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Bright short-term outlook for banks

Banks' financial results improved, although intense competition for housing loans narrowed margins to a record low. The quality of the lending portfolio has remained good and market risks are low. Banks' profitability will develop favourably over the next few years, provided that the economy grows as projected. Risks may materialise later, especially if lending criteria are relaxed now – when times are good.

FSA supervision focusing on thematic inspections

The FSA has identified certain common targets areas requiring supplementary supervision across supervised institutions. Based on the analyses made, the FSA will focus thematic inspections on operational risks, housing loans, outsourcing of operations, risks in credit derivatives and progress in Basel II and IFRS preparations.

Operating environment for supervised entities positive in the early part of 2004

Economic growth was witnessed in all major economic areas in the early part of 2004, despite a dip US economic growth in the second quarter contrary to market expectations. In contrast, Finnish economic growth was relatively fast in the same period. Economic growth is expected to continue at a moderate pace in the USA, euro area and Finland during the latter half of the year. In Finland, companies' and households' confidence in their own financial situation remained relatively good. Long-term money market interest rates fell after mid-June, whereas short money market rates remained more or less unchanged during the first half of the year. Euro appreciated against US dollar during summer.

Uncertainty on the share markets

In spring 2004, share markets were characterised by the weaker-than-expected performance of Nokia, which is the largest company in Finland. The fall in the Nokia share price is turning the HEX All-Share Index on a decline. The indices for other sectors seem to have come to a halt, thereby reflecting the overall uncertainty of the share markets.

Mutual funds continue to grow

Investment in Finnish mutual funds continues to grow. In fact, Finnish mutual funds have posted double-digit performance figures for the past 18 months. Data for the past 6 months shows that short-term funds attracted investments the most, but investment in equity funds has also increased.

MFI lending continued to grow at a rapid pace

The rapid growth of MFI lending is sustained by the buoyant housing market. Competition in respect of housing lending is still very tight and the rise in house prices has gained momentum.

Banks' financial results improved due to net income growth and tight cost control

In January–June 2004, the financial results of Finnish banks improved compared with the corresponding period in 2003. Net income grew slightly, costs were contained and the financial results were not strained by loan losses. As a result of the stronger performance, the profitability of the banking sector improved. Banks' efficiency increased as well.

Strong capital adequacy in the banking sector

Capital adequacy of the banking sector remained strong in the first half of 2004. At the end of June, the capital ratio of the banking sector was 19.1%. The capital adequacy positions of individual banks were also sound.

Investment firms' income up 50%

Active trading and increased demand for asset management services have boosted investment firms' income. Stock market turnover has taken a downward turn since April, which will have the effect of slowing the end-of-year growth of those investment firms involved in brokerage. On the other hand, those investment firms offering in asset management services show signs of steady growth in fee income.

Level of non-performing assets continue to grow

The amount of Finnish banking groups' non-performing assets declined in all sectors. Non-performing assets and loan losses represent a small proportion of Finnish banking groups' total exposures. Hence, the average credit portfolio quality may be considered good. Finnish banks' claims on high-risk countries with low credit quality are small.

Banks' liquidity remained strong

The aggregate liquidity position of deposit banks tightened. The amount of deposits by the public has decreased so far this year, and lending growth was mainly funded by market finance. However, the liquidity position of deposit banks remained strong.

Banks' interest rate risk increased

On the basis of an estimate by the Financial Supervision Authority (FSA), the potential impact of an interest rate increase of one percentage point on net income from financial operations has increased slightly since the end of 2003. At the end of June 2004, the impact would have accounted for 17.8% of net interest income. The effects, if any, of a fall in bond valuations, caused by a rise in interest rates, ie that of an investment risk, have receded.

Banks' derivates trading picked up

Derivatives trading by Finnish deposit banks have shown signs of increased activity, recently. The ratio of the underlying asset of derivatives to the balance sheet total has clearly growth in comparison to the pattern prevailing three years ago. Improved customer business, protection from interest rate risk and the need for protection that arises from the acquisition of funds with embedded derivatives have all been contributing factors to the growth experienced.

Bright short-term outlook for banks

Banks' profitability has improved largely in response to the favourable economic operating environment. Banks have also been successful in halting the increase in expenses. The good performance has ensured that banks' capital adequacy has remained solid, and banks have in place strong loss buffers to resort to in bad times.

Households' confidence in the future, growing earnings and low market rates have driven growth in housing loans for a long time already, while fierce competition for housing loan customers has narrowed banks' interest rate margins to a record low. Because of the concurrent strong growth in lending, the underselling of loans has not been fully reflected in banks' financial results. Net income from financial operations has, nevertheless, declined for nearly all banks.

Growth in the volume of deposits has not kept pace with the increase in lending. To finance the increase in housing loans, banks therefore have had to resort to funding on market terms, rather than less expensive deposits, by issuing bonds, certificates of deposit and commercial papers. Consequently, the liquidity position of banks tightened somewhat but liquidity remained strong.

Mutual funds gaining popularity

Due to the low level of market rates, growing wealth has been channelled away from deposits and towards mutual funds in particular. In the early part of the year, funds' investment capital increased strongly, not even slowed by the uncertainties surrounding stock markets. In comparison with most other European countries, mutual fund investing is still not very widespread in Finland but it is expected to gain popularity. Banks therefore have to be prepared to increasingly resort to funding on market terms, instead of deposits, to finance the growth in lending. However, the higher fund raising expenses have been offset by growing fee income from asset management.

Increasing mutual fund saving and brisk share trading, together with growing demand for asset management services, has boosted the income of investment firms. The uncertainties witnessed in the stock markets over the past few months have, nevertheless, deprived investment firms engaging in securities intermediation of some of their income. Banking groups have a solid position both in the mutual funds and in the investment services market, and so the prosperity of these two sectors also strengthens the financial results of banking groups. As all Finnish banks concentrate on retail banking and asset management, the competitive situation will not get any easier in the future. Intense competition is the customers' gain but the banks' loss. It remains to be seen whether competition for housing loans also expands into savings and investment products.

Good quality lending portfolio

Because of the favourable economic situation, credit customers have been able to service their loans appropriately. Loan losses have therefore remained nonexistent, with nonperforming assets even declining in volume. The proportions of nonperforming assets and loan losses in the lending portfolio are very small, and no sector can be regarded as a problem sector by these measures. Households have also been able to service their loans appropriately. Despite the strong increase in lending, banks' lending portfolio is presently of good quality.

Operational risks supervised through thematic inspections

Market risks, as well as credit risks, are presently low. As a consequence of the low level of interest rates, banks' interest rate risk has fallen, thus reducing the effect of interest rate changes on net income from financial operations. In addition to the traditional banking risks of credit and market risk, banks are also exposed to operational risk. In their analyses, the FSA has identified certain common target areas requiring supplementary supervision particularly in the field of operational risk, such as outsourcing of operations. Banks' readiness to implement International Financial Reporting Standards (IFRS) and the Basel II Accord is also monitored closely. These areas will be subject to closer supervision through thematic inspections.

Current outlook bright – risks growing in the long run

Banks' outlook for the next few years remains positive, provided that the economy grows as projected and interest rate rises are moderate. In the long run, however, economic growth is likely to slow down, weakening customers' ability to service their loans. It is therefore of utmost importance that the pricing of loans reflects the risks involved, that no compromises are made over lending criteria even in good times and that collateral requirements are not relaxed even in times of hard competition.

For further information, please contact
Jaana Rantama, Head of Division, tel. +358 10 183 5281.

FSA supervision focusing on thematic inspections

The Financial Supervision Authority (FSA) focuses supervision on risk-prone institutions and operations of key importance for market stability and efficiency. The FSA annually conducts a comprehensive in-house review, a Risk Assessment, designed to explore the major risks and risk positions present in the entire financial sector and in individual institutions. Supervision concentrates on those smaller banks and investment firms which in the course of Risk Assessment were identified as having exceptionally large exposures or inadequate risk management processes.

On the basis of the Risk Assessment, the FSA has identified certain common target areas requiring supplementary supervision across supervised institutions. The thematic inspections will focus on operational risks, housing loans, outsourcing of operations, risks in credit derivatives and progress in Basel II and IFRS preparations.

Operational risks addressed as a specific theme

Several banks are in the process of revising their systems for operational risk management. This autumn the FSA will commence on-site inspections designed to explore the status of banks' operational risk management. Operational risks are also addressed in the context of credit and market risk inspections. The FSA's standard on management of operational risk will take effect on 1 January 2005.

Analysis of outsourcing risks

Finnish banks have outsourced a host of support functions, including real estate, personnel and security services. Considerable outsourcing has also taken place in the fields of banking services production, accounting and IT services necessary for risk reporting. Some business operations have also been outsourced.

The FSA has inspected the risks involved in the outsourcing of operations, including related risk management processes. The inspections have addressed areas such as IT systems and payment systems. As outsourcing is clearly becoming increasingly widespread, the aim is to undertake a very comprehensive assessment of outsourcing risks also in 2005.

Survey of housing loan risks

Recent developments in the housing loan market have been characterised by strong growth of lending, intense competition for customers and narrowing lending margins. The FSA conducted a survey of banks' housing loan risks and related risk management processes in May 2004. The findings of the survey are currently being analysed.

Closer review of credit derivatives usage

Credit derivatives are increasingly used for managing credit risk and for trading operations. One of the FSA's thematic inspections will therefore address the scope of credit derivatives usage as well as related risks and risk management processes, together with applicable accounting practices.

Banks' IFRS and Basel II preparations under monitoring

The FSA monitors progress made by supervised entities in preparing for the introduction of International Financial Reporting Standards (IFRS) and the Basel II Accord, with particular emphasis on ensuring that their Internal Capital Adequacy Assessment Processes (ICAAP) are in line with the new capital adequacy requirements.

The FSA also supervises implementation of the IAS Regulation by credit institutions. The Regulation will affect information disclosure, supervised entities' accounting and information systems and supervisory reporting to the FSA. Implementation deadlines are tight, which adds to the risks involved in the reform.

For further information, please contact
Juha Savela, Head of Division, tel. +358 10 183 5384.

Annual risk assessments

The FSA annually prepares a Risk Assessment for in-house use and designed to explore the major risks and risk positions present in the entire financial sector and in individual institutions. The Assessment serves as a basis for identifying prioritised risk areas and institutions for supervision scheduled for the following periods.

The first part of the Risk Assessment provides a description of the economic operating environment and discusses changes in financial markets and the regulatory environment as well as their consequences for the financial position and risk positions of supervised entities across the sector

The second part provides estimates of the risk positions and related risk management processes of major supervised entities. To ensure comparability of estimates, experts undertake simultaneous assessment of the various risks of all covered supervised entities. Estimates are based on all quantitative and qualitative information on supervised entities made available to the FSA in reports or obtained in the course of inspections and other ongoing supervision.

Based on the analysis of the operating environment and estimates of supervised entities' risk position, the FSA, in the third part of the Risk Assessment, sets out the risk areas and supervised institutions on which future supervision will focus. The outcome of the Risk Assessment will be made available to supervised entities.

Operating environment for supervised entities positive in the early part of 2004

US economic growth dipped in the second quarter

US economic growth slowed down to 3% in the second quarter of 2004, compared to the annual growth of 4.5% in the first quarter. GDP growth is expected to reach 4.3% in 2004, up from 3% in the previous year.[1]

1) Unless otherwise specified, projections and expectations are based on the Bank of Finland's forecast as of March 2004.

The weaker economic growth was especially due to private consumption growth decelerating to around 1%. In the previous quarter, private consumption had grown by 4.1%, the result being that consumption growth in the second quarter was the slowest since 2001. Households' consumption potential subsided due to higher oil prices, thereby slowing down demand for durable and disposable goods. Consumption growth is expected to decelerate further towards the end of the year. A notable feature was also the fact that corporate investment rose some 8.9% in the second quarter. This means that the growth rate more than doubled from the first quarter. However, this was not adequate to accelerate overall economic growth, of which private consumption accounts for approximately 2/3.

The slowdown of economic growth in the second quarter does not seem to have had a major adverse impact on corporate and household confidence. In July, the purchasing managers' index illustrating cyclical expectations for the US manufacturing industry was more than 60% for the ninth month running[2]. Similar situation was last seen in 1972-1973. Cyclical expectations were consolidated in the second quarter particularly by an increase in order backlog and production. Furthermore, July was the fourth consecutive month when consumer confidence[3] improved.

The risks surrounding the sustainability of US economic growth have not disappeared. Major central government and foreign trade deficits have not diminished, rather to the contrary. In July, the foreign trade deficit peaked at USD 55 billion especially due to oil imports. A significant shrinking of the foreign trade deficit would not only call for a fall in oil prices in the future but also for a major moderation of private consumption, leading to an improvement in the household saving ratio. Potential disturbances in financing the central government deficit could considerably weaken the dollar and raise long-term interest rates in the United States.

2) The ISM (Institute for Supply Management) report is based on a monthly survey conducted among 400 purchasing managers of industrial companies. The report is divided into indices describing different variables such as employment, order and prices, which are combined to produce an overall economic outlook. This outlook is known as the PMI index. If the index is higher than 50%, industrial production is expected to grow.
3) The consumer confidence estimate is based on a monthly survey of 5000 households conducted by Conference Board.

Moderate economic growth in the euro area

Euro area economic growth accelerated by 2.0% in the second quarter. Growth was slightly less than 1% faster than in the previous quarter[4]. Preliminary information shows that exports and private consumption in particular were the main contributors to growth. In the next few years, the euro area economy is expected to show moderate growth, driven by exports.

Looking at a sectoral break-down, economic growth was boosted by both industry and services. The economic outlook was strengthened in July especially as a result of an improved order backlog. Service production in turn showed positive growth for the 13th month running. From the historical perspective, confidence in future economic growth in different sectors is still not very strong.

Although still low, euro area consumer confidence has improved steadily for about a year now. This improvement was reflected in, for example, an increase in the registration of new cars. A persistently low level of consumer confidence indicates that euro area consumers have a rather pessimistic view of their own economic situation and overall economic development. Confidence is further weakened by fear of unemployment in particular.

In July 2004, euro area unemployment was 9%, but in practice, the number of the unemployed has remained virtually unchanged since the beginning of 2003. If economic growth continues, unemployment is not expected to increase markedly in the near future. Employment has in turn remained relatively stable since the middle of 2002. Continuing previous years' trend, job creation was more active in the services sector than in the manufacturing industry.

4) Euro area growth figures are presented as annual growth figures, whereas US growth figures are annualised quarterly figures.

Finnish economy grows faster than that of the euro area

According to preliminary data published by Statistics Finland, Finnish GDP growth accelerated in the second quarter by 1% compared to the first quarter and by over 3% year-on-year. Last year growth had amounted to 2%, with growth taking place in all sectors. The Finnish economy is expected to grow in the current year by more than 2.5%, if exports pick up and private consumption remains brisk.

Finnish employment growth did not meet targets in the first half of 2004, even though the rate of employment did rise in July, year-on-year, by 0.1 percentage point to approximately 70.6% The seasonally adjusted unemployment rate was 67.2%. The number of employed in retail trade, hotel and restaurant services, business services as well as in public and other services increased. Those In contrast, jobs were lost in the manufacturing industry, transportation and the construction industry. The unemployment rate fell by 0.1 percentage point, year-on-year, amounting to 7.8% in July. The fall was mainly due to a decline in the supply of labour.

According to Statistics Finland's consumer confidence indicator, the positive growth trend witnessed since the middle of 2003 improved in August 2004, following a slight dip in July. The consumer confidence indicator was higher than six months ago and even higher than the long-term average. The most notable improvements can be seen in views concerning savings possibilities and employment prospects.

The Tendency Survey of the Confederation of Finnish Industry and Employers[5] shows that industry confidence remained strong in August, even though the confidence indicator fell from July. In August, the indicator was above its long-term average. Although still positive, production expectations in the manufacturing industry weakened from the peak figures of July. Inventories of manufactured goods ran down from the previous month and order backlog remained unchanged. According to the banking survey of the Finnish Bankers' Association, demand for corporate loans is expected to increase during the remainder of the year, indicating that companies' positive cyclical expectations are particularly important for the profitability of banks.

5) Confederation of Finnish Industry and Employers.

Euro area long-term money market interest rates to decrease

Euro area long-term money market interest rates started to rise in early April, following a decline in the first few months of the year. The rise continued until mid June, after which the rates have been following a declining trend until the end of August. The shortest money market rates followed the key ECB interest rates throughout the first half of the year. That is why the money market yield curve has mainly reacted to movements in long-term money market interest rates. In early August, the interest rate differential between short-term and long-term money market rates was around 35 basis points.

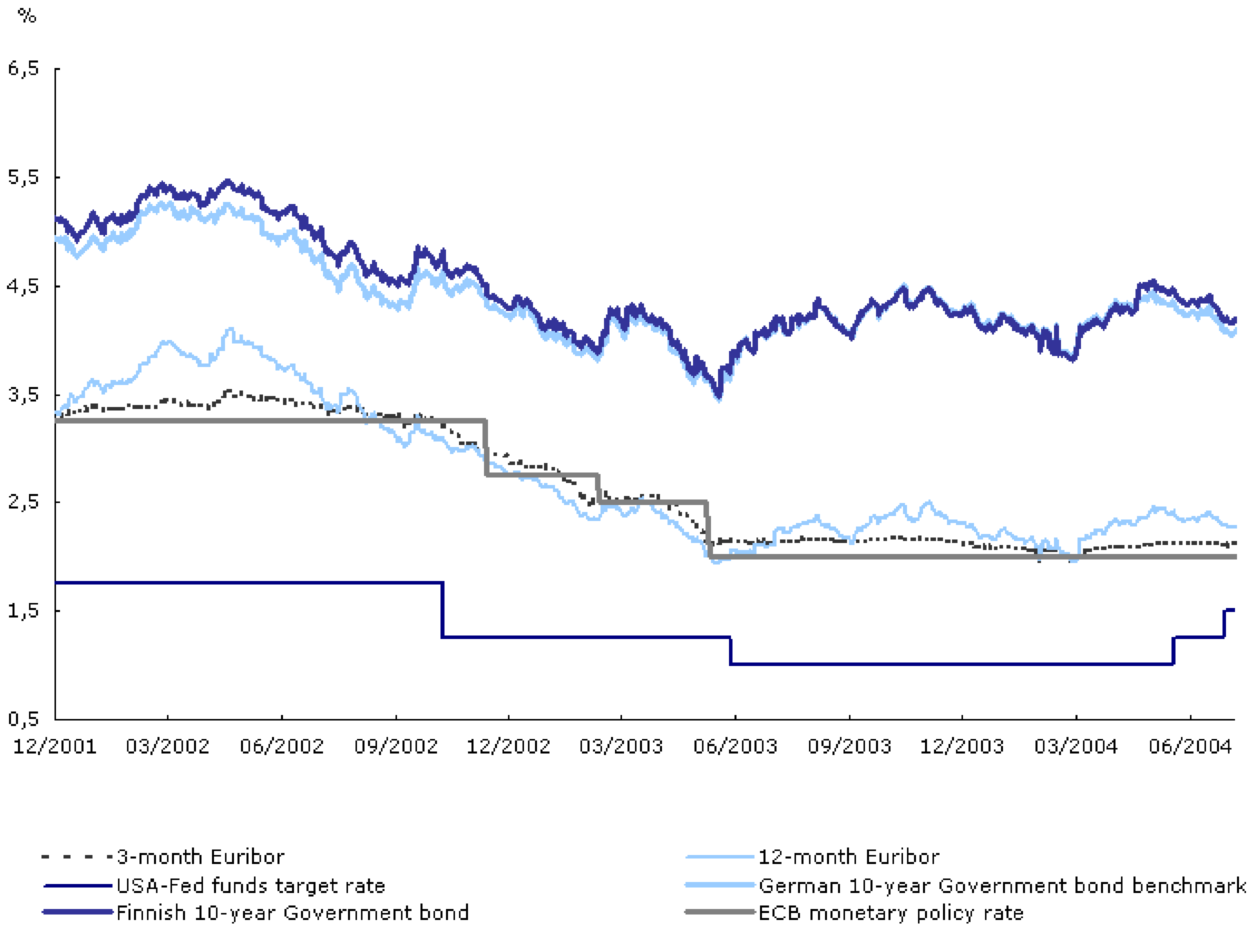
The moderation of expectations concerning euro area economic growth and inflation in recent months has clearly attenuated markets expectations of an interest rate rise during the remainder of the year. This is especially reflected in a fall in three-month Euribor futures, as the expected path of short-term interest rates is lower than before. In 2005 and 2006, the three-month Euribor rate is expected to be approximately 3.0% and 3.6%, respectively.

Euro appreciated against US dollar during summer

The performance of the euro against the US dollar varied in the early part of 2004. Euro weakened from the peak level seen at the turn of the year, reacting to more optimistic US economic data, but strengthened afterwards until early August. Dollar depreciated mainly as a result of conflicting data about the US employment situation and the current account deficit. The interest rate increases by the Federal Reserve at the end of June and August did not have a marked impact on exchange rates, because markets had already taken the increases into account in pricing.

The second quarter of 2004 saw the Japanese yen depreciate against the Euro, mainly in reaction to weakening consumer demand in the country. However, the depreciation was slowed down by a positive growth outlook for the current year from the Japanese government as well as by positive developments on the securities markets.

Financial markets, changing interest rates, 29 Dec 2001 - 5 Aug 2004



Source: Financial Supervision Authority.

For further information, please contact
Jukka Hemmi, Financial Analyst, tel. +10 831 5251.

Uncertainty on the share markets

The current share market performance reflects uncertainty relating to future economic growth. After rising for close on a year, share indices made a downward turn in spring 2004. Although companies' financial performance has been good and short-term economic prospects are favourable, uncertainty over the sustainability of the global upswing also affects the prospects and share price of Finnish companies.

Rising share indices came to a halt and in early 2004, indices turned slightly downward globally. The performance of the HEX All-Share Index has been weaker than that of comparable indices for the euro area and other continents.

Share trading brisk in the early part of 2004 – now back at the 2003 level

Share trading was very active on the Helsinki Exchanges during the first four months of 2004, reaching peak levels in April. Relative to market value, share trading was then even higher than in January 2001, when the value of euro-denominated trading on the Helsinki Exchanges reached an all-time high. Trading has now stabilised at the 2003 level.

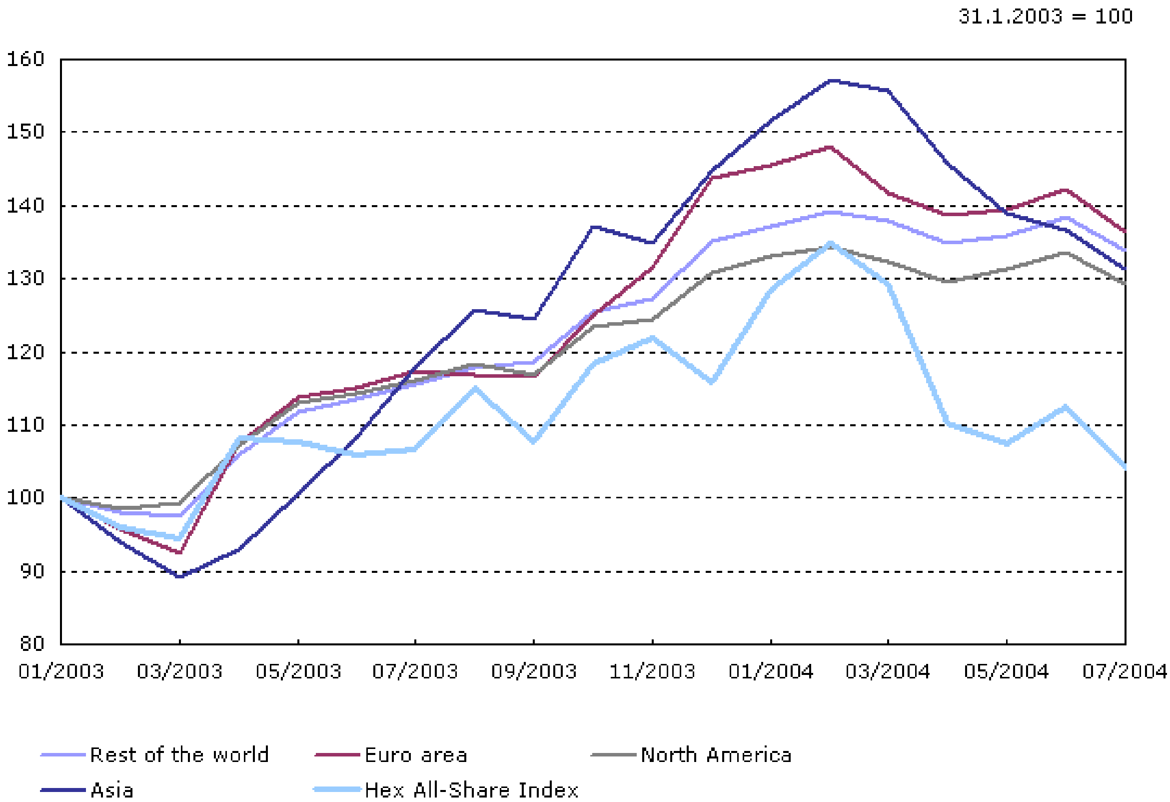
Nokia only around 36% of the market value share

The market value of Helsinki Exchanges was the highest in early March, totalling EUR 185 billion. By the middle of August, it had diminished by nearly 30% of the value posted in March, ie to EUR 134 billion.

This dip is due to the heavy emphasis on technology on the Helsinki Exchanges. The market value of Nokia has dissolved faster than market average. In fact, the falling Nokia share price has pushed the value of the entire Helsinki Exchanges to a decline. The Nokia share price reached its highest level of nearly EUR 19 at the beginning of March, while the lowest quotation (EUR 9) was registered in August. The share of Nokia of the market value of Helsinki Exchanges amounted to only 36% at the end of July, while in 2000 it had been as much as 70%.

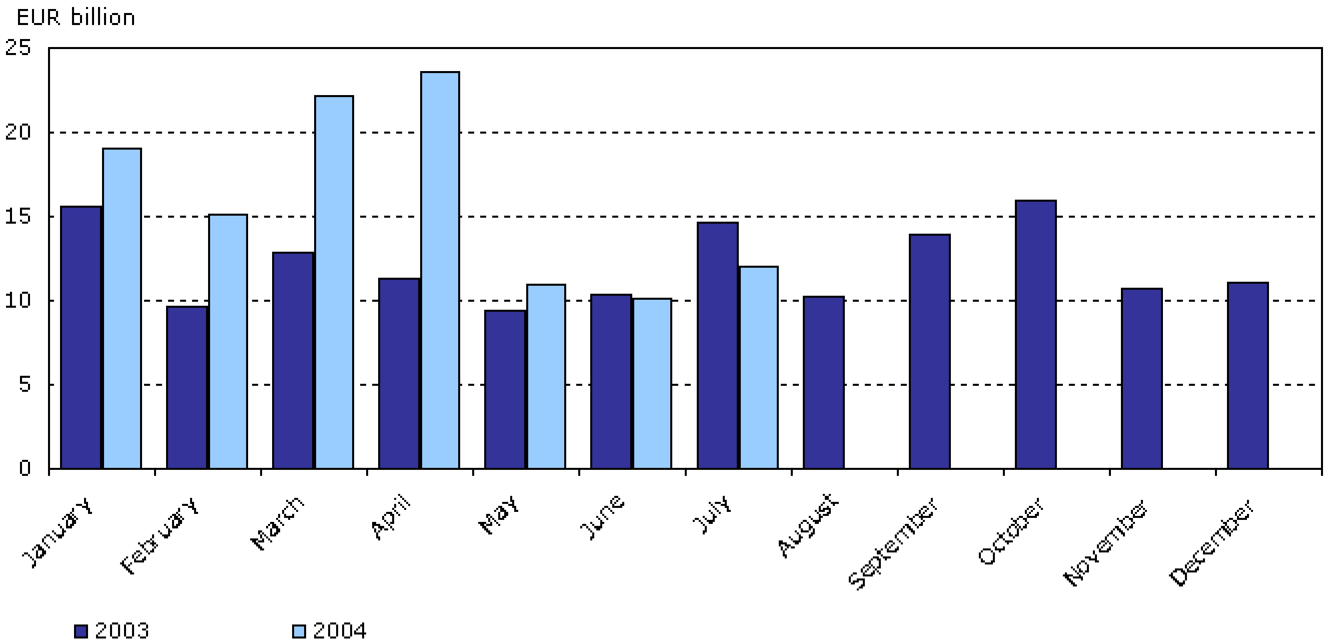
The heavy emphasis on technology on the Helsinki Exchanges is reflected in the similarity of historical changes observed in the All-Share Index and HEXTech Index. At the end of July 2004, Nokia accounted for 83% of the HEXTech Index. Share price performance in other sectors has been steadier than in the IT and electronics sector, and in some sectors share prices have even risen.   For example, the higher steel price has increased the metal industry index. Overall, industrial production is increasing and capacity usage rates are high. The prices for industrial goods have not yet reacted to intensified demand, but the forest industry, for example, anticipates paper prices to increase.

Share index performance for different regions



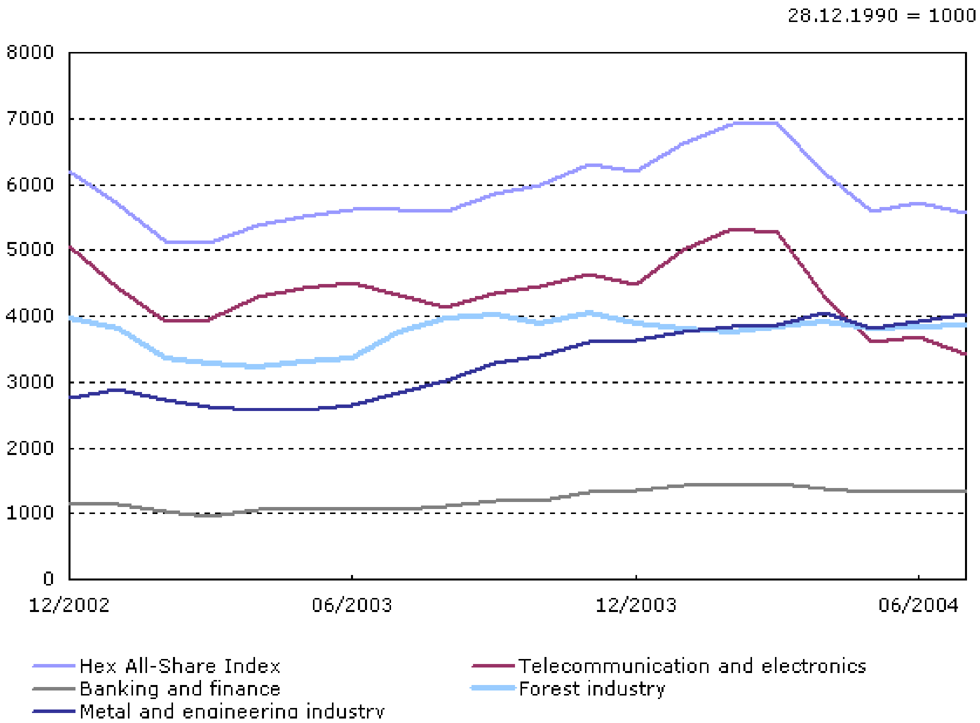
Source: Morgan Stanley Capital International and Bloomberg.

Share turnover on the Helsinki Exchanges



Source: HEX Integrated Markets.

Performance of sectoral indices



Source:HEX Integrated Markets.

For further information, please contact
Sirpa Joutsjoki, Financial Analyst, tel. +358 10 183 5205.

Mutual funds continue to grow

Mutual funds continue to grow strongly. During the first half of 2004, mutual funds' total net assets grew by 21% or EUR 5 billion, of which net subscriptions accounted for EUR 4 billion and value increase for EUR 1 billion[1]. At the end of June 2004, net assets totalled EUR 28 billion[2]. Although total investment in funds is already quite substantial and growth has been particularly strong during the last 18 months, investment in funds per capita is in Finland still among the lowest in Europe.

1) Net subscriptions denote mutual fund subscriptions less redemptions.
2) Mutual funds supervised by the Financial Supervision Authority (FSA). The FSA supervised 27 management companies, which manage a total of 380 funds.

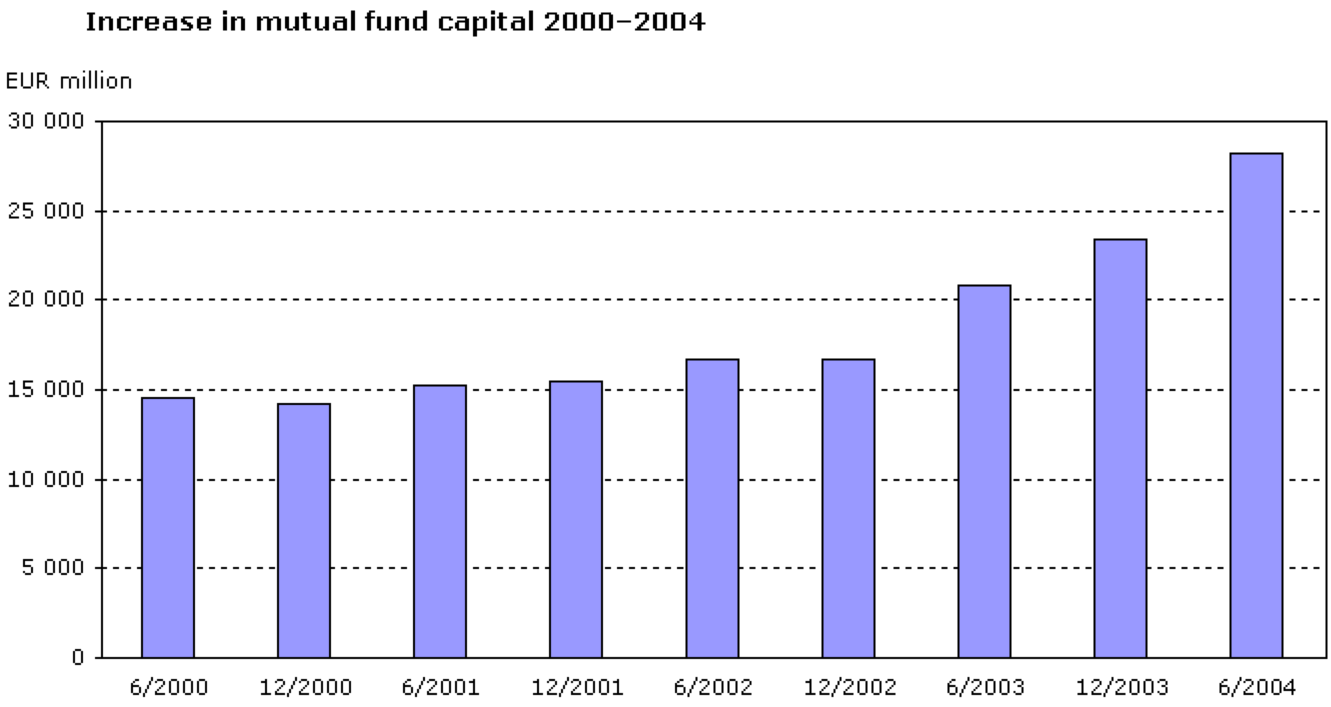
Investment in equity funds has increased

Investment in equity funds in particular increased in the first half of 2004, year on year. Correspondingly, investment in short-term funds decreased compared to the same period last year. Even the current uncertainty and volatility of the share markets have not turned equity fund investment to a decline. Only in May, redemptions of fund units outnumbered new subscriptions. During the first six months of 2004, net subscriptions were the highest in equity funds investing in Finland and Europe, while funds investing in developing markets were the third most popular fund type.

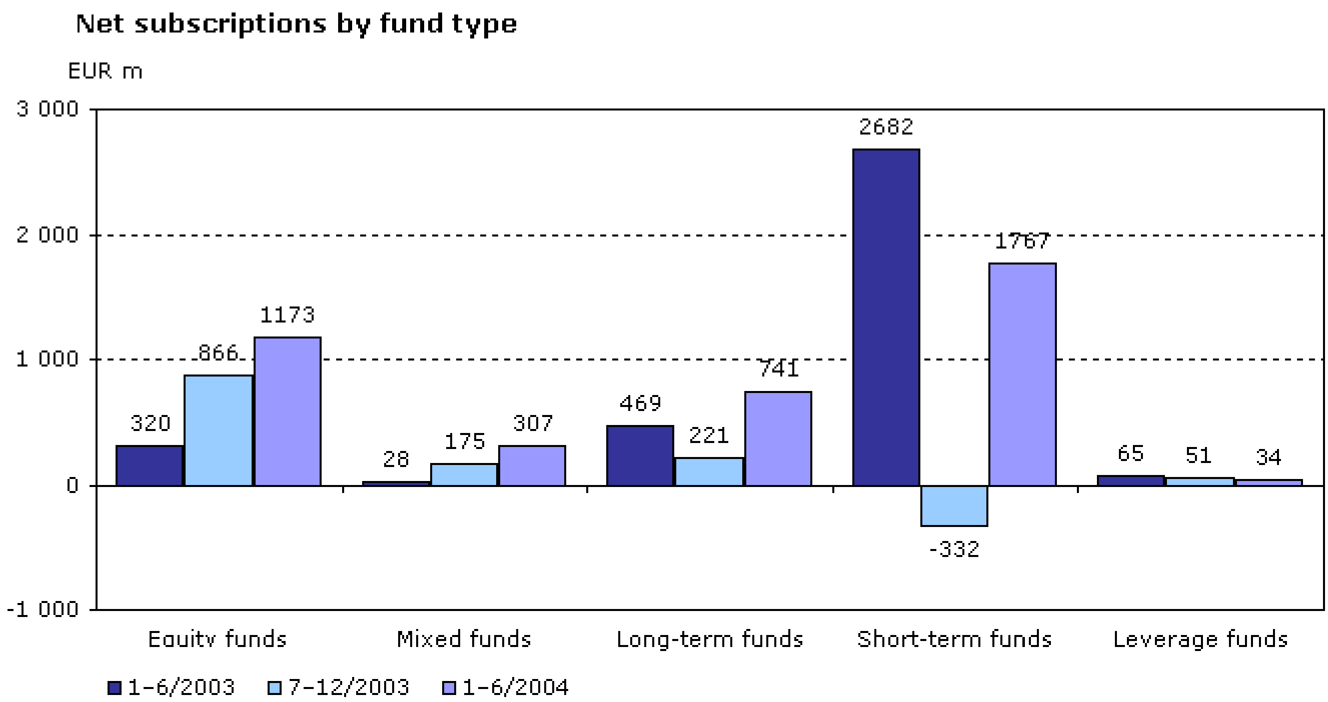
The majority or 35% of equity funds' EUR 10 billion assets has been invested in nearby areas, ie in Europe and other Nordic countries. Equity funds investing in domestic firms account for about a fifth of total equity fund assets. When comparing the breakdown by continent of investments by Finnish equity funds with the equity fund investment of the other Nordic countries, differences can be found between the shares of funds investing in Europe and those investing in the rest of the world. Finnish funds' investment in Europe is relatively higher than that of the other Nordic countries, whereas the share of funds investing in the entire world is the smallest in Finland in comparison with the other Nordic countries.

Households' fund holdings account for approximately a third

In June 2004, households' share of Finnish fund holdings amounted to 31%. The FSA does not conduct sectoral monitoring of investment in funds by various institutional bodies, but according to June 2004 data by Statistics Finland, most of the Finnish fund units, ie 24%, are held by insurance and employment pension institutions. Investment in funds by banks and financial institutions is very modest compared to the insurance sector, amounting to only 4%. In contrast, companies hold 15% of Finnish fund units, while another 12% is held by foreign investors.



Source: Financial Supervision Authority.



Source: Rahastoraportti (mutual funds report), Sijoitustutkimus Oy

For further information, please contact
Sirpa Joutsjoki, Financial Analyst, tel. +358 10 183 5205.

MFI lending continued to grow at a rapid pace

At the end of June 2004, resident MFIs' combined euro-denominated stock of loans to the public stood at EUR 96.2 billion. The major part of MFI loans are granted by deposit banks. On an annual basis, the stock of MFI lending grew by 11.6 %, which is clearly faster than a year ago, when the corresponding rate was 10.3 %. However, the annual rate of growth was slightly slower than at the turn of the year 2003/2004, when it was 12.2%.[1]

The increase in lending is sustained by the persistently strong growth of housing loans. By contrast, consumer loans are growing distinctly more slowly. Corporate investment has remained modest, which has dampened demand for corporate loans.

At the end of June, the stock of household credits stood a EUR 56.5 billion, which translates into an annual increase of 13.7%. The stock of corporate loans, on the other hand, grew by 8.5% and amounted to EUR 35.7 billion. Resident MFIs' stock of loans consists mainly of household and corporate credit.

1) The data, which is based on the Bank of Finland's statistical review Financial Markets, covers resident MFIs' euro-denominated loans to euro area residents. Resident MFIs refer to the Bank of Finland, deposit banks, lending institutions and money market funds.

Household indebtedness increased

The ratio of household indebtedness to household disposable income has risen to more than 70%. However, indebtedness in Finland is still fairly low in international comparison. The debt to GDP ratio of euro area households is over 50% compared with roughly 40% in Finland.

Strong growth of housing loans remains

The housing market is driven by demand. It is fuelled by low mortgage interest rates, higher earnings of households and strong confidence of households in their own financial position. In addition, the stock of housing loans is expanding in the wake of increasingly longer maturity periods that makes it possible to raise larger loans than before.

At the end of June 2004, the stock of housing loans amounted to EUR 38.9 billion (EUR 33.6 billion at end-June 2003). This translates into an annual growth rate of 15.8% (14.5%). For as long as a year, the housing loan stock has grown at an average rate of 15%. The average interest rate on housing loans was 3.41% (3.86%) in January–June 2004.

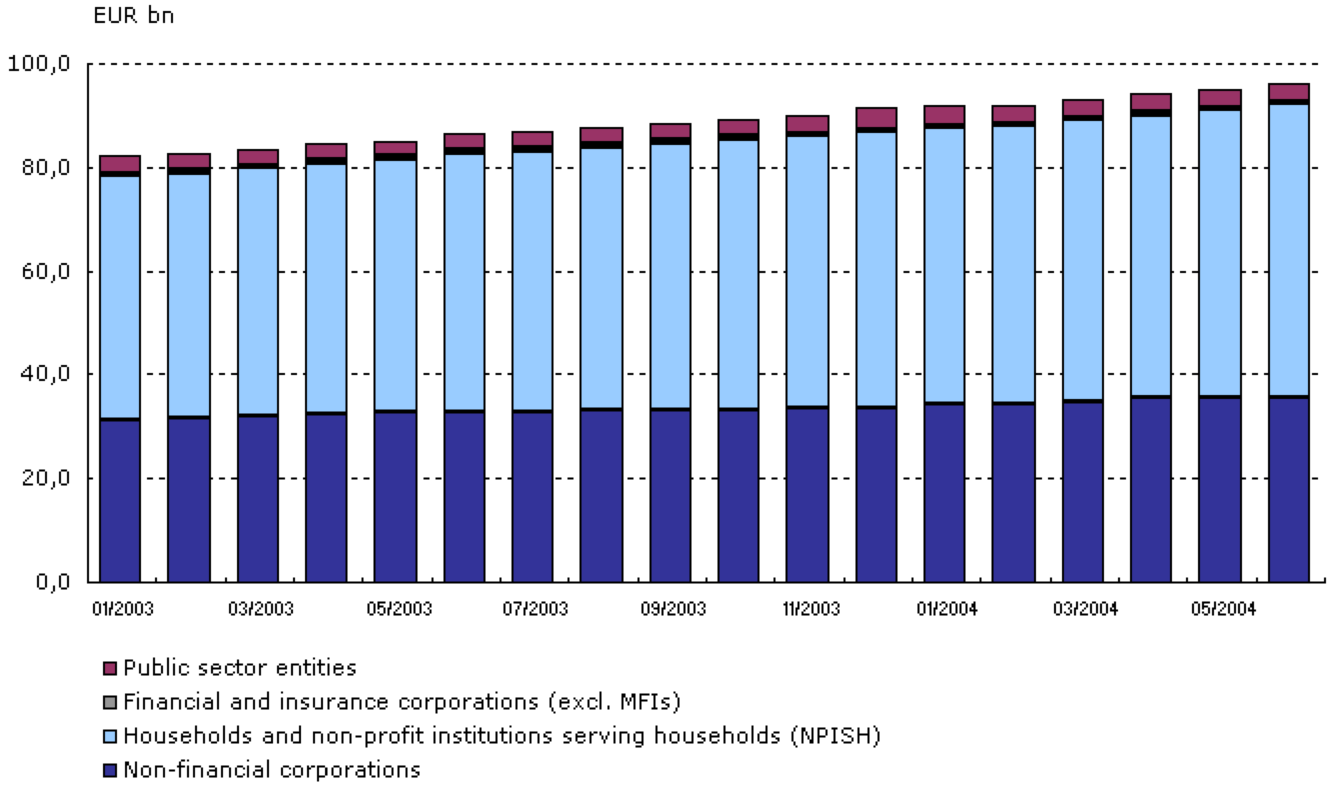
Tight competition in respect of housing loans

Besides rapid growth of housing loans, the narrowing interest margins are a sign of tight interbank competition in the housing market. In fact, banks’ interest rate margins on housing loans have narrowed to about one percentage point. In January–June 2004, the average interest margin on new housing loans was clearly below one percentage point in almost all banks. It is all important that banks ensure that margins cover all risks attached to credits.

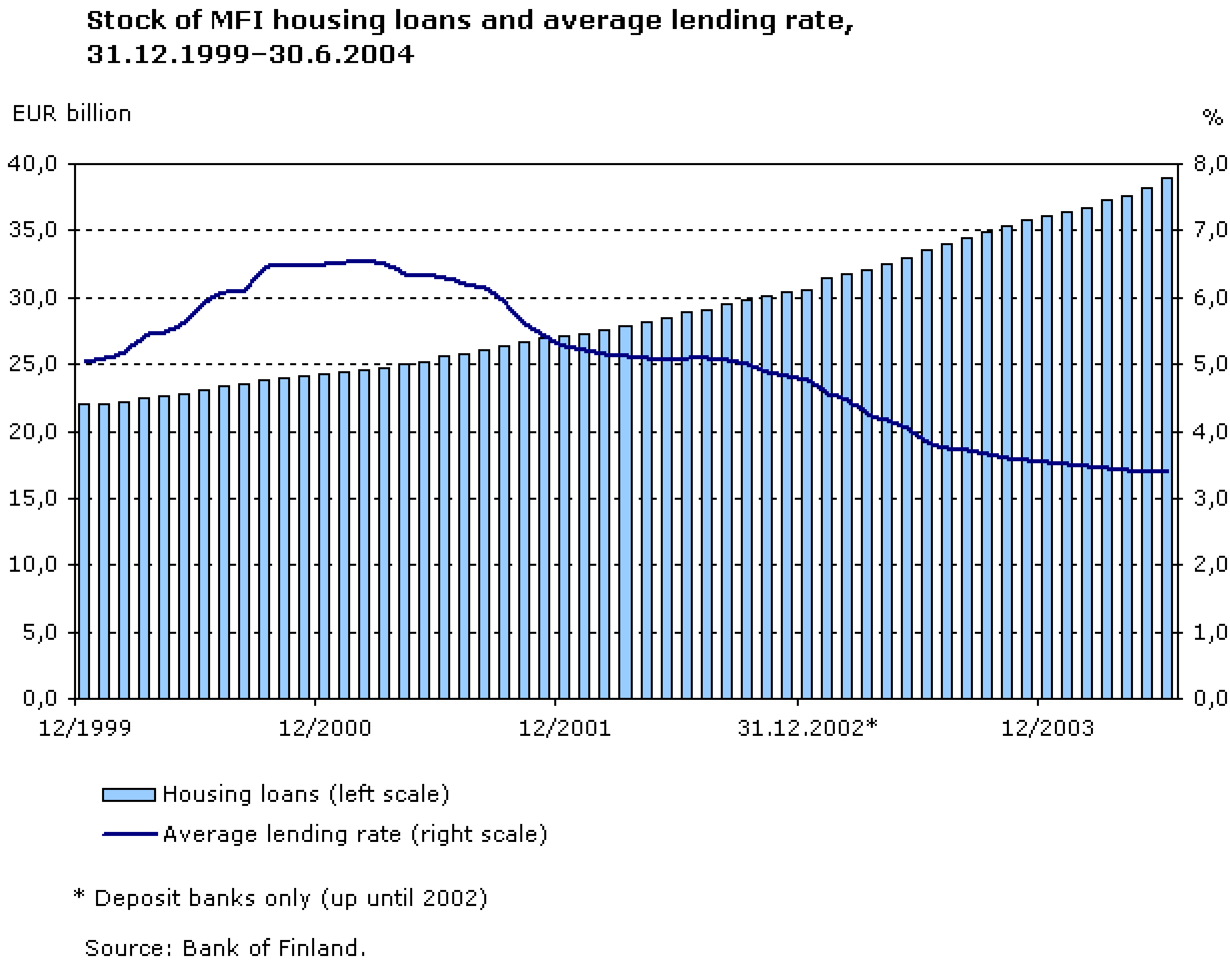
Acceleration in house prices

Strong demand in the housing market has kept house prices at a high level. According to Statistics Finland, the prices of old flats in Finland rose by 8.3% on average during the 12 months up until June 2004. The rate of increase has accelerated from a year ago, when it was 4.9 %. However, as lending rates go up price rises are expected to level off. Nevertheless, adequacy of collateral requires constant vigilance, and especially in a situation where house prices are high.

Sectoral breakdown of MFI loans



Source: Bank of Finland.



For further information, please contact
Niko Syrjänen, Financial Analyst, telephone +358 10 183 5369.

Banks' financial results improved due to net income growth and tight cost control

In January–June 2004, the financial results of Finnish banks[1] improved compared with the corresponding period in 2003. The improvement was mainly due to an increase in net income, but cost control also played a part. Staff-related costs declined due to staff reduction.

1) Finnish banks excluding Nordea Bank Finland. The table includes data on Nordea Bank Finland.

Net income grew despite a decline in net income from financial operations

In January–June 2004, the combined net income of Finnish banks grew by 2% compared to the corresponding period in 2003, even though the banks' main source of income, ie net income from financial operations declined in nearly all banking groups due to narrower interest rate margins. In fact, the continuous strong growth in lending offset the impact of narrowing interest rate margins on net income from financial operations. Hence, even a minor rise in interest rates is likely to affect lending rates more than deposit rates. As a result, interest rate margins would widen again and reinforce net income from financial operations.

Other banking income grew strongly. The sharpest increase was recorded for net income from securities trading and foreign exchange dealing and for net income from other income on business operations. Nevertheless, fee income was the main source of other banking income. Fee income structure remained virtually unchanged: most of fee income was generated from fund transfers and lending. True, the proportion of fee income related to asset management services grew slightly.

Expences were contained through tight cost control

Banks' combined expenses were on a par with the 2003 level. Although staff-related expenses declined due to staff lay-offs, the savings thus gained were eroded by an increase in other administrative expenses. Write-offs and write-downs remained unchanged compared with January–June 2003. In January–June 2004, banks' combined cost/income ratio amounted to 65% compared to the slightly weaker ratio of 67% recorded for the year-earlier period. It is probable, however, that costs in the banking sector will move back onto its earlier moderate-growth path, unless significant changes in the structure or operating environment of the banking sector occur.

Loan and guarantee losses had a negligible effect on banks' results

Loan and guarantee losses were low. For some of the banks, loan losses continued to have an enhancing effect on performance since previous loan loss recoveries and compensations, as well as reversals of loan provisions, exceeded the loan losses and loan loss provisions recorded during the period under review. As lending increases, however, loan losses will grow in absolute terms even when their relative share remains the unchanged.

Banks' profitability increased in line with stronger financial results

Banks' profitability was reinforced through income growth, tight cost control and low loan losses. Banks' operating profits were up by 9% on average compared to the year-earlier period. The profitability indicators for banks also improved: the average return on equity (ROE %) was 12.4% (11.3%) and the average return on assets (ROA %) 1.0% (0.9 %). Considering the current level of interest rates, the profitability of Finnish banks is surprisingly good.

For further information, please contact
Toni Honkaniemi, Financial Analyst, telephone +358 10 183 5222.

Strong capital adequacy in the banking sector

Capital adequacy of the banking sector is strong. At the end of June 2004, total capital adequacy was 19.1% and Tier 1 capital adequacy, calculated on the basis of original funds, 16.7%. Thus, the capital adequacy level remained roughly the same as at the turn of the year 2003/2004, when total capital adequacy was 18.9% and Tier I capital adequacy 16.9%.

The capital adequacy ratios of individual banks were also high. At the end of June, all individual banks recorded total adequacy ratios of more than 10%.

Own funds growth in line with profits

In January–June 2004, the banking sector's own funds grew by 2.7%: from EUR 18.5 billion to EUR 19 billion. Banks' own funds, in particular, increased in line with rising profits. Profits made during the accounting period in question may be included in a bank's own funds provided that profits are calculated according to the FSA regulations in force. For example, any planned distribution of profits must be deducted from profits before profits are included in a bank's own funds. Banks' additional own funds also grew due to issuance of new debentures.

Major part of banks' own funds are original own funds

The quality of the banking sector's own funds is sound. Original funds account for nearly 88% of banks' own funds, which mainly consist of share capital or unrestricted capital. Capital loans represent only a small part of banks' own funds. Capital loans account for 1.2% of the banking sector's original own funds, but there are differences in the issuance of capital loans between different banks. The FSA considers it very important that original own funds are genuine capital items such as share capital, retained profits and non-restricted reserves formed from retained profits.

Moderate growth of risk-weighted assets

In the first half of the year, the rate of growth of risk-weighted assets was moderate. The combined amount of risk-weighted assets and off-balance sheet commitments grew by 1.6%, ie from EUR 98.3 billion to EUR 99.8 billion. Bank lending to the public remained brisk, but the growth of risk-weighted assets was offset by a decline in guarantees issued on behalf of off-balance sheet commitments.

For further information, please contact
Niko Syrjänen, Financial Analyst, telephone +358 10 183 5369.

Investment firms' income up 50%

The position of the Finnish investment firms has strengthened. The fall in investment firms' income levels ceased in 2003 and showed a 50% increase in the first half of 2004. Proportionately, fee income accounts for most of the investment firms' income; of which brokerage and asset management service generate the most significant amount. In the first half of 2004 net income from investment services amounted to EUR 163 million (EUR 109 million for the same period in 2003) and fee income totalled EUR 136 million (EURO 91 million).

Trading was extremely brisk in the first four months of 2004, which was reflected in a doubling of the income received by the brokerage sector of the investment firms. On the other hand, the same period also saw a fall in the market value of shares which lead to investment firms' net income from securities trading on own account being similarly weakened. The combined net loss of investment firms was EUR 3.4 million at the end of June 2004, but the results on trading brought in by individual firms varied considerably. Stock market turnover has taken a downward turn since April, which will have the effect of slowing the growth of those investment firms involved in brokerage.

Investment banking operations quiet

There has been very little activity with equity offerings for some time and investment banking income has been minimal in relation to the income generated by investment firms' other products. However, such subdued activity is a pan-European phenomenon. A period of standstill is currently pervading the stock markets and there have been virtually no new equity offerings elsewhere in Europe either.

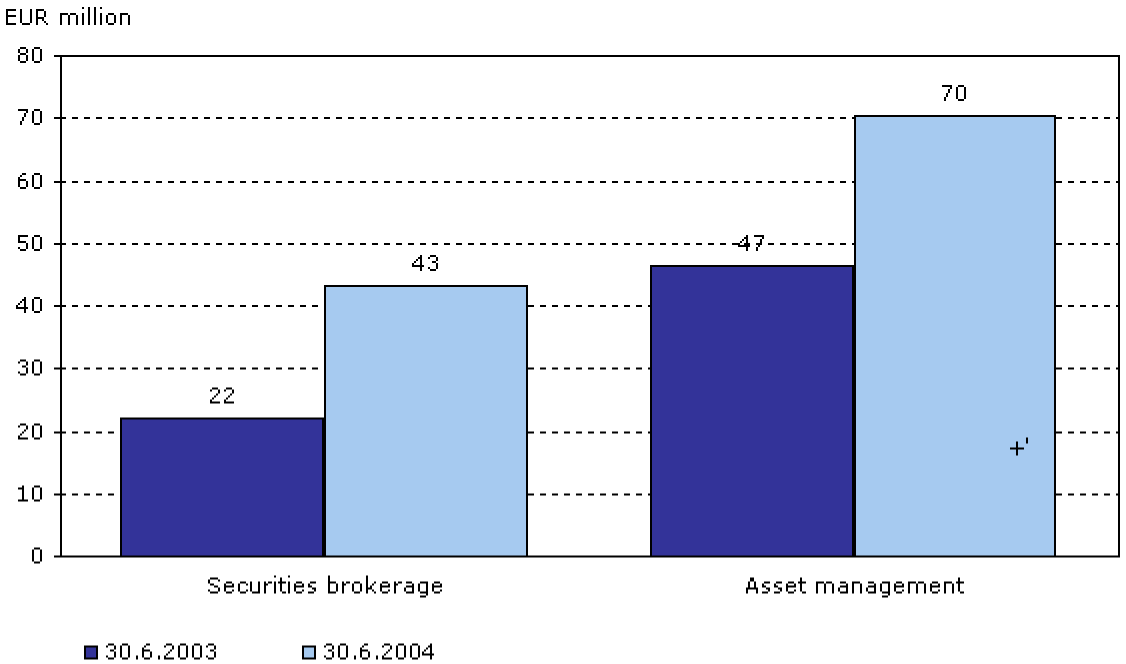
Asset management services have become operational foundation stone

It is becoming apparent that asset management services are the foundation stone upon which investment firms' operations are based. There has been a steady growth in both the assets under management and the respective income generated. Fee income from asset management services was up 63% in the period January to June 2004, in comparison to the figures from the same period in the previous year.

Managed assets covered by general powers of attorney[1] totalled EUR 46.0 billion and those under consultative management were valued at EUR 12.3 billion.[2] Assets of domestic mutual funds managed by investment firms and covered by full powers of attorney totalled EUR 21.5 billion.[3]

1) Power of attorney concerns those assets for which investment decisions are made by the investment firm managing them.
2) The investment firm provides investment advice in accordance with a written contract, but the final investment decision lies with the customer
3) At the end of 2003, managed assets covered by general powers of attorney held in banks totalled EUR 4.0 billion and those under consultative management were valued at EUR 12.7 billion and EUR 3.5 billion of domestic mutual fund assets were being managed by banks.

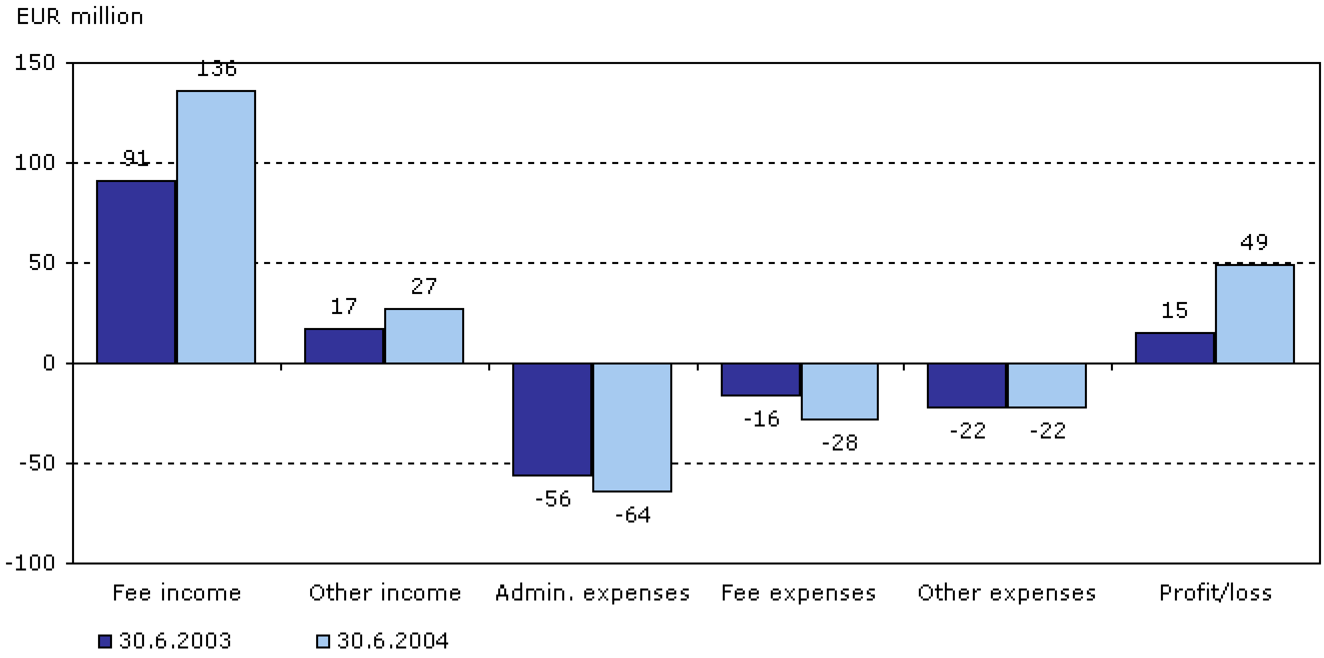
Investment firms' fee income June 2003 and June 2004



Please note! The division of fee income by business sector is indicative only. The division is not specifically outlined in any reporting requirements issued by the authorities.

Source: Financial Supervision Authority.

Investment firms' income and expenses June 2003 and June 2004



Source:Financial Supervision Authority.

For further information, please contact
Sirpa Joutsjoki, Financial Analyst, tel. +358 10 183 5205.

Level of non-performing assets continue to grow

The amount of Finnish banking groups' non-performing assets is low. In June 2004, non-performing assets amounted to EUR 438 million, which is 21.1% less than in the previous year. The quality of lending stock has improved slightly, on average, since non-performing assets' share of total exposures has decreased over the year since June 2003 to 0,4% (0,6%).

Non-performing assets' share of total exposures declined in all sectors

Non-performing assets' share of total exposures declined in all sectors. The decline was most notable in the non-resident sector. Non-performing assets' share of total exposures in the non-resident sector was 0.83% in June, compared with 1.25% in the previous year. Non-performing assets in the non-resident sector mainly arise from the problems of individual counterparties. Country risks related to particular states have not affected the amount of non-performing assets significantly.

Non-performing asset's share of total exposures decreased by about 0.15 percentage points from the previous year in both the corporate and household sectors. In June 2004, non-performing assets' share of total exposures was 0.42% and 0.47% in the corporate and household sectors respectively.

Loan losses accounted for a small share of total exposures

Finnish banking groups' net loan losses amounted to EUR 11 million in June. Net loan loss recoveries in the previous year accounted to EUR 7 million. Previous loan loss recoveries and compensations, as well as reversals of loan loss provisions, exceeded the then-recorded loan losses. By contrast, the share of gross loan losses of total exposures increased slightly, but was still very low, at 0.08%, compared with June 2003, when they accounted for 0.06% of total exposures.

The share of loan losses of total exposures increased slightly in the corporate sector

The share of loan losses in the corporate sector rose to 0.18% of total exposures in June, after being 0.09% in the previous year. The share of loan losses in the household sector remained broadly unchanged. By contrast, loan losses declined from 0.18% to 0.02% in the non-resident sector.

Finnish banking groups' credit risks have long been at a low level. Lending to household sector continues to grow at a brisk space, and competition is strong in the housing loan market in particular. As a result of strengthening economic growth, signs of recovery can also be seen in companies' propensity to invest.

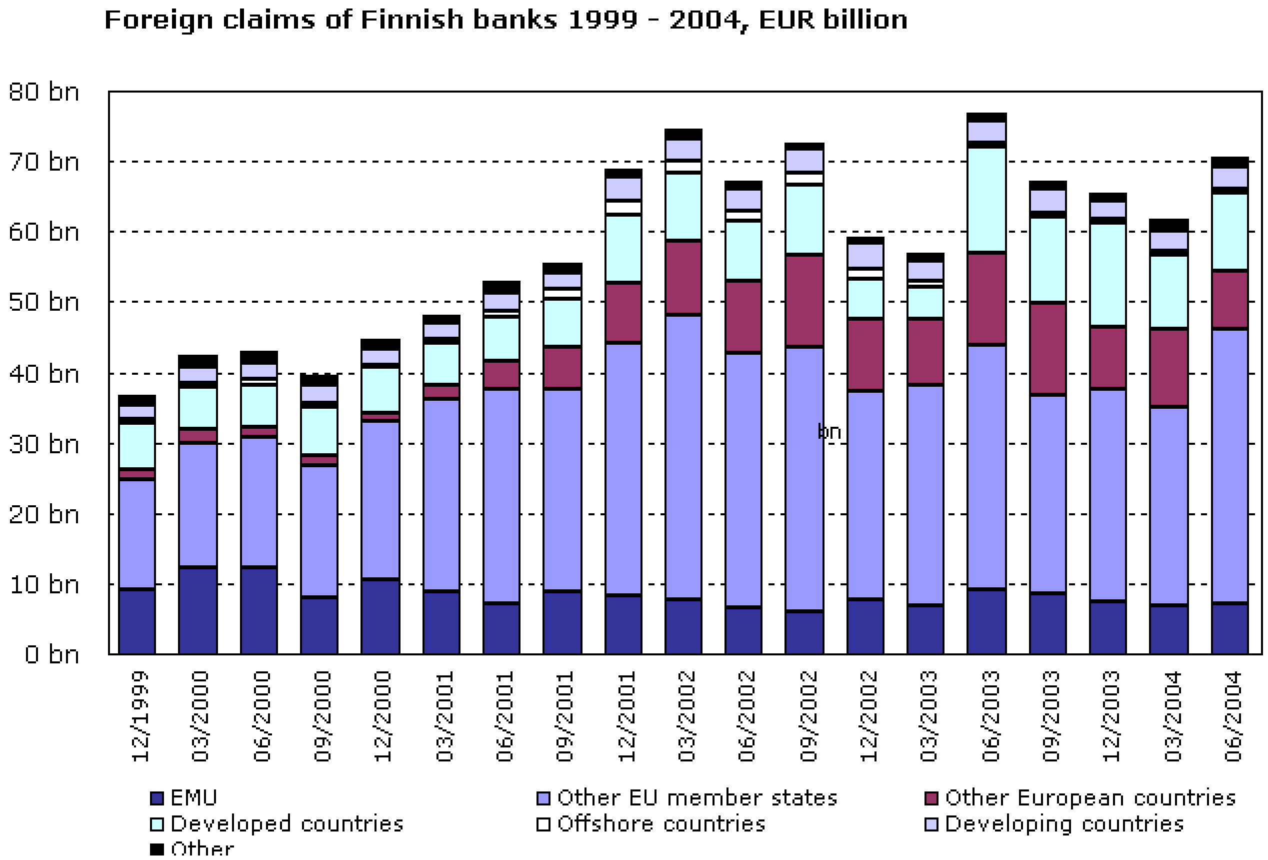
The strong growth of lending stock imposes high demands for the effective management of credit risk. During times of brisk loan competition, banks should not forget to follow their loan granting rules carefully, since the loosening of lending criteria increases the risk of exposure to loan losses in long term. The creditworthiness of the customer, sufficient ability to service the loan and collateral for loan are issues that do not allow room for flexibility even in times of strong loan competition.

Small claims on countries with low risk ratings

Finnish banks' foreign claims increased by 9.2% from the previous year. Foreign claims represented EUR 70.6 billion at the end of 2003 and EUR 77.1 billion at the end of June 2004. When claims on foreign branches operating in Finland are included, foreign claims totalled EUR 83.7 billion in June 2004.

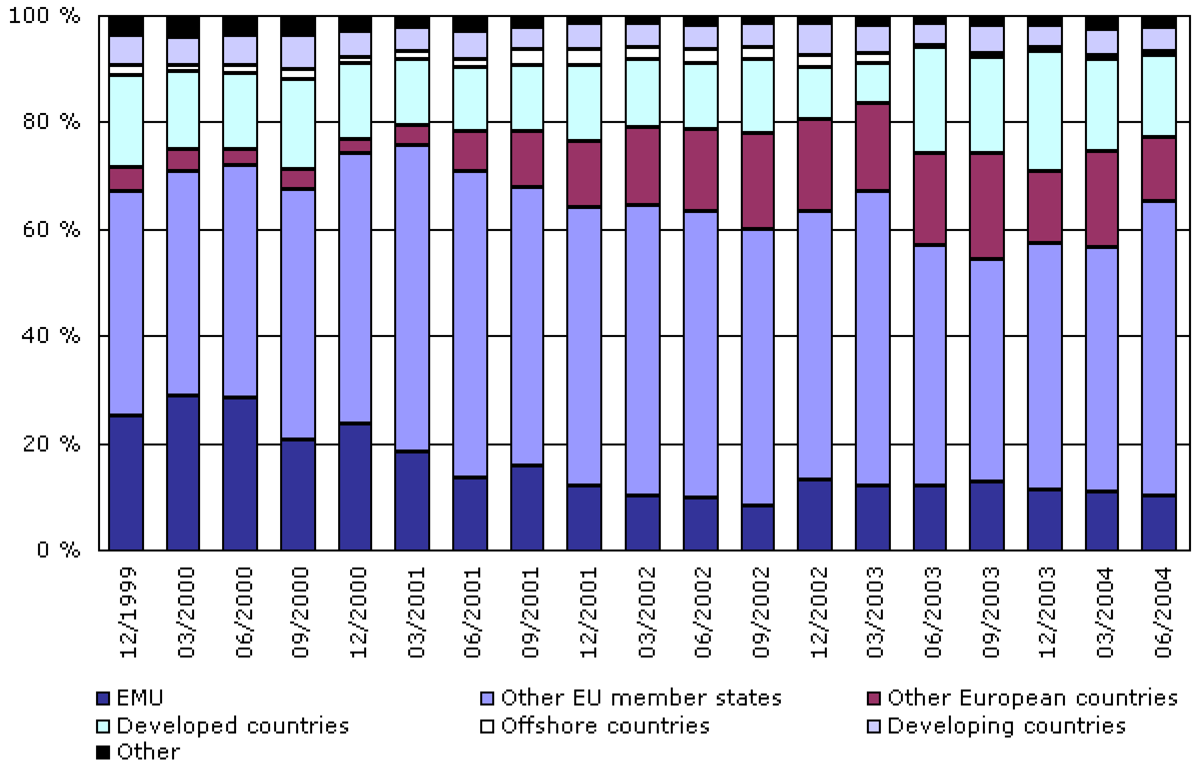
The breakdown of foreign claims by area has remained stable during the past few years. Banks' largest claims concern low-risk countries, ie countries rated as investment grade. Claims on high-risk countries, ie countries rated as speculative grade[1], accounted fro some 1% of foreign claim in June 2004. Approximately 65% of banks' foreign claims concern EU countries and 12% other European countries.

1) Credit rating BB or lower.



Source: Financial Supervision.

Foreign claims of Finnish banks by geographical area 1999 - 2004, %



Source: Financial Supervision Authority.

For further information on loan losses and non-performing assets, please contact
Tülin Bedretdin, Banking Supervisor, tel. +358 10 183 5429.

For further information on country risk, please contact
Banking Supervisors Peter Palmroos, tel. +358 10 183 5333, or Seppo Pitkänen, tel. +358 10 183 5376.

Banks' liquidity remained strong

Lending funded increasingly by market finance

Banks' aggregate balance sheet has grown by about 7% so far this year[1]. The growth was mainly due to an increase in lending and a growth of assets and liabilities between credit institutions. Lending has grown by 6.5% so far this year. In contrast, deposits at banks have shrunk by 1.2% over the same period. The proportion of deposits in the funding of lending has been decreasing for a long time. By the end of June, it had decreased to 80%.

The low level of interest rates has attracted depositors to alternative investments, and therefore banks have had to resort to more funding on market terms. Banks have funded their growing lending by issuing more bonds, certificates of deposit and commercial paper than last year. The value of bonds outstanding has increased by a third so far this year, to almost EUR 6 billion. The value of certificates of deposit has likewise grown by almost a third, to a good EUR 27 billion.

Banks' funding maturities lengthened somewhat since the amount of publicly issued bonds increased. Excluding deposits redeemable at notice, 40% of deposit banks' liabilities will fall due within a month, 66% within half a year and 73% within the year. Commercial banks' liabilities fall due faster than those of local banks. Two thirds of deposit banks' liabilities were euro-denominated.

1) The banking sector covers Finnish deposit banks (parent banks) and their branches (eQ Bank Ltd., Evli Bank Plc, Gyllenberg Private Bank Ltd, Nordea Bank Finland Plc, Sampo Bank Plc, The Mortgage Society of Finland, Tapiola Bank Ltd, the OKO Bank, local cooperative banks, savings banks, Aktia Sparbank Abp, Nooa Savings Bank Ltd, Skärgårdssparbanken Ab).

Deposit banks' aggregate liquidity position weakened but still remained strong

The measurement of financial risk is based on the difference of income and expenditure in each maturity class. The calculation also accounts for ex-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.

The liquidity position of the deposit banking sector weakened during the first half of the year. As regards individual banks, developments were mixed. In spite of lending growth, many deposit banks have displayed an improving liquidity position so far this year.

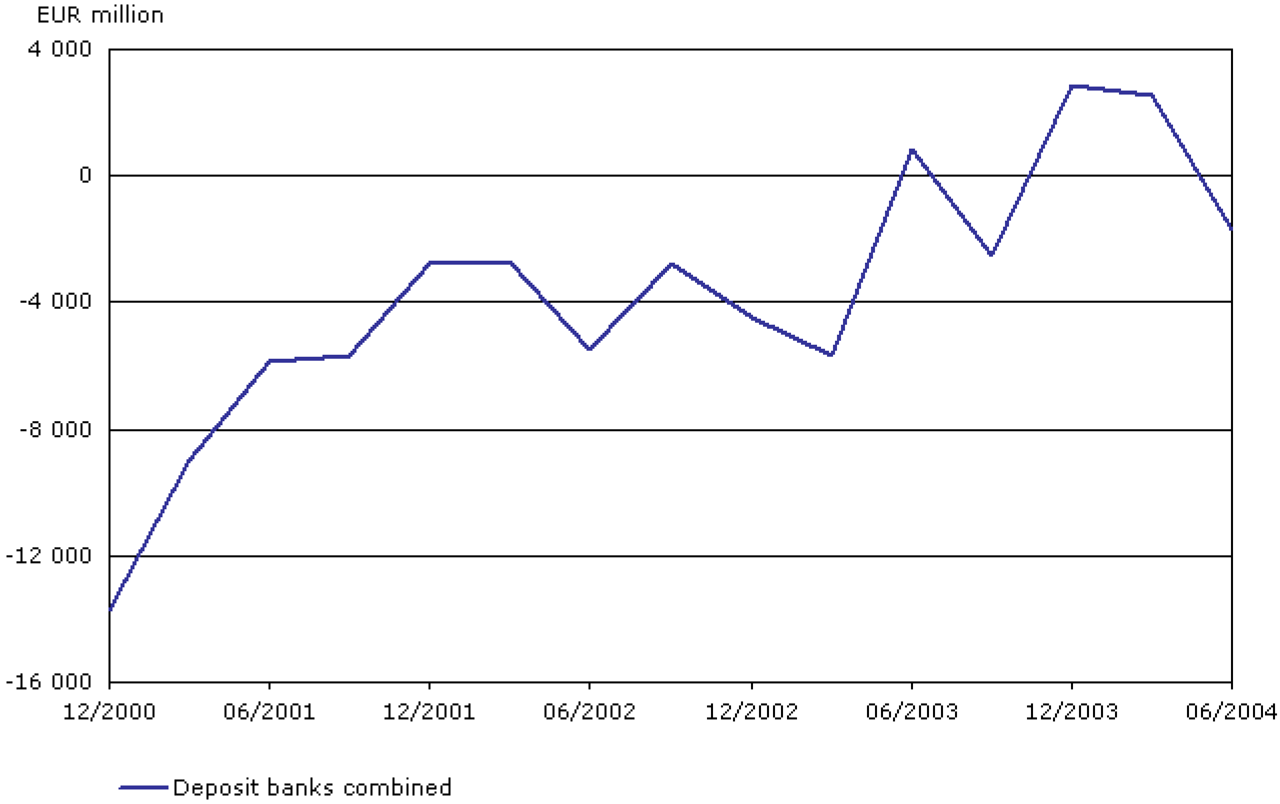
Banks' short-term, one-month funding deficit has fluctuated this year between a EUR 2 billion deficit and EUR 4 billion surplus. The aggregate one-month funding deficit stood at EUR 1.7 billion at the end of June, which amounts to about 1% of the deposit banks' aggregate balance sheet. Funding deficits appeared in the commercial banks, which utilise the money and capital markets in addition to deposits from the public for their business financing. In contrast, local banking groups continued to run financial positions in surplus.

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 June, banks had the same amount of certificates of deposit eligible to central-bank financing as at last year-end, that is, EUR 5.9 billion[2]. Also the amount of other money and capital market certificates held by the banks was the same as at last year end, that is, about EUR 5 billion.

Hence the liquidity position of deposit banks is strong. Banks have been able to renew their expiring financing and their certificates of deposits eligible for central-bank financing alone could cover the funding deficits of one month.

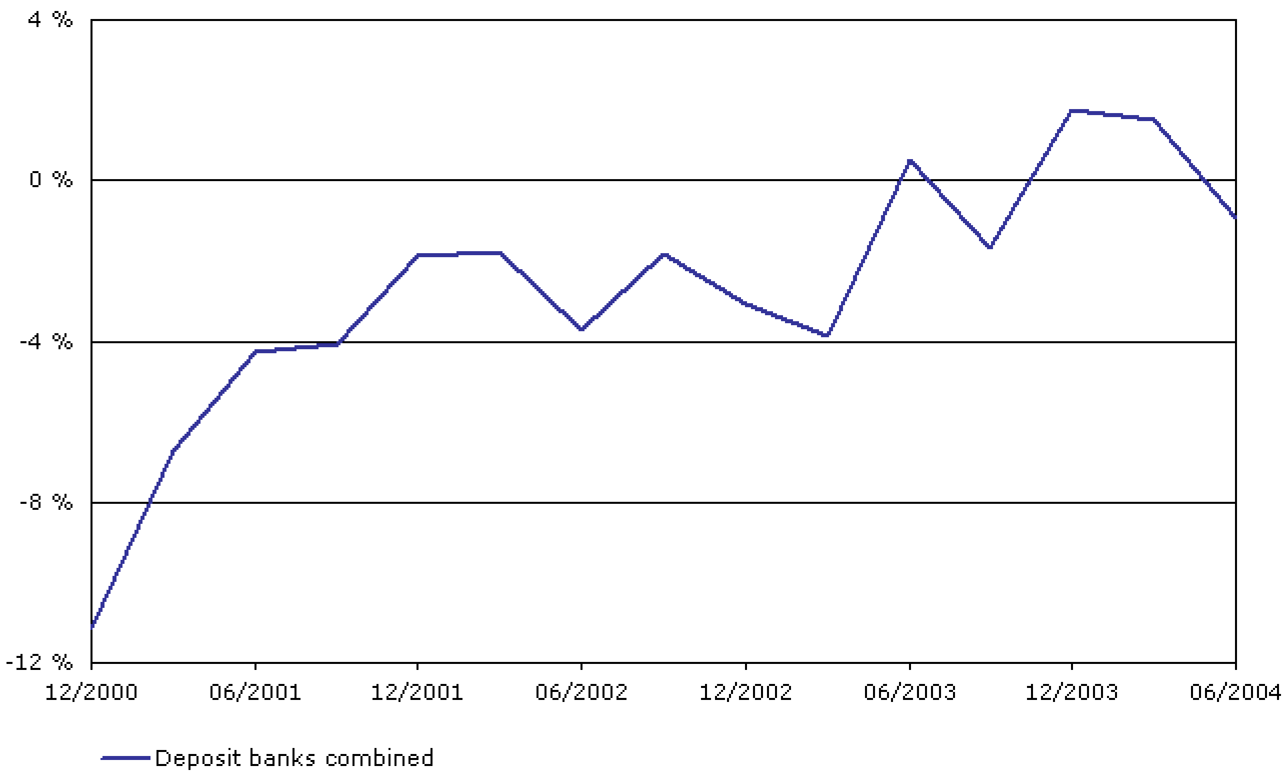
2) This figure is only approximate since official reporting contains no information on the use of eligible assets. The reporting does not specify how much of the securities is for instance lent against collateral and how much of the securities placed as collateral with the central bank are used as collateral for open-market operations and the payment system facility.

Deposit banks' one-month funding deficit



Source: Financial Supervision Authority.

Deposit banks' one-month funding deficit as a percentage of balance sheet



Source: Financial Supervision Authority.

For further information, please contact
Meri Rimmanen, Banking Supervisor, tel. +358 10 183 5379.

Banks' interest rate risk increased

Banks' financial account shows slightly higher income risk

The interest rate risk measure of the Financial Supervision Authority (FSA) shows that Finnish deposit banks' potential income risk has increased slightly. The income risk caused by an interest rate change of one percentage point would currently account for 17.8% of net income from financial operations, or EUR 393 million, compared to 14.6% or EUR 324 million at the end of 2003. Hence, an interest rate increase would improve banks' earnings by EUR 393 million. However, an interest rate change of one percentage point, as used in the calculations, will not materialise for a while, even though expectations of a rise in interest rates have generally strengthened.

The income risk described above is a measure of the effect of market rate changes on net income from financial operations. However, the most important factor affecting net interest income is the lending margin charged by banks. The size of the margin depends for example on competition in the banking sector, the overall economic situation, borrowers' ability to service their loans and the collateral used. Interest rate margins were at a record low at the end of June 2004.

Investment risk of the trading book has declined

There has been a decline in the combined investment risk of bonds and related interest rate derivatives held in the trading book. A weakening of market values as a result of an interest rate fall of one percentage point would currently amount to EUR 32.7 million. The investment risk has diminished since the end of 2003, when a rise in interest rates would have caused a loss of EUR 128.6 million to banks. Thus, banks' combined trading book operates at a loss when interest rates rise, as opposed to the behaviour of net income from financial operations.

The lower investment risk of the trading book is due to a smaller amount of bonds and a more effective hedging of the trading book via derivatives.

Investment risk of the financial account has remained unchanged

The investment risk of bonds recorded in the financial account is a measure of the effect of changes in the market values of bonds and related derivatives. The effect of an interest rate increase of one percentage point would have been EUR -41.4 million at the end of June, being only EUR 0.1 million higher at the end of 2003. A fall in market values would equal 2% of net interest income.

For further information, please contact
Peter Palmroos, Banking Supervisor, tel. +358 10 183 5333.

Banks' derivates trading picked up

Derivatives trading by Finnish deposit banks have shown signs of increased activity, recently. The ratio of the underlying asset of derivatives to the balance sheet total has clearly growth in comparison to the pattern prevailing three years ago. Improved customer business, protection from interest rate risk and the need for protection that arises from the acquisition of funds with embedded derivatives have all been contributing factors to the growth experienced.

Increase in counterparty risk reduced by netting agreements

Counterparty exposure of non-standardised derivatives relative to own funds clearly varies from one banking group to another. The generalisation of bilateral netting agreements and their being taken into account in the statement on capital adequacy of the derivatives have significantly reduced credit exposure counterparty risk in the statement on capital adequacy.

Derivatives have traditionally been used in the management of market risk and recently the use of credit derivatives in the management of credit risk has been on the increase. The risk management of various types of market risk, i.e. those related to interest, foreign exchange, securities and commodities has been managed through the application of futures and forwards, swap and option contracts. Contracts are made as bilaterally over the counter or on the derivatives exchanges. Taking up use of new types of derivatives requires, for example, derivative pricing models, accounting practices and capital adequacy calculations and the carefully analysis of the related credit, market and operational risks.

Eight Finnish deposit banks or branches of foreign credit institutions have a total of over one million euro in currency forwards, in terms of the nominal value of the underlying asset. For the purpose of this assessment, the forward leg of a currency swap is included in the term currency forward. Typically of currency forwards, approximately two thirds mature within three months. Four of the reporting institutions reported having currency options valued at over one million euro in terms of the nominal value of the underlying asset. Currency options, with their short maturity terms, are applied to currency risk management, as the contract stock matures almost completely within three months.

A majority of currency swaps or cross-currency interest rate swaps are made with foreign counterparties.

Changeover to euro almost eliminated use of interest rate derivatives

The changeover to the euro and the consequent closing of the markka-denominated bond market on 1 January 1999 reduced the number of forward rate agreements used in the management of short term interest rate risks. For example, by the end of March 2003, the total nominal value of the underlying assets was no longer more than EUR 800 million, whereas it had been as much as EUR 190 billion at the beginning of 1999. However, the use of forward rate agreements has become noticeably more common since March 2003.

A majority of interest rate swaps have been entered in the trading book. Interest rate swaps are also used in the management of the financial account for both hedging against interest rate risk on bond issue and protection of the banking book as a whole. The increase in index-linked bonds and deposits has, in turn, increased the associated hedging requirements ofp embedded options.

Credit derivatives operations have been initiated by Finnish deposit banks. The most typically used instruments are credit default swaps. The agreements are only made with foreign counterparties as a domestic market for credit derivatives does not yet exist.

For further details, please contact
Veli-Jukka Lehtonen, banking supervisor, tel. +358 10 183 5373.

Reporting of off-balance sheet committments under renewal

Finnish deposit banks, their foreign branches and the branches of foreign credit institutions involved in deposit banking in Finland all fall under the requirement for the reporting of off-balance sheet commitments. Recent structural changes have caused intense concentration in deposit banks derivatives operations. Due to this shift the Financial Supervision Authority has not published aggregate details of the nominal underlying value of derivatives, since 2002.

The classifications concerning off-balance sheet commitments statistics are those established by the joint project group of the FSA, Bank of Finland and Statistics Finland, and have been in use in their present format since 1997. The reporting system, which is to undergo renewal this autumn, will see changes in reporting frequency. This will be changed to being required only quarterly, while reporting of undrawn commitments and credit derivatives has been more closely itemised.