds increased by 10.2%, or EUR 20.5 billion, in 2004. Their profits improved, and on average dividends for the financial year 2004 were more moderate than for 2003, so profits accrued in banks' original own funds. In addition banks have more frequently than before issued capital loans and debentures eligible for original and additional own funds.

Original own funds should be genuine capital items

In general, the quality of capital is good. Original own funds constitute 89% of banks' total own funds and they are mainly formed by equity and profits from the previous year. Capital loans' proportion of original own funds is still very small, below 2%, but there are clear differences between the banks concerning the amounts of capital loans.

Capital loans are not as permanent as other capital items eligible for original own funds. In addition, they are in practice available for covering losses only in liquidation. The Financial Supervision Authority (FIN-FSA) considers it very important that original own funds are genuine capital items such as share capital, retained profits and non-restricted profits formed from retained profits, which are available on request to cover losses during operations.

Banks' swift lending increases risk-weighted items

The growth of banks' total risk-weighted items was more moderate than the increase of own funds in 2004. Risk-weighted claims and exposures and off-balance sheet commitments increased by 6.1% and amounted to EUR 104.3 billion. Lending to the public has still been buoyant.

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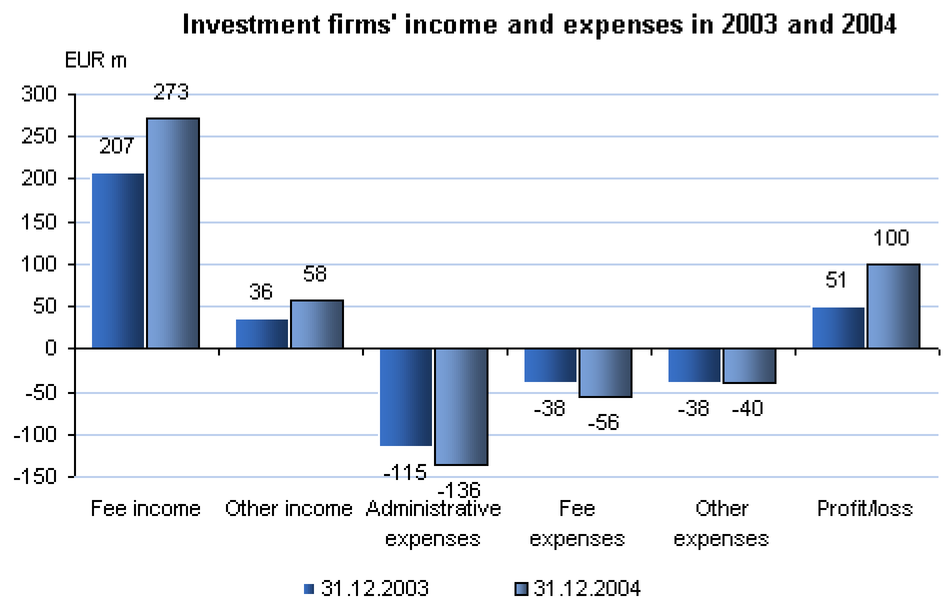
Improved profitability of Finnish investment firms

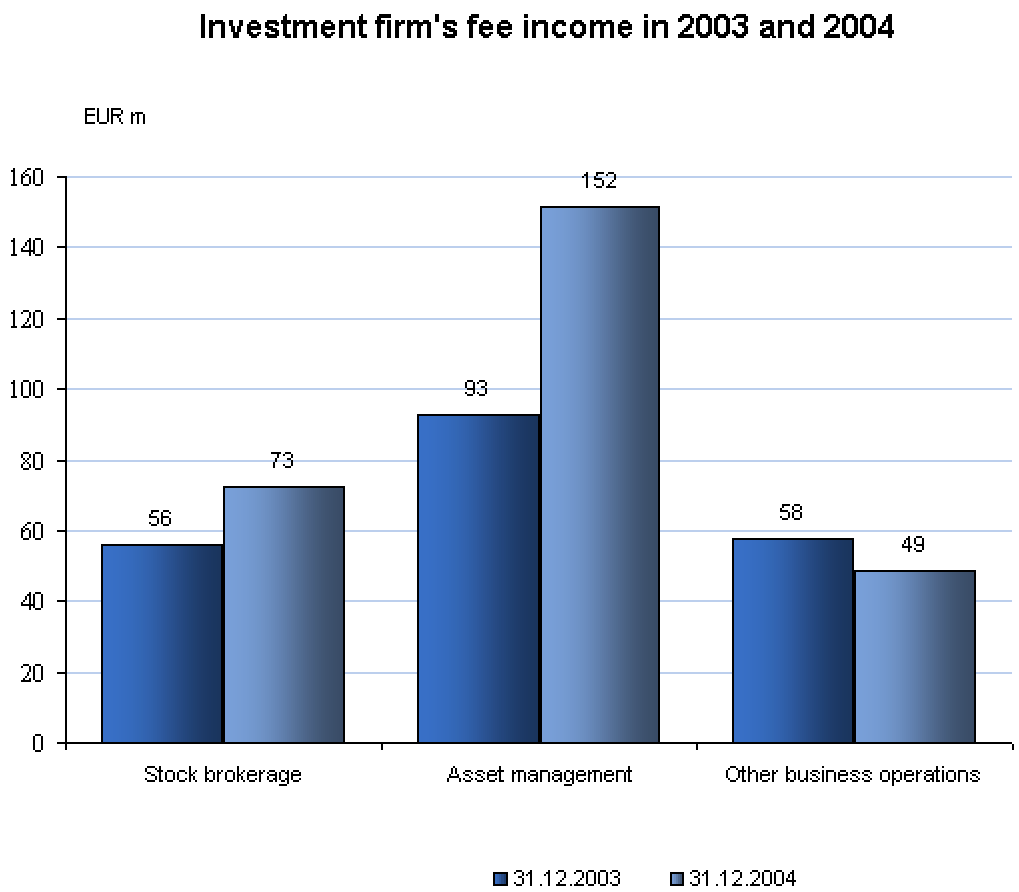
The profitability developments of Finnish investment firms have been very similar to those observed in other countries. Investment firms' profitability started to pick up across the world in 2003, and recovery continued in 2004. Investment firms, which are highly dependent on business cycles, recorded an upswing in income as a result of the stock market recovery. A very rapid growth in income has been recorded for both the investment services and mutual fund sectors, but it is more doubtful whether the rate of growth will keep up. Economic forecasts suggest that a peak in growth was reached in 2004.

The profitability of Finnish investment firms improved significantly in 2004. The sector's income increased by a third and profits doubled. Personnel costs of investment firms were also turned around: whereas staff costs were cut during recession, they started to grow again in 2004.



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

Source: The Finnish Financial Supervision Authority.



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

Source: The Finnish Financial Supervision Authority.

Fee income from asset management increased at a much faster rate than income from any other investment service. The stock brokerage situation was still looking bright early last year. Towards the end of 2004, however, share turnover declined, and the rate of growth of brokerage income started to slow.

Tight competition in stock brokerage and investment banking

In 2004, income from stock brokerage grew at the same rate as share turnover on the Helsinki Stock Exchange. In relation to share turnover, however, income from stock brokerage has collapsed since the peak years. In the record year 2000, the Helsinki Stock Exchange share turnover was only 25% higher than in 2004, but income from stock brokerage was nearly three times as high. Separate stock brokerage is no longer as profitable as it used to be.

The share of domestic brokers in the trade of the Helsinki Stock Exchange has been falling for many years. In 2004, Finnish brokers accounted for 33% and remote members for 56% of share turnover. For the largest part, international stock market trade is in the hands of American investment banks, and the same institutions are also taking an increasing stake of the Finnish stock market. Since foreign investors account for the most of the turnover on the Helsinki Stock Exchange, it is understandable that brokerage also to an increasing degree is handled by foreign brokerage firms.

Table 1:
Market shares of domestic stock brokers

	2004	Market share % 2003	Change
Nordea Bank Finland Plc.	6,1	8,9	-2,8
Kaupthing Sofi Securities	5,9	4,5	1,4
eQ Bank Ltd	4,8	1,6	3,2
Evli Bank Plc	3,8	4,1	-0,3
Alfred Berg Finland Oyj Abp	3,3	3,5	-0,3
Mandatum Stockbrokers Ltd.	3,1	3,9	-0,9
FIM Securities Ltd	2,7	2,0	0,7
Opstock Ltd.	2,1	1,5	0,7
Estlander & Rönnlund Financial Products Ltd.	0,4	0,5	-0,1
Bank of Åland Plc	0,3	0,2	0,1
United Bankers Securities Ltd.	0,2	0	0,2
Aktia Savings Bank Plc	0,1	0,1	0
Conventum Corporated Finance Limited	0	4,5	-4,5
Finnish stock brokers	32,8	35,2	-2,4
Remote members	55,6	52,1	3,5
Foreign branches	11,7	12,7	-1,0

Source: OMX.

Moreover, investment banking[1] did not recover to such the degree envisaged by the cyclical upswing either. The combined income of investment firms that engage in investment banking grew by 23%, but income of some firms declined. Tight competition is reflected in the fact that large European investment banks active in this field have started to cut costs by shedding thousands of employees, mainly in London, and by moving their activities to cheap-labour countries.

1) Referring here to corporate finance services such as provision of issuance and issuance guarantee services and company services in connection with capital restructuring, business strategy planning and mergers &acquisitions.

Asset management is a growing business area

In the past two years, asset management providers recorded the fastest rate of growth where both income and managed assets are concerned. Asset management performance was slightly better in 2004 than in 2003. Fee income from asset management grew by 44% in 2004 (42% in 2003). The value of managed assets increased to the same degree.

Mutual funds account for a large part of the increase in the value of managed assets. About half of the assets managed with full powers of attorney are assets of Finnish mutual funds.

Table 2:
Assets managed by investment firms in 2004 and 2003

	12/2004 EUR bn	12/2003 EUR bn	Change EUR bn	Change %
Assets managed with full powers of attorney	62	43,2	18,9	43,7
- of which Finnish mutual fund assets	27,1	19,0	8,1	42,7
Assets managed under consultative asset management agreements	12,6	11,5	1,2	10,4

Source: FIN-FSA.

Banks are predominantly engaged in consultative asset management. Consultative asset management has not grown to the same degree as asset management covered by full powers of attorney.

Table 3:
Assets managed by banks in 2004 and 2003

	12/2004 EUR bn	12/2003 EUR bn	Change EUR bn	Change %
Assets managed with full powers of attorney	2,1	1,7	0,4	21,5
- of which Finnish mutual fund assets	0,1	0,1	0	8,1
Assets managed under consultative asset management agreements	12,0	10,5	1,5	14,5

Source: FIN-FSA.

Although investment service providers have been doing reasonably well on average, the financial positions of individual firms vary considerably. Most firms recorded an increase in income from investment services. However, net income has declined for a few individual firms within the group. The ratio of expenses to income is 70% on average, but in the case of some investment services providers, expenses exceed income. On average, investment firms' average return on equity (ROE) was 37%, which is extremely high, but ROE varies a great deal from firm to firm. In 2004, the aggregate surplus of investment firms' statutory own funds grew by 15% and was on average twice as high as the own funds requirement.

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Management companies' income up by 39%

The strong rise in mutual fund investment for the second year running also led to an increase in management companies' turnover. In 2004, the total assets of mutual funds grew by 36% or EUR 8.4 billion, of which net subscriptions accounted for EUR 6.8 billion and value increases for EUR 1.5 billion. At the end of 2004, net assets of mutual funds stood at EUR 32 billion.

Management companies' turnover grew by 39%, or even faster than fund assets. This compares with a turnover of just 10%, despite a 40% increase in fund assets, in 2003.[1]

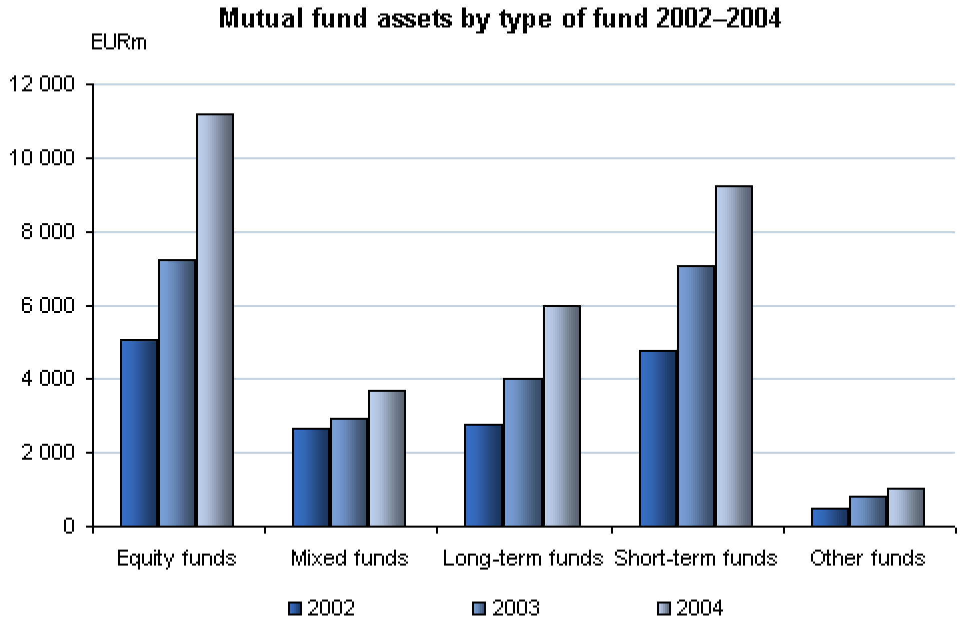
1) These figures cover 27 management companies, supervised by FIN-FSA, managing a total of 403 mutual funds at the end of 2004.

Turnover and fund assets do not necessarily grow uniformly, since net income depends on the proportion of equity and fixed income funds managed by a management company. Fees charged to fixed income funds are lower than those charged to equity funds. Furthermore, fee levels vary between companies.

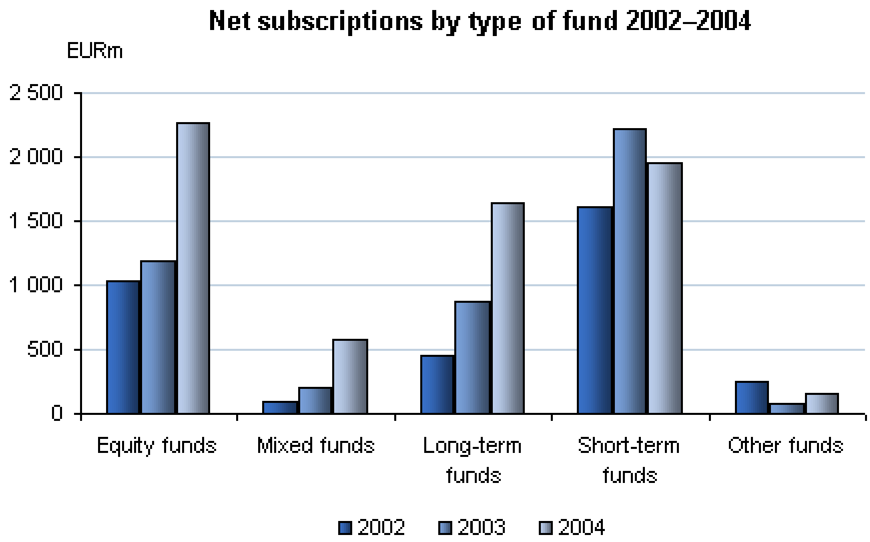
In all management companies, the fees-to-assets ratio grew on average. Fee income also increased as a result of the increase in the relative share of assets held in equity funds in 2004.

Fixed income investments account for half of fund investment

As a result of the upswing in the stock market, net subscriptions in equity funds almost doubled compared to 2003, and equity fund assets grew by 55%. Despite the relative increase in equity fund assets in 2004, their share continues to be smaller than fixed income fund assets. At the end of 2004, fixed income funds accounted for 49% and equity funds for 36% of total mutual fund assets.



Source: Rahastoraportti (Mutual Funds Report), Sijoitustutkimus Oy.



Source: Rahastoraportti (Mutual Funds Report), Sijoitustutkimus Oy.

Revised minimum capital requirements for management companies under the new Mutual Funds Act

The statutory capital requirements did not cause any problems for the majority of management companies in 2004. However, one of the less well performing management companies, Veritas, closed its operations at the end of the year. Veritas' funds merged with the mutual funds of Aktia Savings Bank.

The new Mutual Fund Act, which entered into force in April 2004, lays down new minimum capital requirement for management companies. Management funds must fulfil the new capital requirements by 13 February 2007. The absolute minimum equity capital requirement for a management company and the own funds requirement calculated as a percentage of the assets of the funds it manages are less strict than the corresponding requirements under the old mutual funds act. In practice, the alternative capital requirement based on fixed expenses is likely to be the domineering capital requirement.

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Minimum equity capital requirement for management companies

Under the new Mutual Funds Act, the minimum equity capital requirement is EUR 125,000 and it is applicable to all management companies.

In addition to the above requirement, a management company's own funds must cover 0.02% of fund assets in excess of EUR 250 million. However, the maximum own funds requirement is EUR 10 million.

Furthermore, the own funds of a management company must at all times be at least 25% of the company's fixed expenses according to the approved profit and loss account for the preceding accounting year. Finally, management companies that provide asset management services must, in addition to the above requirements, meet the capital requirement for covering credit and market risks under the Investment Firms Act.

Low credit risks for Finnish banking groups

Finnish banking groups continue to report small amounts of non-performing assets. In December 2004, non-performing assets amounted to EUR 359 million, which is 13.9% less than in the previous year. Non-performing assets accounted for 0.34% of the stock of lending and guarantees.

Non-performing assets declined for all sectors

The amount of non-performing assets declined for all sectors in 2004. Non-performing assets for the non-resident sector fell by about EUR 38 million, that for the household sector by EUR 20 million and that for the non-financial corporate sector by EUR 17 million. The proportion of non-performing assets in the stock of lending and guarantees also declined from the year before.

The proportion of non-performing assets in the stock of lending and guarantees declined by 0.1 percentage point for both the non-financial corporate sector and the household sector. In December 2004, non-performing assets accounted for 0.39 % of the stock of lending and guarantees in the household sector and 0.35% in the non-financial corporate sector.

Continued low loan losses in the stock of lending and guarantees

Finnish banking groups' net loan losses stood at EUR 16 million, while gross loan losses, excluding loan loss reversals and recoveries, stood at EUR 172.2 million. Despite the increase in gross loan losses by 21% compared with 2003, their proportion in the stock of lending and guarantees did not grow. Gross loan losses accounted for 0.16% of the stock of lending and guarantees.

Loan losses in the non-financial corporate sector

The loan losses for the non-financial corporate sector increased by EUR 31 million, accounting for 0.30% of the stock of lending and guarantees. The proportion of loan losses posted a slight increase compared with 2003, when it amounted to 0.23%. The proportion of loan losses for the household sector remained unchanged at 0.09% from the year before. By contrast, loan losses for the non-resident sector declined by EUR 6 million, and their proportion in the stock of lending and guarantees also fell slightly.

Although the amount of loan losses has grown, their proportion in the stock of lending and guarantees has remained broadly unchanged from the year before. This is largely due to the concurrent growth in the lending stock, with the stock of housing loans posting notably strong growth. It is however necessary that banks bear in mind their risk management requirements even under conditions of tight competition for housing loans. In their credit granting process, banks should still account for factors such as the creditworthiness of their customer, the customer's ability to service their loans and the collateral for the loan. Too large a housing loan, which strains the creditor's loan servicing ability to its extremes, provides no leeway for unpredictable or surprising expenses, especially if the threats of rising unemployment, higher interest rates or a strong decline in housing prices materialise.

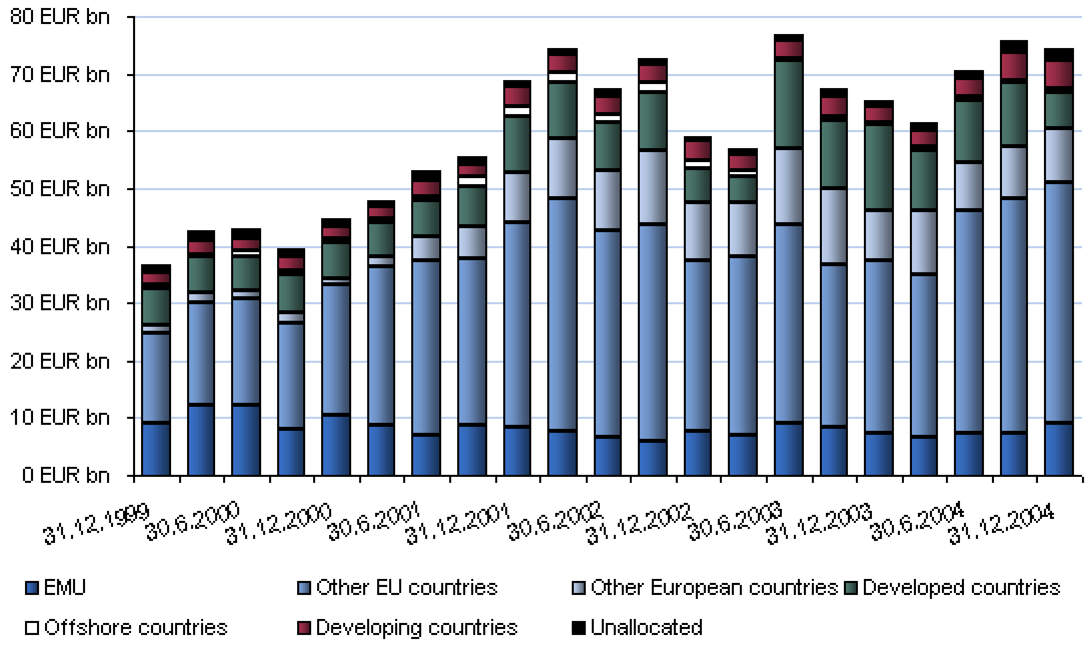
Banks' claims on countries with low risk ratings still small

Finnish banks' foreign claims increased by about 6% in 2004 to roughly EUR 75.0 billion, compared with EUR 70.6 billion in the year before. Including foreign branches operating in Finland, foreign claims totalled EUR 82.1 billion at the end of 2004.

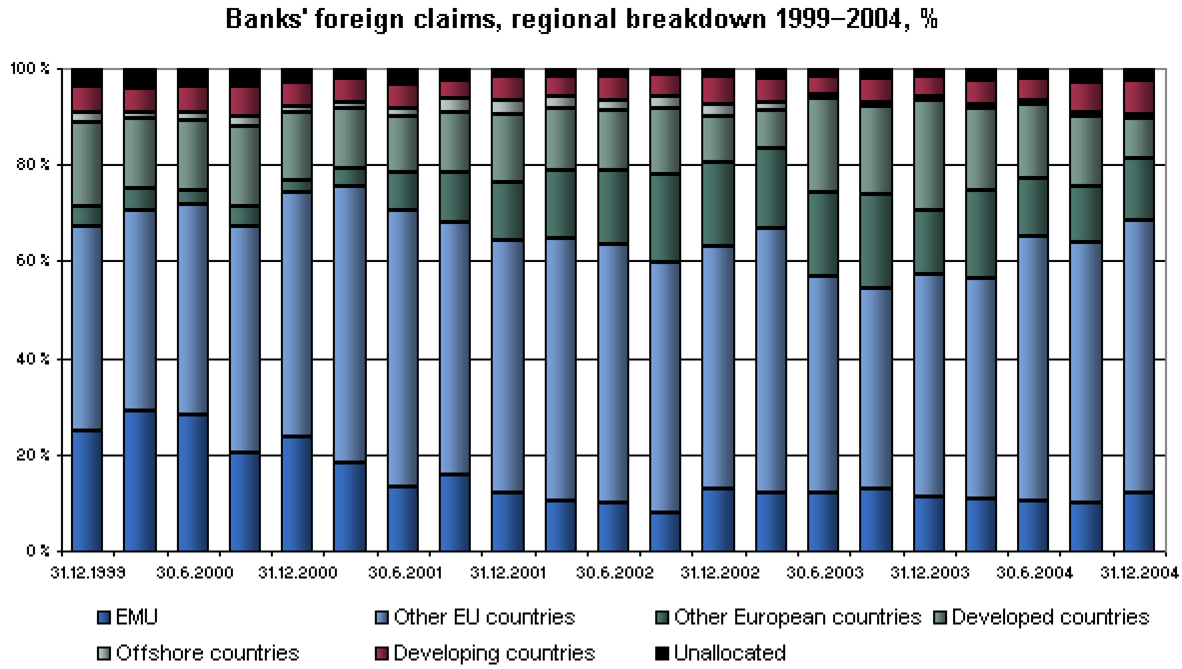
The majority of banks’ claims concern low-risk countries, ie countries rated as investment grade. Claims on high-risk countries, ie countries rated as speculative grade, accounted for less than 1% of foreign claims at the end of 2004. EU countries stood for roughly 68%, and other European countries for roughly 13%, of the country risk portfolio. The proportion accounted for by claims on developing countries in the portfolio was growing in 2004, but their proportion in the portfolio remained small, less than 7%.

Banks should apply limits to their country risks. Country risks have not caused banks any significant losses.

Banks' foreign claims, changes 1999–2004, EUR bn



Source: The Finnish Financial Supervision Authority.



Source: The Finnish Financial Supervision Authority.

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Banks' liquidity remained strong

Banks' balance sheets continued to grow in 2004. Growth was mainly due to a strong increase in lending, in housing loans in particular. Deposits were still growing at a slower rate than lending, and the proportion accounted for by deposits in the funding of lending fell to 80%.

Because of low interest rate levels, the volume of fixed-term deposits continues to be clearly smaller than a few years ago. However, the volume started to increase in 2004, concurrent with the growth in the supply of structured deposit products. Banks have also actively marketed other savings products to their customers, such as mutual fund shares and life insurance policies. With the fee income from these products, banks have covered the more expensive cost of raising funding on market terms.

Banks have also funded their growing lending by issuing more bonds, certificates of deposit and commercial papers than last year. The volume of bonds increased by 60% to a little under EUR 7 billion, while that of certificates of deposit and commercial papers grew by 12%, to a little over EUR 24 billion. The banking sector was not, however, exposed to any liquidity problems as banks' debt securities were in demand.

Deposit banks' aggregate one-month funding surplus slightly down

The liquidity position of the deposit banking sector remained strong in 2004. Banks' aggregate short-term, one-month funding deficit, however, fluctuated over the year between nearly a EUR 10 billion deficit and a EUR 2 billion surplus. The aggregate one-month funding surplus stood at EUR 1.7 billion at the end of the year, accounting for roughly 1% of deposit banks' aggregate balance sheet.

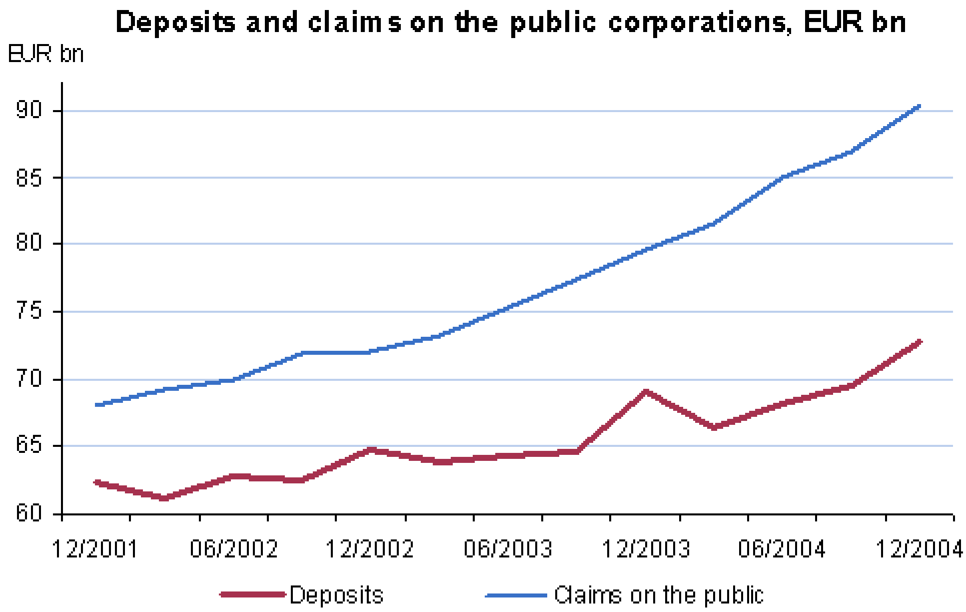
Banks may obtain liquidity from the central bank against collateral or by selling certificates of deposit or equity shares in their possession if they are unable to renew money or capital market financing falling due. At the end of the year, banks held certificates of deposit eligible to central bank financing in the amount of EUR 7.4 billion, which was about EUR 1.5 billion more than in the year before. Other money and capital market certificates held by banks totalled EUR 3.8 billion, which was more than at last year-end, thus reflecting a shift of assets in the year from other certificates of deposits into certificates of deposits eligible to central bank financing.

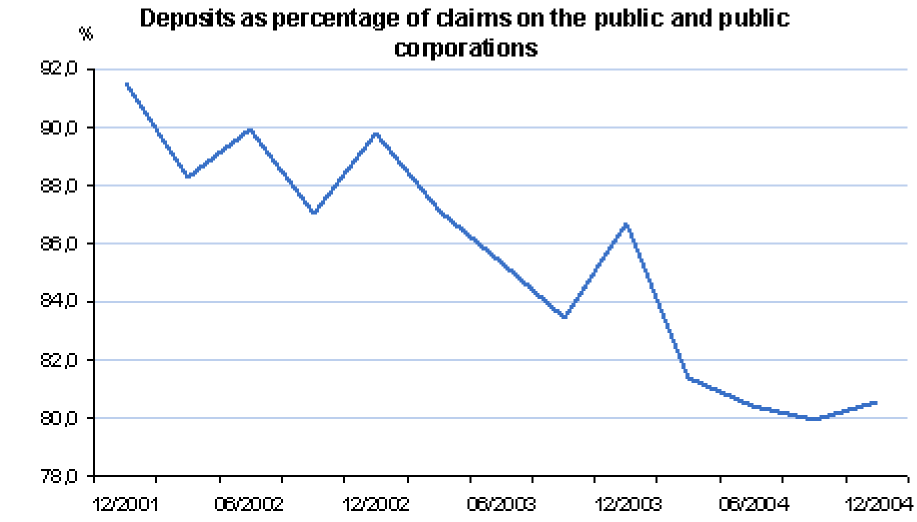
Funding risk

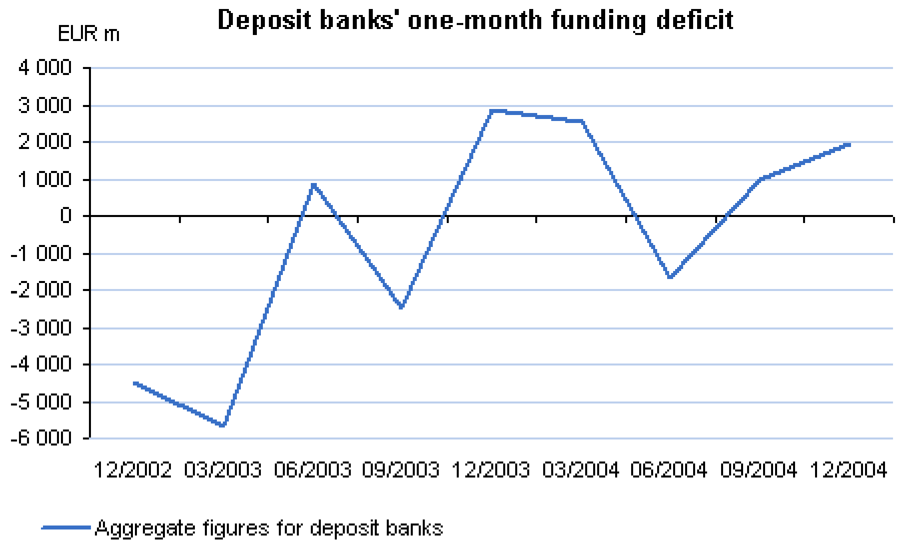
Funding risks are divided into long-term structural funding risks and liquidity risks related to short-term cash flow imbalances.

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.

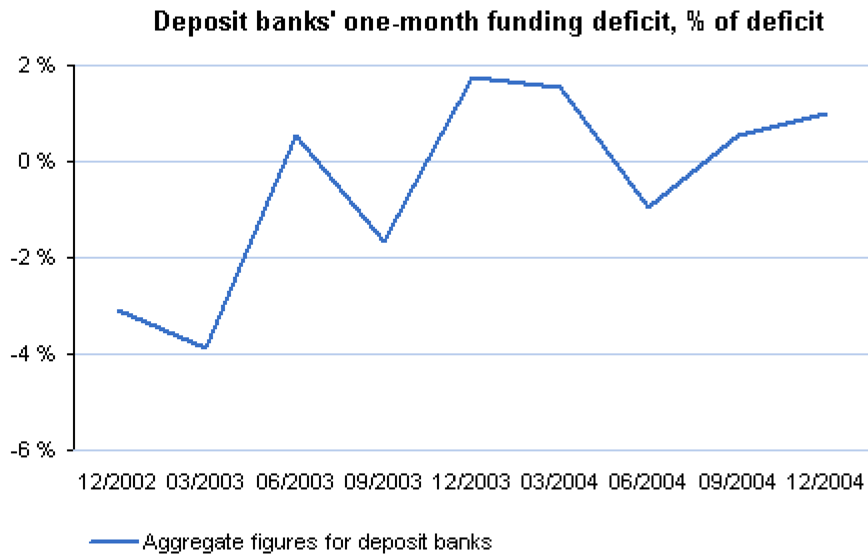
The measurement of short-term liquidity risk is based on the cash flow difference between income and expenditure, in each maturity class. Cash flow calculations also account for off-balance sheet items. The difference resulting from maturity imbalance shows the amount the bank has to invest or finance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







Source: The Finnish Financial Supervision Authority.



Source: The Finnish Financial Supervision Authority.

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Banks' interest rate risks remained moderate

The interest rate risk measure of the Financial Supervision Authority (FIN-FSA) shows that the potential income risk of Finnish deposit banks, ie the effect of market rate changes on net interest income, has declined since the end of 2003. At the end of 2003, the income risk accounted for 7.3% of net interest income, or EUR 162 million, compared with 5.6%, or EUR 133 million, at the end of 2004. An interest rate rise of 0.5 percentage point would, thus, improve banks' financial results in the following year by EUR 133 million, provided that the balance sheet structure remains unchanged.

The income risk was at its largest in March and June 2004, when it accounted for nearly 9% of net interest income. The risk however declined towards the end of the year. The relative interest rate risk fell in response to banks' better risk bearing capacity, which is reflected in higher net interest income.

Investment risk of the financial account increased

The investment risk of bonds recorded in the financial account refers to a change in the market values of bonds and interest rate derivatives recorded in the financial account. The investment risk of the financial account, in euro terms, has increased fourfold from the end of 2003. This means that the effect of a 0.5 percentage point rise in interest rates would have resulted in a EUR 82 million loss at the end of 2004, representing 3.5% of net interest income. Of this loss, EUR 9 million would have been related to certificates of deposit and EUR 73 million to derivatives.

Investment risk of banks' trading book declined

The investment risk of the trading book has declined only slightly from the end of 2003. The loss of market value following an interest rate rise of 0.5 percentage point would now amount to EUR 62 million, compared with EUR 64 million in 2003. Of this loss, certificates of deposit would account for EUR 44 million and derivatives for EUR 18 million.

By contrast, the aggregate investment risk of bonds and interest rate derivatives recorded in the trading book, as a percentage of turnover, was almost halved in the course of 2004, standing at 3.8% at the end of 2004. In response to banks' growing profits, the relative investment risk has been considerably reduced.

Investment risks cause the trading book and financial account to operate at a loss as interest rates rise, contrary to the income risk, which causes the financial account to operate at a profit under the same conditions.

Interest rate risk of the Finnish banking sector, 2003–2004
(EUR million)

	31 Dec 2004	31 Dec 2003	Change %
Interest rate risk of the entire balance sheet			
Income risk, total	133,0	161,8	-17,8
Stress test 1; sight deposits < 1 month	-98,6	-58,7	67,9
Stress test 2; currencies, absolute values, total	141,4	184,2	-23,3
Net interest income (31 Dec 2003)	2 374,0	2 212,2	7,3
Relative income risk, % of net interest income	5,6	7,3 %	-1,7
Investment risk of financial account	-81,4	-20,8	292,3 %

Interest rate risk of trading portfolio			
Investment risk of trading portfolio	-62,3	-64,3	-3,1 %
Stress test 3; currencies, absolute values, total	-140,2	-93,2	50,5 %
Current assets, total	10 389,9	10 168,5	2,2 %
Relative investment risk, % of market value	-0,6 %	-0,6 %	0,0

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