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Sound economic situation for supervised entities

Supervised entities have been operating in a favourable economic environment. Lively demand for household lending and a positive tone to the securities market boosted the income of banks and investment firms. Banks' capital position improved. Capital adequacy remained sound and capital buffers were strengthened. The quality of the banks' credit portfolios is high although small signs of an increasing risk of loan losses have been detected. Banks are advised to prepare for such risks and ensure their capital adequacy over the long term. Also evaluation of risk bearing capacity in the face of unforeseen weakening of the economic position is essential. Development of risk management is still a challenge to banks, in order that they satisfactorily meet the readiness requirements of Basel II.

Favourable growth prospects overshadowed by long-term macroeconomic risks

There are no major risks in sight in the economic operating environment of supervised entities in the short term. Favourable economic growth is forecast to continue over the next three years. In the longer term, there are risks associated with the macroeconomic development, which if they materialise, will have an unfavourable effect on the operating environment of supervised entities.

European Central Bank weighing towards interest rate hikes

The ECB has raised its key rate twice within a short period of time. The rate hikes were primarily justified by the preservation of price stability. Market rates began to rise before the ECB rate hike.

Stock exchange year 2005 better than expected

Excess liquidity in the financial markets, the low level of interest rates and increases in corporate profits have supported stock trading activity on a global scale. Also in the Helsinki Stock Exchange, stock prices rose more than the markets expected, during 2005.

Banks have been funding their lending growth by issuance of bonds

The European bond market has developed extremely rapidly in the early 2000s, measured both in terms of market size and product range. Bond financing by Finnish financial institutions has increased, while the outstanding stock of bonds issued by Finnish enterprises has remained virtually unchanged.

Demand for credit remained strong

Households' demand for housing loans rose to a record high in 2005. The demand for consumer credit was also buoyant. By contrast, the demand for corporate loans weakened and it is not likely to pick up this year either.

Rich profits for banks in 2005

The strong profits for deposit banks continued in 2005. Profitability remained good, as growth in operating profits almost held pace with the growth in volumes of outstanding loans. Efficiency in terms of cost/income ratio improved as well, especially as income increased significantly. In particular, fee and commission income from asset management and growth in other household loans with better margin than housing loans raised the profits. Costs did not increase much.

Banking sector capital adequacy remained strong despite some deterioration

Capital adequacy in the banking sector remained strong, although it deteriorated slightly. Favourable financial performance and measurement of financial assets at fair value strengthened own funds. In contrast, the growth in the stock of lending increased the amount of risk-weighted items, and as a result the capital adequacy deteriorated. FIN-FSA has become more rigorous in its interpretation of the maximum amount of capital loans.

Investment firms' favourable financial performance continued

A favourable operating environment contributed to investment firms' positive financial performance in 2005. The competition in securities broking tightened further, but the growth in exchange of securities still kept fee and commission income growing. Fees and commissions for asset management services also increased, but somewhat more moderately than the previous year.

Lending quality high, but housing market risks have increased

Flexible collateral arrangements, longer maturities and record narrow margins indicate the tightening competition in housing loans. Inspection findings support the view that very narrow margins and flexible loan criteria seem to be a general trend. Housing market risks have increased over the long term. Banks should apply good risk management principles and methods in order to ensure sufficient, long-term preparation for risk. At present the lending quality is exceptionally high, when calculated from the share that nonperforming assets and impairment losses represent of the stock of lending.

Deposit banks' liquidity deteriorated somewhat

Growth of deposits stepped up, but the share of market-based financing also continued to increase. Banks increasingly financed housing loans via mortgage bonds.

Slight increase in banks' interest rate risks

Finnish deposit banks' total income risk increased from the end of June 2005, totalling EUR 318 million at the end of December. This was mainly due to the increase in maturity imbalances between receivables and debts of derivatives. The total investment risk of trading books also heightened. This was mainly due to changes in the maturity structure of banks' derivatives positions.

Sound economic situation for supervised entities

The economic environment in which the supervised entities have been operating has been favourable in that the Finnish economy has grown faster, on average, last year than the euro area overall. Production growth is expected to slow somewhat in the coming years. The world economy also continues to growth, albeit at a slightly slower rate than before.

The updated capital adequacy requirements due to come into force from the beginning of next year (Basel II), have initiated challenging risk management development projects within the supervised entities. Credit institutions and investment firms are currently involved in developing minimum capital requirements calculations, reporting and their internal capital adequacy assessment process (ICAAP).

A particularly challenging development faces those banks planning to implement advanced credit risk models (Internal Ratings Based Approach IRBA) soon after the coming into force of the new regulations. Banks have to be able to improve their own risk management systems, bringing them suitably up to the standards required by the IRBA.

Upward trend in lending and securities markets boosts income

Robust demand for lending and an upward trend in the stock markets has created good earning opportunities for supervised entities. The rapid growth in lending improved banking groups' net interest income, despite a narrowing of interest rate margins. Meanwhile, an increase in demand for savings and investment products has boosted fee income. There has been an improvement in bank groups' cost efficiency over the previous year as income levels grew while expenses were kept as before or increased by a relatively small amount.

Trading on the Helsinki Stock exchange has clearly increased over the year and the all-share index was up by 31%. The public's keen interest in fund investments continued and mutual fund assets grew 41%. Banks and investment firms have been actively marketing their savings and investment products and have thereby shown improvements in the income derived from that source.

Capital adequacy suitably proportionate to risks

Banks and investment firms own funds were up and the capital buffer was strengthened. However, rapid growth in lending led to a slight weakening in banks' capital adequacy ratios. Despite which, Finnish banks' capital adequacy remains better than the average seen elsewhere the euro area.

The quality of the banks' credit portfolio has remained high, although gross impairment losses (loan losses) show signs of a slight increase. Interest and exchange rate risks are down and do not pose a threat to banks' capital adequacy.

Due to the rapid growth in lending banks are increasingly financing their operations through market funding. This shift in the banks' refinancing structure tends to make some banks susceptible a little sooner than before to structural financial risks. Overall, banks have reduced their real estate holdings. Despite this, price risks in the property market have an indirect effect on banks, where property is used as collateral for loans. The market value of banks' share portfolio grew as a result of the upward movement of the stock exchange and the associated risks to the banks, in relation to their own funds, increased somewhat.

Risks increased in the long term – adequate risk management essential

Due to the high level of demand for lending and a tightening of competition credit criteria continued to loosen. This will lead to loan loss risk in the future. The tough competitive environment has also reduced credit margins which threaten to be too narrow in the long run, as far as viability and risk are concerned. When competition is tight it is essential neither to give way on the principles of sound risk management and practise nor to slack on collateral requirements for loans.

Housing loans increased in 2005 by as much as 16.7%. This reflects a clear rise in household indebtedness and means that some households may be over-indebted. There are no indications, in the short term, of significant threats to macroeconomic development which could weaken households' debt servicing capacity overall and thereby add to banks' loan losses. In the long term, the growth in household disposable income could slow down, which – were it to be realised – would cause problems to over-indebted households. In addition to this, a substantial plunge in housing prices would weaken the value of housing loan collateral and add to banks' credit risks.

According to stress tests undertaken by the FIN-FSA, the larger banking groups' capital adequacy would not be directly threatened by a significant rise in interest rates, a substantial drop in asset prices or impairment losses. When planning against future risks, it important to take into account the fact that change in the economy's many variables can weaken simultaneously, leading to interdependent risks bearing down on the banks.

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Favourable growth prospects overshadowed by long-term macroeconomic risks

The Bank of Finland projects that the Finnish economy will grow by 3.4% in 2006, 3.0% in 2007 and 2.8% in 2008. In 2005, GDP growth was weaker than expected, only 2.1%, which was due to the strike in the paper industry witnessed in the spring and summer months.

Despite the downturn, the Finnish economy has grown at a faster pace than the euro area on average. However, during the past few years economic growth in Finland has been clearly weaker than towards the end of the past decade. In the longer term, economic growth is projected to slow in response to the ageing of the population. According to an EU report, future economic growth in Europe is expected to average 1.5%. After 2015, economic growth will be solely reliant on an increase in productivity[1].

Sources: Bank of Finland, Eurostat, Statistics Finland.

World economic growth faster than European economic growth

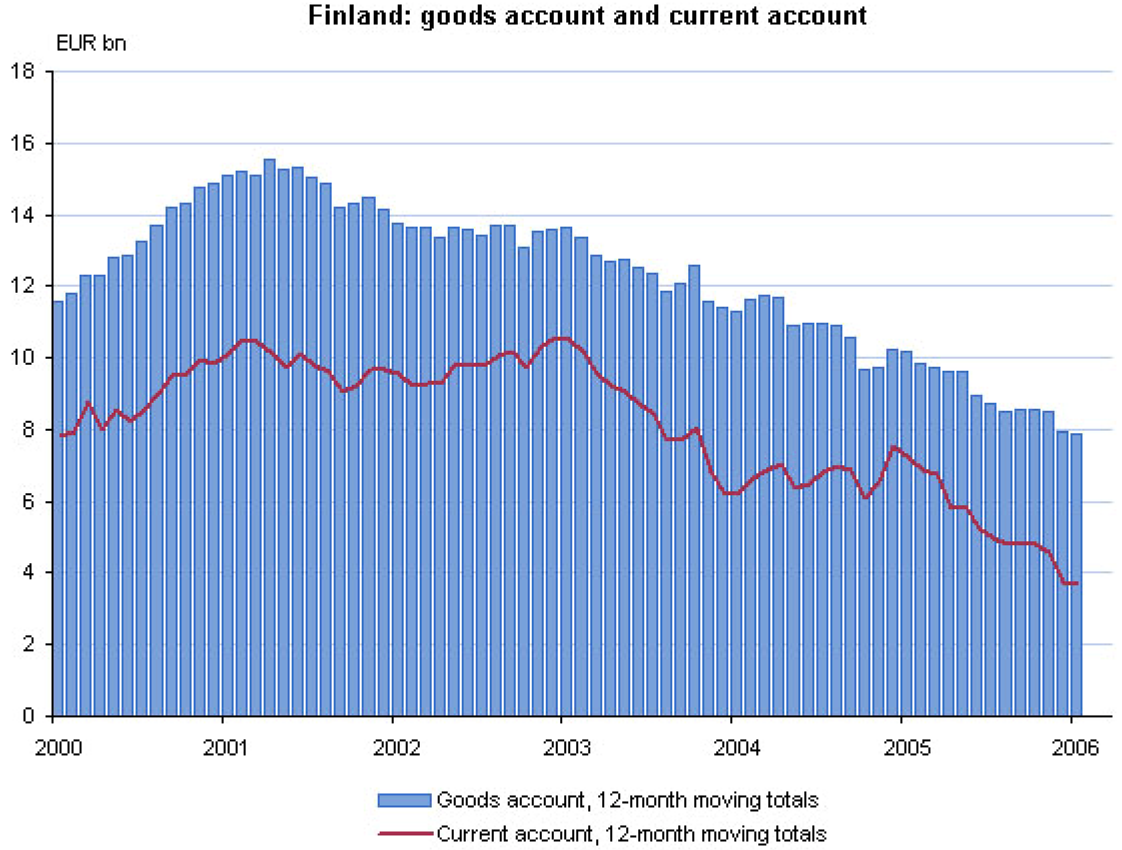
While the world economy has expanded at a rapid pace, economic growth in Europe is floundering. The euro area has been expected to recover and the economic development in Germany has been particularly closely monitored. So far, the growth figures for the European economy lag behind those foreseen, although factors supporting growth are in place – the world economy is currently experiencing a boom, exports are thriving and the level of interest rates is low. There are forecasts showing that European GDP growth would, however, be clearly faster this year than in 2005.

The world economy is forecast to continue to grow in the near future, as well, albeit at a slightly slower pace. US economic growth slackened somewhat in 2005 already, whereas the economic development in Japan produced a positive surprise. According to the Bank of Finland's forecast, the world economy will grow at a rate of 4.3% this year, the annual growth rate slowing down to 4.0% over the next two years.

Finnish economic growth based on private consumption

Although economic growth in Finland has been above the European average, its dependence on private consumption has been a problem. The low level of productive investments has aroused general concern.

Industrial production in Finland declined in the course of 2005 and Finland has also lost some ground in export markets. The current-account and trade surpluses are disappearing. In its forecast, the Bank of Finland warns against too strong reliance of economic growth on private consumption and against the Finns entertaining too high expectations of future growth. The growing indebtedness of private households involves a higher risk for the savings ratio to rise steeply and domestic demand to shrink in a context of higher interest rates, deteriorating economic situation and falling property prices[2].



Source: Bank of Finland.

Are Finnish investments adequate and appropriately targeted?

Key concerns in terms of future economic growth are whether the investments of Finnish companies are sufficient to maintain or even raise productivity to meet the future expenses of the national economy and whether there is a structural change in progress involving redirection of industrial investment abroad and diversion of national investment to other sectors of the industry and to immaterial input.

Investments in machinery and equipment are projected to increase in the near future. The volume of investments is growing for the very reason that companies must renew their outdated production capacity. However, the main export sectors are increasingly investing abroad. The domestic investments are replacement investments and the production capacity of the manufacturing industry is not expected to grow significantly in the future.

According to a study undertaken by the Research Institute of the Finnish Economy, ETLA, the assessment of corporate investment should not focus too much attention on traditional measures of investment as they may give a misleading picture. The major drawback of traditional investment statistics is that they do not include R&D expenditure. For example, the investment ratio of the manufacturing industry declined from an average of 25% in the 1970s and 1980s to 11% in this century. Including R&D expenditure, the investment ratio has varied between 20% and 25%, with no downtrend in sight. The industrial production capacity has increased despite the decline in the traditional investment ratio[3].

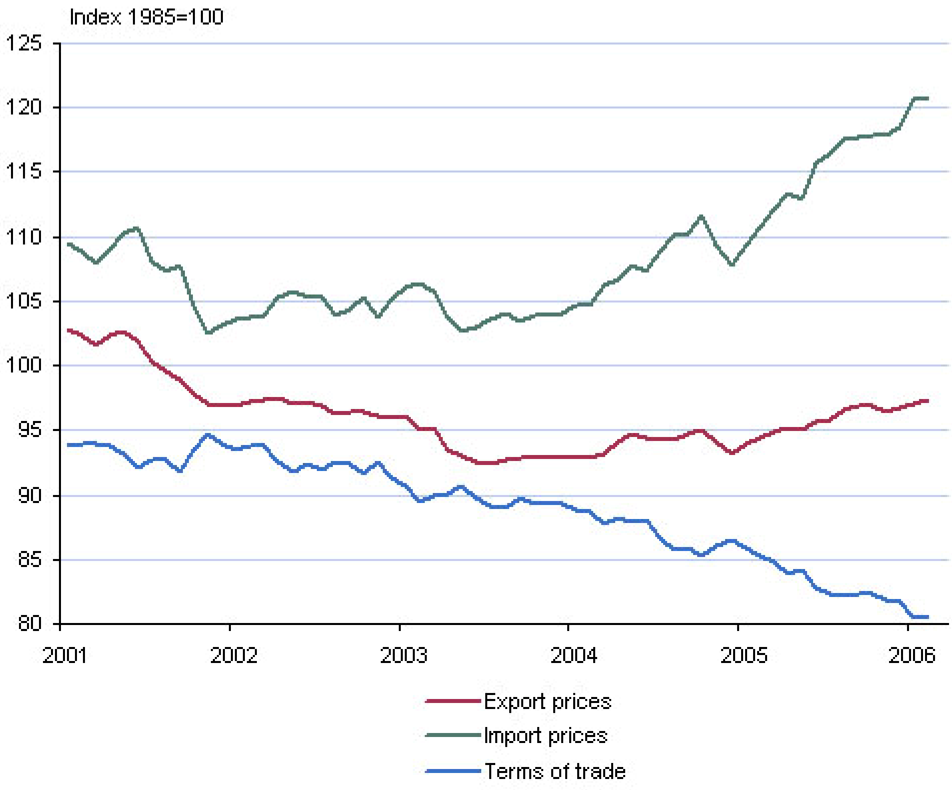
The Bank of Finland's study, however, points to the problem of the high concentration of R&D spending in one sector of industry, ie electronics. Excluding electronics, industry's investment ratio has declined, even when taking R&D expenditure into account. It would also seem that the IT investments of other industrial sectors have lagged behind those of the leading countries[4].

Exports are growing, while terms of trade are deteriorating

The proportion of Finnish exports accounted for by the EU has declined in step with an increase in trade with countries outside Europe. As expected, Finnish exports to oil producing countries have increased, with exports to Russia in particular growing significantly in the course of 2005. Russia has become the most important receiver of export, currently accounting for 11% of Finnish exports[5]. Projected world economic growth will contribute to favourable developments in exports in the near future. Finland's geographical position as the neighbouring country to Russia is likely to further boost exports to Russia.

Despite the growth of exports, Finland's balance of trade, however, started to decline as imports have grown faster than exports. Higher prices for energy and other raw materials have had a dramatic effect on the increase in the value of imports.

Finland's foreign trade: export prices, import prices and terms of trade



Source: Statistics Finland.

The terms of trade are not expected to improve rapidly as Finnish exports are based on products the market of which is characterised by very strong competition. The relocation of production facilities abroad is undertaken to generate savings in the market for production costs with price as the only factor of competition.

The Finnish labour market situation will deteriorate in the future if productivity enhancing investments or new investments does not grow and relocation of production abroad continues. The decline in the number of industrial jobs is expected to halt temporarily during 2006 but continue again in 2007. The rate of employment has increased especially in services and construction. The increase in the employment rate has also been largely related to an expansion of part-time and fixed-term employment.

Economic growth creates good operating conditions for banks

The boom creates a solid basis for banks' and other financial market companies' operations in the near future. For several years already, banks have focused on the development of household lending and savings products. For the sake of firms' sound profitability and a low level of investments, the demand for external finance has, however, been small and there are still no signs of corporate demand for credit picking up. The stock of corporate lending has been steadily growing during the past couple of years, at an annual rate of approximately 8%.

Households' demand for credit has increased at a faster rate than corporate borrowing. Growth is expected to continue but at a somewhat slower rate than before in response to the higher interest rates. Consumer confidence is high and households' debt ratio has not yet reached an unsustainable level, by international comparison. The demand for savings products is also growing in step with the growth in general prosperity. Excessive indebtedness is likely to be a problem for individual households, although problems may also arise regionally in response to structural changes in the industry. The longer-term international and national macroeconomic development is, however, associated with risks which, if they materialise, will influence growth in credit demand and the volume of loan losses.

1) Report by the EU Economic Policy Committee on the financial implications of an ageing population in EU member states.
2) Bank of Finland Bulletin 3/2005.
3) The Research Institute of the Finnish Economy: International Economic Outlook 1/2006.
4) Bank of Finland: Bank of Finland Bulletin 1/2006.
5) Customs: Monthly review of foreign trade 12/2005.

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European Central Bank weighing towards interest rate hikes

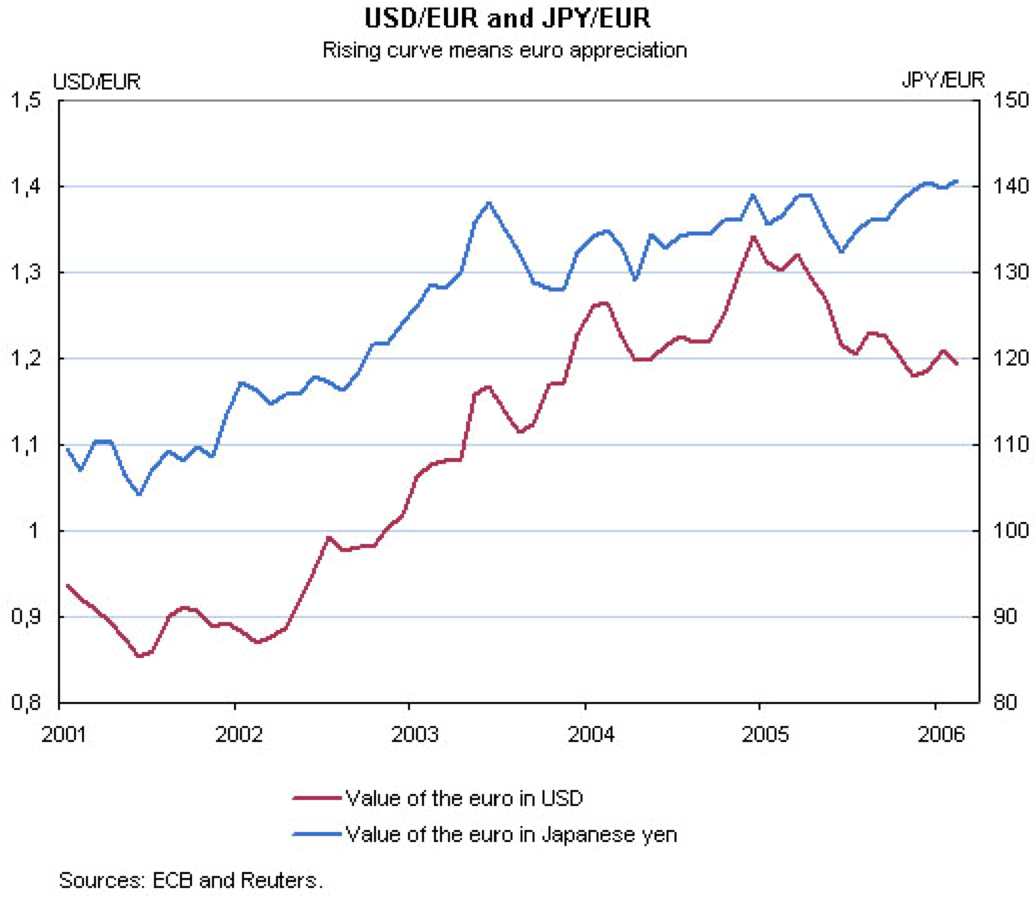
The European Central Bank (ECB) has raised its key rate twice within a short period of time in accordance with market expectations. In March, with the second rate hike, the interest rate used in the main refinancing operation increased to 2.5%. Although the ECB justified the rate hike primarily with the preservation of price stability, the hike is also likely a reaction to the increase in house prices and private borrowing.

The upper limit of price stability is 2%, and the euro area consumer price index has been slightly above that limit. Oil price has not so far boosted the prices of other goods even though production costs are exceptionally high. However, there is a risk that as economic growth picks up, prices tend to be more flexible to the upside. Rate hikes are not likely to end at this point if there is a threat of inflation in sight and if economic growth allows for rate hikes.

Monetary policies also tightened in US and Japan

The Fed raised its policy rate steadily during the whole year and the interest rate spread against Europe grew by 2 percentage points. At the end of March 2006, the Fed Funds rate stood at 4.75%. As a consequence of the interest rate spread, the dollar appreciated against the euro. The exchange rate of the dollar was also supported by stronger economic growth in the US in comparison with Europe. In 2006, the dollar is no longer expected to appreciate against the euro.

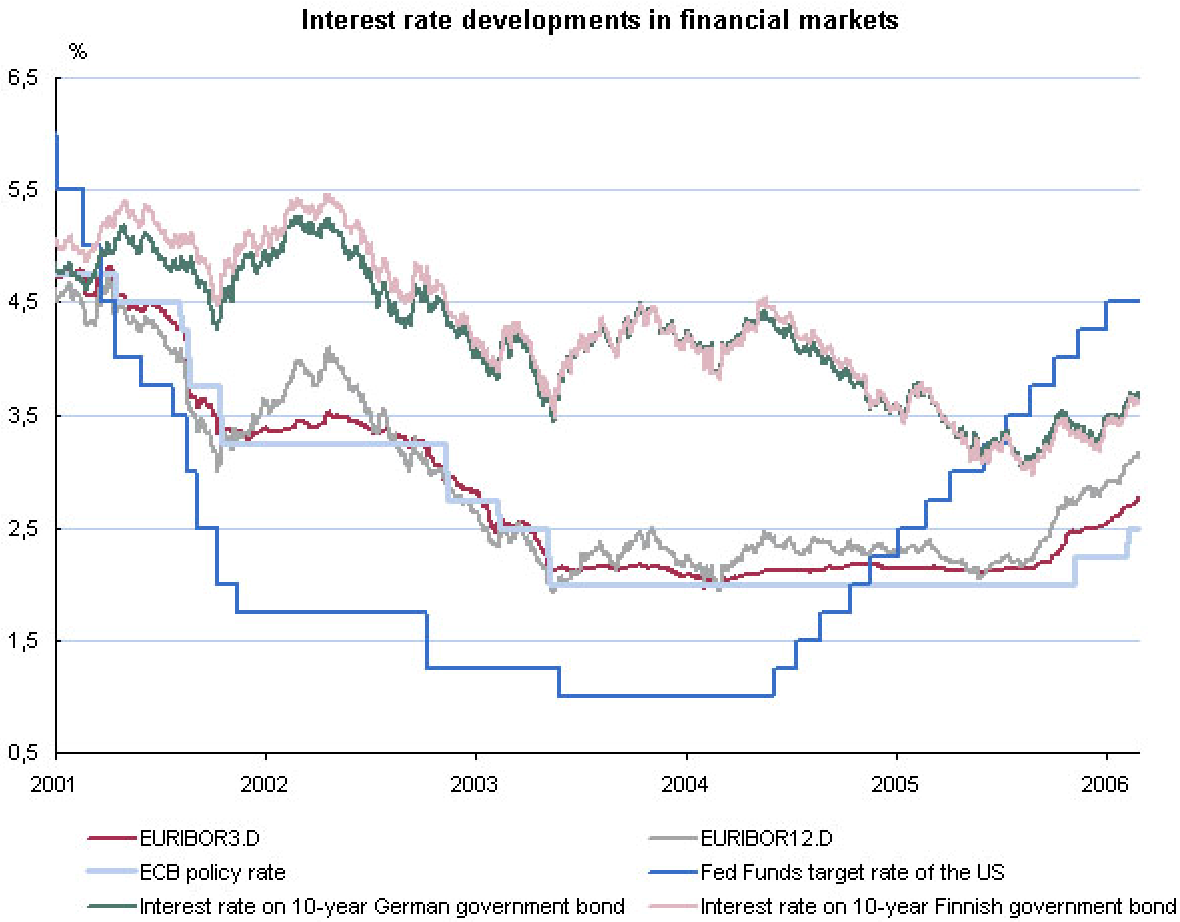
The Japanese central bank is also steering its monetary policy stance towards being less expansive. Economic growth in Japan has taken off, and rate hike expectations are consequently strengthening. However, markets are only expecting a slight increase in the level of interest rates. Depreciation of the yen against both the euro and the dollar has supported Japanese exports.



Market rates began to rise towards end of 2005

Euribor rates and long-term market rates began to rise towards the end of 2005 even before the ECB rate hike. Euribor rates have now risen from their lowest level in 2005 by about 0.5–1.0 percentage points, and in March 2006, the 12-month Euribor rate was already above 3%.

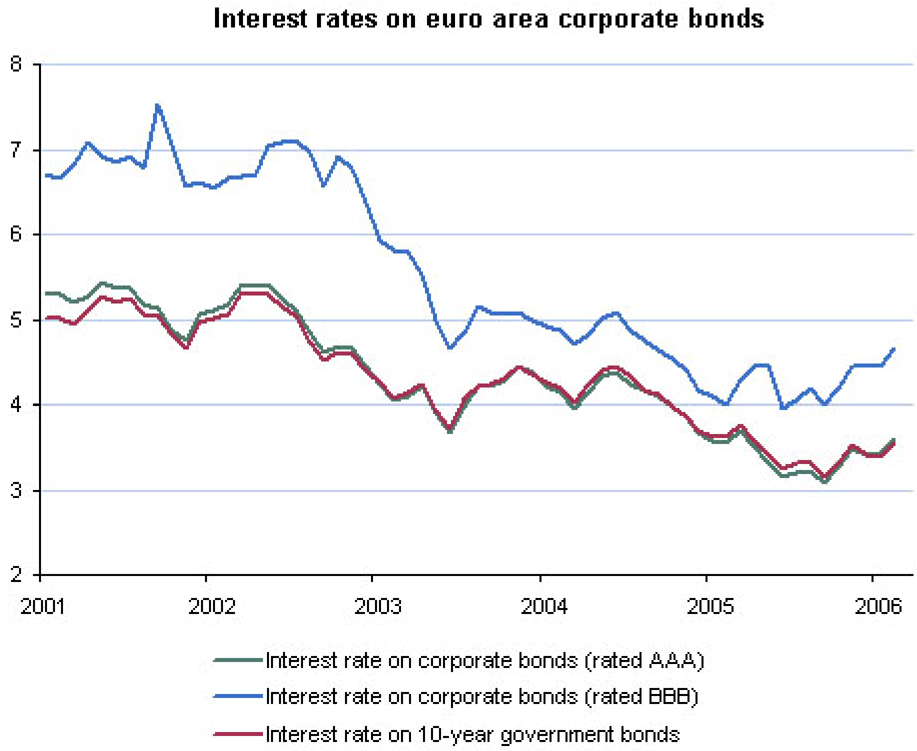
The yield curve has become shallower. For example, the interest rate on the Finnish 10-year government bond was in March 2006 only one percentage point higher than short Euribor rates. A level yield curve generally predicts a slowdown in economic growth. On the other hand, ample liquidity in the financial markets and over-demand for securities lower the rates on long-term papers.



Sources: Bloomberg, Reuters and ECB

Yield spreads on euro area corporate bonds have broadened in 2005. For example, the interest rate spread between corporate bonds rated AAA and BBB was about half a percentage point at the lowest. At the beginning of this year, the interest rate spread was at the level of about one percentage point.

Risk premia on corporate bonds are considered to have been too low, and difficulties of individual companies have gradually started to contribute to a broadening of risk premia. Markets have also financed long-term investments with short-term, low-interest loans. Rate hikes by central banks may lead to the unwinding of such investments, which would lower the prices of securities and increase long-term interest rates.



Sources: Merrill Lynch and the ECB.

Real interest rates still at historic lows

Real interest rates have been historically low. Even after the rate hikes by the ECB, the real interest rate, after tax, for example on a housing loan is about one percentage point. Therefore, the current level of interest rates should not have an impact on the demand for housing loans, but it could lead to a shift in the atmosphere. In the best case, the rise of interest rates contains housing markets, and housing prices stabilise.

So far, interest rate increases have not been so significant that they could be expected to have a material effect on the debt-servicing ability of housing borrowers and thus increase banks' credit losses. The slight increase in market rates has a positive impact on banks' net interest income.

In the near future, the European Central Bank will have to weigh between price stability and economic growth. Since the euro area inflation has not accelerated, rate hikes by the central bank will likely be moderate. The rising trend of interest rates will however strengthen since the markets are expecting an increase in the exceptionally low interest rates. According to forecasts and market expectations, however, interest rates would remain relatively low.

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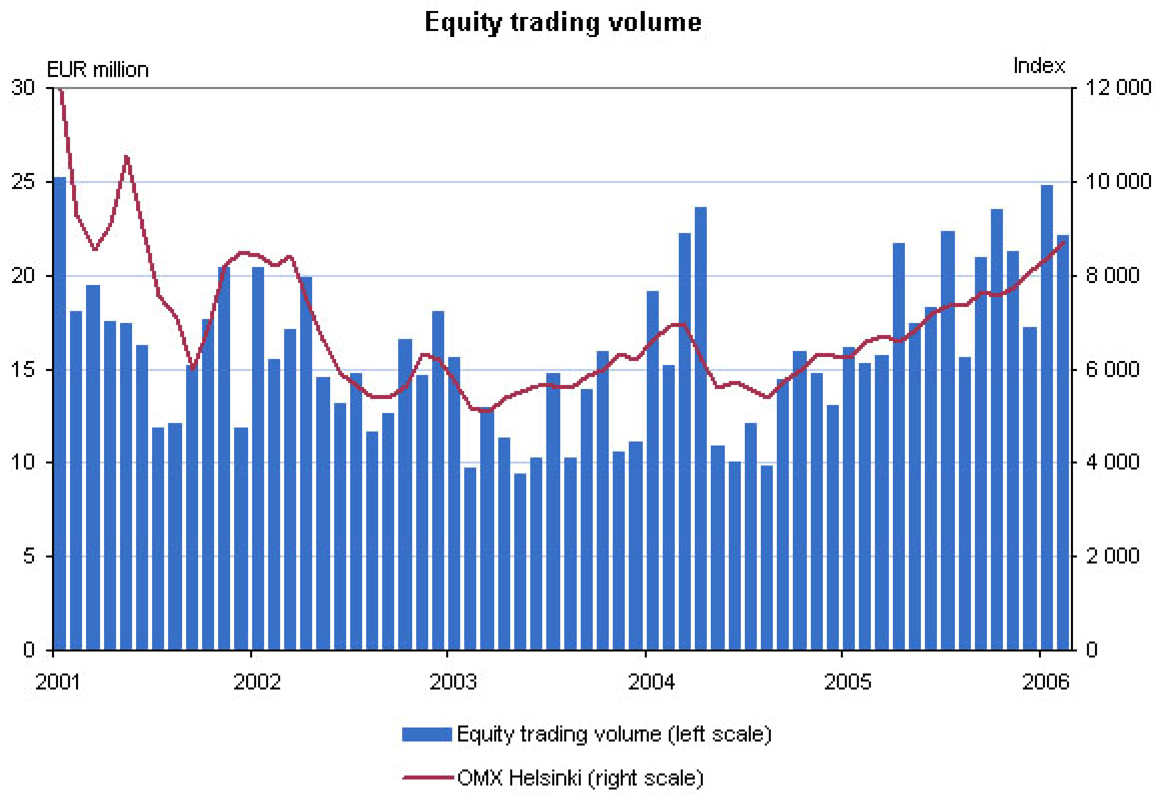
Stock exchange year 2005 better than expected

Trading volume in the Helsinki Stock Exchange rose by 24% in 2005, market value by 27% and the all-share index by 31%. Although trading volume was as high as in the record year 2000, the market value of the stock exchange has not, quite understandably, reached the levels of 2000 boosted by the technology boom. However, the all-share index rose considerably, much more than expected in the markets.

Finnish equities more expensive than European equities

Excess liquidity in the financial markets, the low level of interest rates and increases in corporate profits have supported stock trading activity on a global scale. Prices of Finnish equities measured by the P/E ratio are now higher than for example in Europe or the United States. In Finland, equities are now trading at about 16 times and in Europe about 13 time's earnings forecasts.[1] The high P/E ratios of Finnish equities may be a sign of overheating in the stock markets, and corrections may be expected.

Equity market experts are expecting weaker stock price development for 2006 than last year. On the other hand, development at the beginning of the year has been better than forecasted. The all-share index rose in January-March as much as 13%, and trading was very active. According to international surveys, big investors have very recently begun to decrease their equity investments. So far, mutual funds have overweighed equities in their investment portfolios.



Source: Helsinki Stock Exchange.

IPOs under way

2005 was also an active IPO year in major European stock exchanges. Some pick-up was also seen in the Helsinki Stock Exchange, but there were still relatively few listings. In 2005, only two new companies were listed on the Stock Exchange,[2] and this year five companies have announced their IPO intentions. Nowadays the Helsinki Stock Exchange no longer is the first or only option for companies considering a stock market listing. Bigger stock exchanges may provide companies with better visibility concerning international investors and wider benchmarking base among companies in the same industry.

Stock market indices renewed to match international classifications

The industry classifications of the Stock Exchange were renewed in 2005 to match the Global Industry Classification Standard (GICS).[3] This autumn OMX will launch a pan-Nordic share list where companies are classified in three categories: Nordic Large Cap, Mid Cap and Small Cap. Small and medium-sized companies are categorised at least during the initial phase according to their home markets.

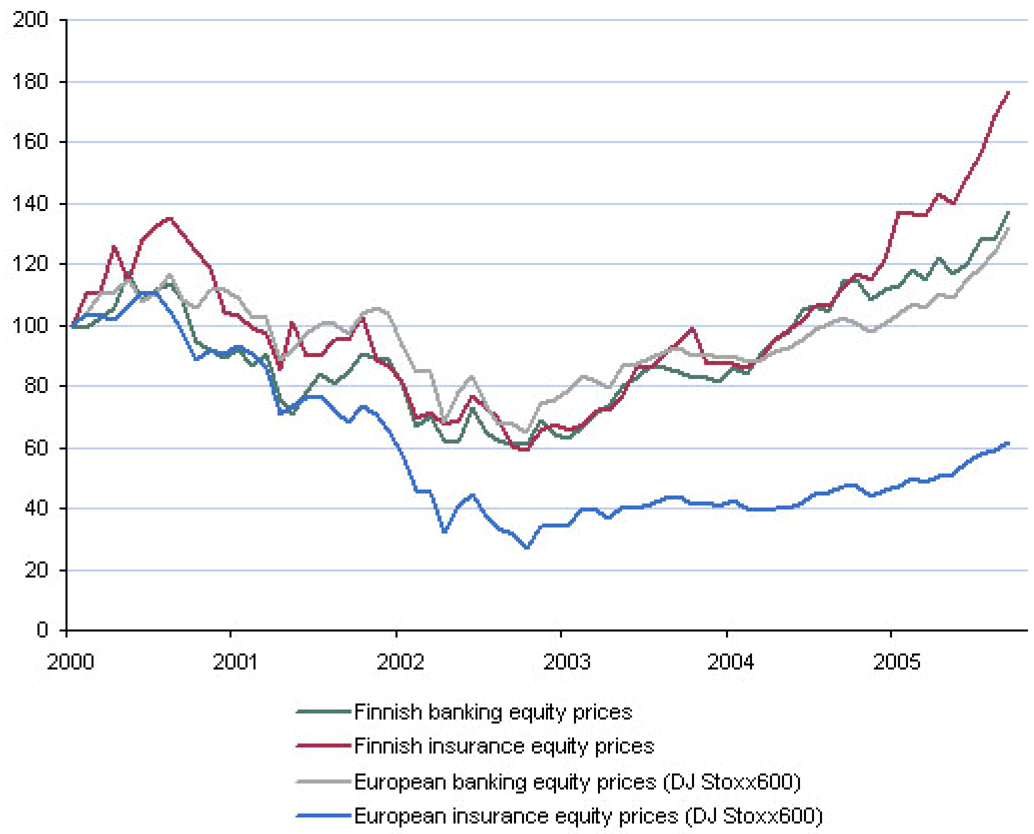
Changes related to the pan-Nordic stock exchange are aimed at improving efficiency, visibility in the international investment markets and growth of trading volumes. Whether OMX is capable of handing the challenge posed by international stock exchanges depends ultimately also on its cost-effectiveness.

Prices of Finnish banking equities have climbed apace with European banking equities

Price performance of banking equities shows that banks are doing fine at the moment. The economic upswing increases the demand for financial services and securities markets products. Banks' net interest income and commission fees are growing, and their credit losses are still small. Prices of Finnish banking equities have climbed apace with European banking equities.

The European insurance industry index has performed over the longer term clearly weaker than the banking index. After the stock market crash at the beginning of the millennium, profitability in the insurance industry was weak due to low investment income and exceptionally high claims incurred in the insurance operations. The insurance industry at the Helsinki Stock exchange consists of Sampo and Pohjola. Since these companies have participated in mergers and acquisitions, their price performance cannot be directly compared to European insurance industry indices.

Banks' and insurance companies' equity price performace



Sources: Reuters and Bloomberg.

1) Investment Management Tresor Ltd: Markkinakatsaus (Market Review) 19 January 2006.
2) The oil company Neste Oil, which was separated from Fortum, and the information technology company AffectoGenimap.
3) The industry classification was developed by Morgan Stanley Capital International and Standard & Poor's.

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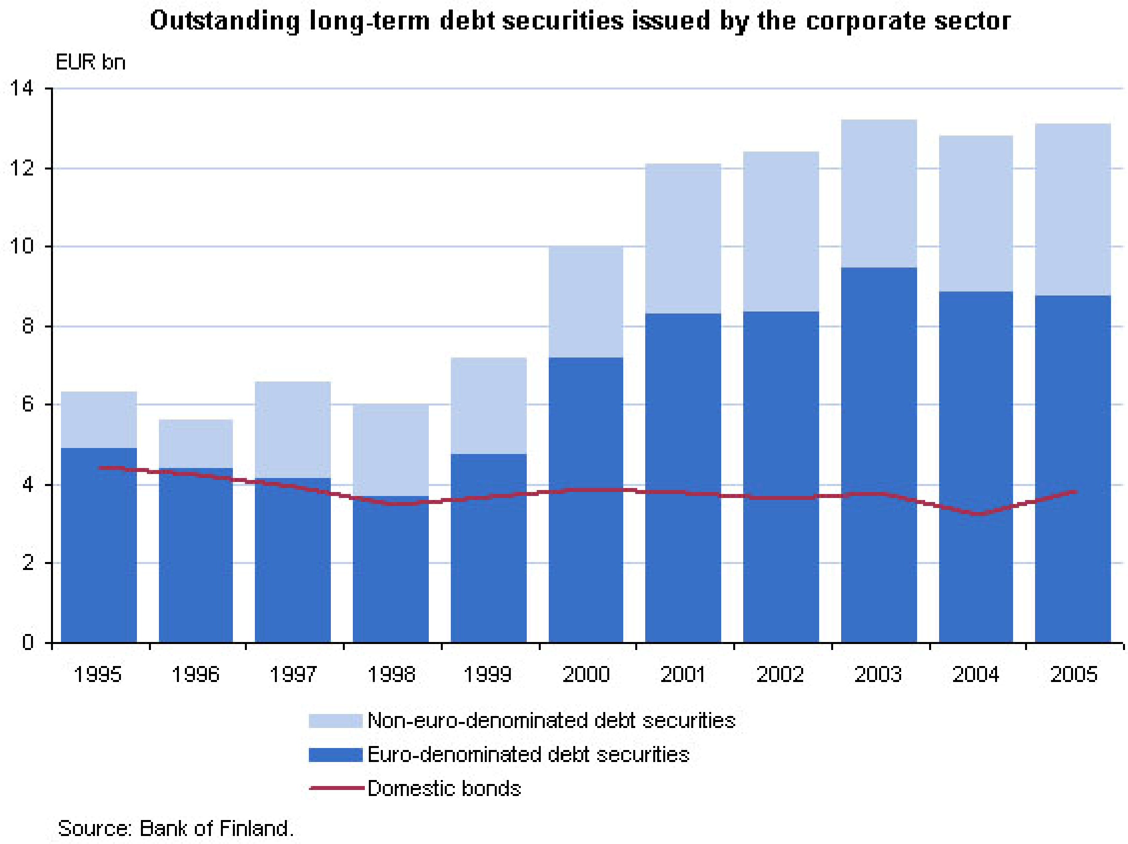
Banks have been funding their lending growth by issuance of bonds

According to the financial accounts prepared by the Bank of Finland, the Finnish corporate sector debt, after a period of zero growth, gained momentum again over the past three years.[1] Bank borrowing, in particular, has been on the increase, and the issuance of commercial paper has also picked up. By contrast, corporate bond financing has remained virtually unchanged during the past few years.[2] The trend is surprising, since it has generally been assumed that the corporate sector's bond financing would increase at the expense of bank financing. Apparently, banks have been able to offer competitive financing, besides which enterprises have also financed their activities with funds of their own. The traditional investments in premises and machinery have been slight, and large companies have not needed bond market financing. For smaller firms it is quite natural to raise bank loans.



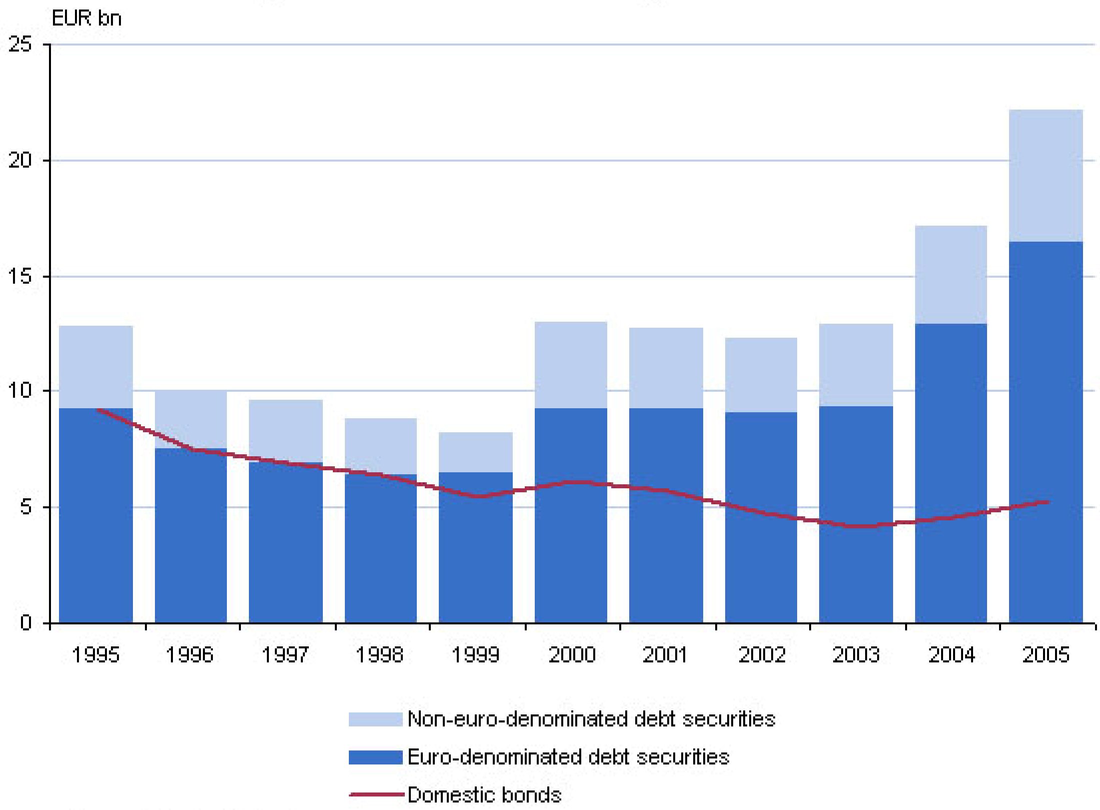
Bonds are an important source of financing to banks

In contrast to the corporate sector, the financial sector has to a substantial degree funded its lending through issuance of bonds. In the last two years, the stock of outstanding financial sector bonds has grown at a considerably faster rate than in earlier years. At the end of 2005, the stock of outstanding bonds amounted to

EUR 22 billion against EUR 13 billion at the end of 2003. Mortgage bank bonds with mortgage collateral, for the first time issued last year, totalled EUR 1.5 billion at the end of 2005.

Home equity loans are the only loans that have been securitised in Finland so far. In other countries, loans of small and medium-sized enterprises (SMEs) are also being securitised. The capital adequacy reform has furthered the securitisation of loans of small and medium-sized enterprises, and the European Investment Fund for instance is providing guarantees for SME loans so as to ease the funding problems of enterprises.[3] In contrast to Finland, elsewhere in Europe financial instruments for transferring credit risk have rapidly become increasingly common.

Long-term debt-securities issued by the financial sector



Source: Bank of Finland.

The single currency has furthered the achievement of a common European bond market

The European bond market has developed extremely rapidly in the early 2000s, measured both in terms of market size and product range. The stock of outstanding loans has grown at a more rapid rate than in other economic areas, and the euro has obtained equal status to the dollar as investment currency.

The majority of the bonds listed on European territory are quoted on the stock exchanges of Luxembourg, London, Germany and/or Ireland. By contrast, most of the secondary market trading in bonds takes place in OTC markets outside the stock exchanges. Finnish enterprises and banks have also been able to derive advantage from the integrated market. Nowadays, most Finnish bonds are issued abroad.

1) Bank of Finland: Statistical Review 3/2006, Financial Markets, Table 11.2, and Financial Markets Report 4/2005.
2) N.B. The stock of bonds shown in the chart complies with ECB statistical specifications. According to the Finnish financial accounts, the stock of bonds is some EUR 3 billion larger than that calculated by the ECB. The changes in stock data, however, show a uniform trend.
3) Bank of Finland: Financial Market Report 4/2005.

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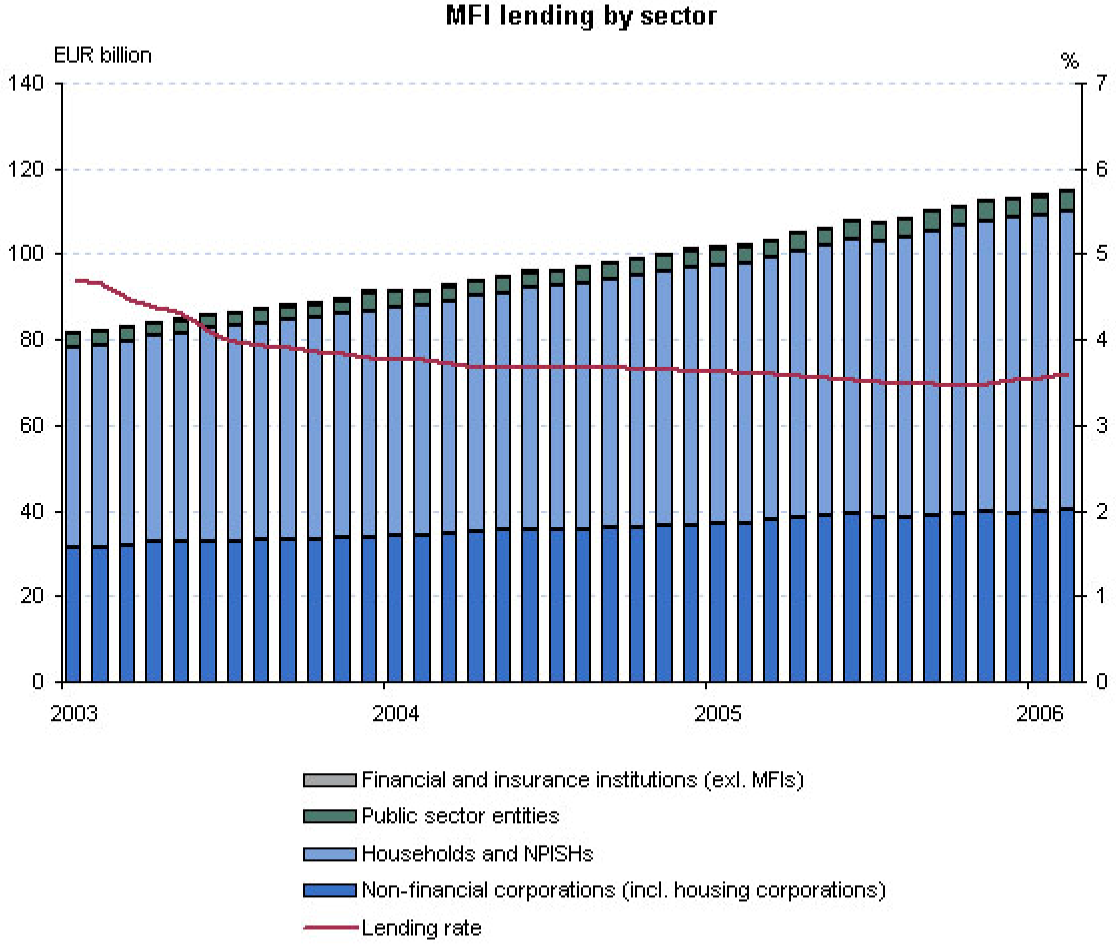
Demand for credit remained strong

The long-continued favourable developments in the financial sector were reflected in a further growth of demand for credit. Finnish monetary financial institutions' (MFIs) outstanding loans grew by 12.7% in 2005, amounting to EUR 113.5 billion at the end of the year. The share of household lending in the stock of bank lending has increased steadily, and hence private customers have started to play a more important role for banks' financial results. At the turn of the year, household credit accounted for 61% of the banks' outstanding lending stock while corporate credit accounted for a mere 35%.



Source: Bank of Finland.

Demand for household credit rose to a record high

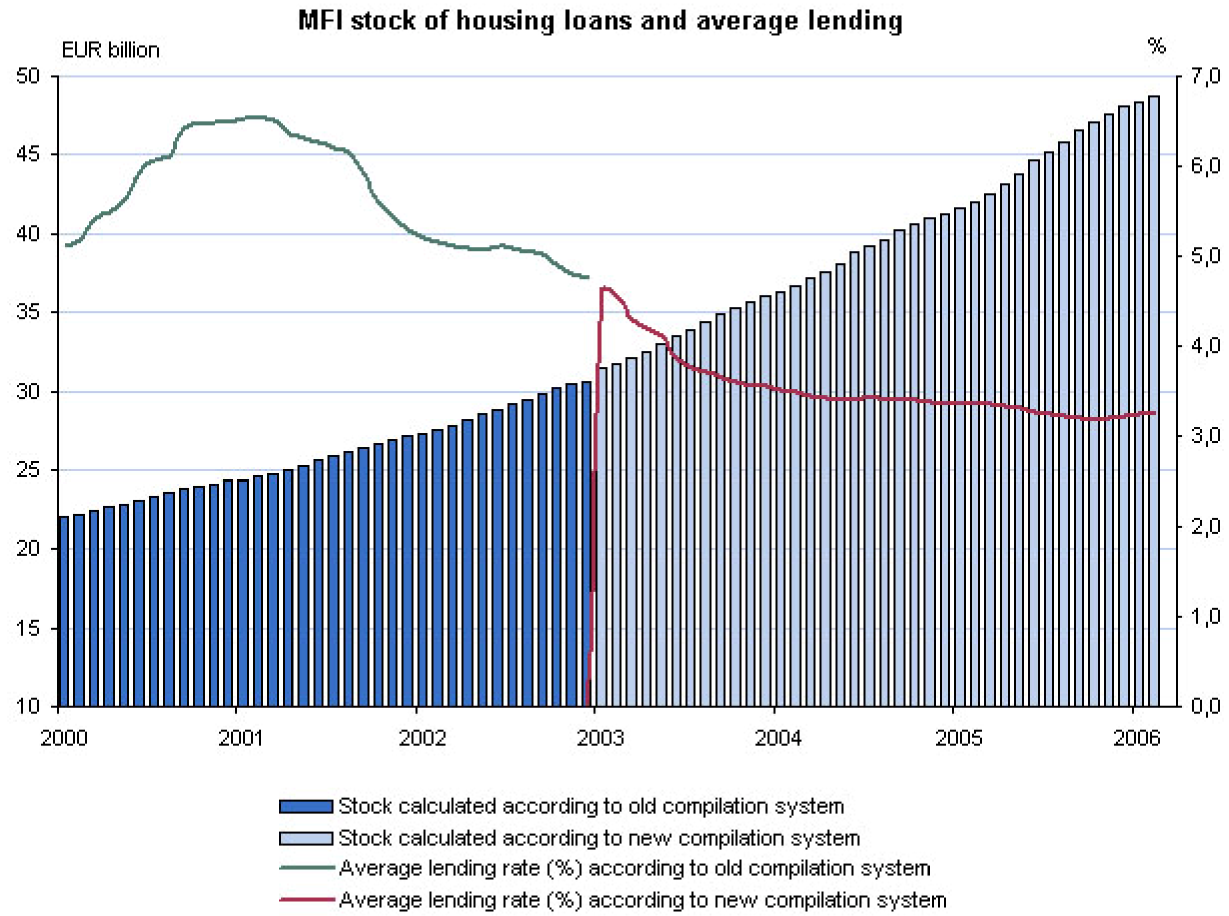
Lending to households continued to accelerate in 2005. At the end of the year, credit issued to households totalled EUR 69.1 billion. The demand for housing loans grew especially much due to households' solid confidence in their own economic outlook. The demand for credit was also boosted by reasonable servicing costs of even relatively large loans to low market rates, narrow lending rate margins and long repayment periods.

At the end of 2005, the outstanding stock of housing loans amounted to EUR 48.5 billion, twice the amount of five years ago. The increase in the demand for housing loans reached a record high of 16.7% (15.3% in 2004).

According to Statistics Finland, an average price increase of 9.0% was recorded for old flats and apartments (excl new stock) in the country as a whole in 2005. In the Greater Helsinki area, the corresponding increase was 10.2%. However, very recent surveys indicate that selling periods have become longer and that the rate of increase has declined in the past few months. Hence, it is likely that slowing of house price inflation and gradual increase in interest rates will have some dampening effect on the demand for housing loans in 2006.

Tight competition in respect of housing loans continues

Interbank competition in the market for housing loans has remained intense. According to the survey on household credit carried out by the Financial Supervision Authority in autumn 2005, banks seek edge in competition through credit pricing, longer repayment periods, and larger credit amounts, degree of indebtedness, collateral relaxation and/or product and service developments. In recent years, Finland has had the narrowest lending rate margins on housing loans in the euro area. Nevertheless, margins continued to narrow towards the end of 2005 and they remain extremely narrow.



Source: Bank of Finland.

Tighter competition also in respect of consumer credit

Besides housing loans, there was an increase in households' demand for consumer credit as well. In 2005, the stock of household loans other than housing loans grew by 11.5%, compared with 8.8% in 2004. At the end of 2005, the outstanding stock of consumer loans amounted to EUR 20.6 billion.

To a certain extent at least, the growth of consumer credit was due to the increase in the supply of credit. In fact, banks are actively selling consumer credit to customers who take out housing loans. Consumer credit margins narrowed clearly in 2005, reflecting stiffer competition and the growth in collateralised consumer credit. Keener competition in the consumer credit market can in particular be attributed to the entry in the market of new agents and higher activity levels of old ones. The consumer credit figures do not include fast loans provided via mobile phone.

The rate of growth of corporate loans declined

Since the early 1990s, corporate indebtedness in Finland has clearly declined and it is quite modest by international standards. Nonetheless, the rate of growth of corporate loans has slowed down: from 8.9% in 2004 to 7.8% in 2005.

According to the report on the 2005 Survey on Business Finances,1 the importance of banks as providers of funds to the corporate sector has grown in the past two years. This cannot be explained by a tightening of competition, since the rate of growth of outstanding corporate loans has declined. Nonetheless, a large part of the financial corporations participating in the survey reported on narrowing lending rate margins on new loans and relaxation of other terms of credit. However, the report does not indicate any acceleration in the rate of corporate borrowing for this year either.

1) Released by the Bank of Finland and the Ministry of Trade and Industry on 16 March 2006 (in Finnish only).

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Rich profits for banks in 2005

In 2005 banks' average income was almost 10% higher than the year before. The rapid growth in household loans continued, and the net interest income increased by about 5%. Due to the accelerated demand for consumer credit and the continued strong demand for housing loans, the net interest income that had been shrinking for three years started to grow. The rise in market interest rates towards the end of the year strengthened the net interest income even further.

Also in 2005 the net fee and commission income increased faster than the net interest income. In particular, the strong demand for asset management products, such as fund units and investment insurances, added to the fee and commission income.

Little increase in costs

Costs increased slower than income. As a rule other administrative expenses remained unchanged or even decreased slightly, but increases in wages and salaries and new recruitments may have raised staff costs.

A staff cost comparison with the figures for 2004 is impeded by non-recurring events. Staff costs of the OP Bank Group comprise Pohjola's operations in November–December. The increase in Nordea Bank Finland's staff costs was mainly due to lower pension costs in 2004, as disability pension according to the Employee Pension Act changed from a defined benefit pension plan into a defined contribution pension plan.

Stock of lending still of exceptionally good quality

The quality of the stock of lending has remained exceptionally good. However, the rise in interest rates must inevitably mean that the quality of the stock will not continue to improve. Early signs of deterioration can be seen. Nordea Bank Finland recognised clearly more impairment losses on loans than the previous period, and Aktia Group increased its loan loss provisions by industry. However, the figures are still very low historically.

No fast deterioration in sight

The prospects for 2006 still look good, and consumers' confidence in the development of their own economy is strong. The demand for both household loans and asset management products is likely to remain strong throughout the first half of the year. The interest rate rise improves banks' basic profitability, as deposit rates rise more slowly than lending rates.

In recent years bank profits have consistently improved. However, the increased share of other income and, on the other hand, the transition to IFRS-based financial statements may bring cyclicality into bank profits in future.

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Banking sector capital adequacy remained strong despite some deterioration

Banks' average capital adequacy remained sound in 2005, although the capital adequacy indicators had dropped compared to 2004. As the capital adequacy of Nordea Bank Finland Group is still seemingly good, it has not been taken into account in the capital adequacy analysis of the banking sector; instead the analysis has been prepared on the banking sector aggregates excluding NBF Group.

Risk-weighted items increased faster than own funds

Banks' total own funds increased by 11.6% in 2005. Primarily the favourable financial performance affected the growth in own funds, but it was also affected by increased capital loans and measurement of financial assets at fair value.

The strong growth in lending continued, which increased the amount of risk-weighted items. In 2005 risk-weighted items increased even more than own funds, ie by about 17.9%. The capital adequacy indicators dropped due to the growth in risk-weighted items, but they are still better on average than elsewhere in the euro area. Banks' total euro-denominated loss buffers strengthened further.

Banking sector capital adequacy

EUR billion	Banking sector			Banking sector excl. NBF Group		
	2005	2004	2003	2005	2004	2003
Own funds	20,7	19,7	17,5	7,7	6,9	5,5
Original own funds	18,0	17,0	15,0	6,5	5,9	4,7
capital loans	0,6	0,3	0,0	0,6	0,3	0,0
Additional own funds	3,1	2,9	2,6	1,5	1,1	0,9
upper-level additional own funds	1,2	0,9	0,8	0,5	0,2	0,2
lower-level additional own funds	1,9	1,9	1,8	1,0	0,9	0,7
Deductions from own funds	0,4	0,2	0,2	0,3	0,1	0,1
Funds for covering market risk	0,0	0,0	0,0	0,0	0,0	0,0
Sum total of risk-weighted items	120,0	103,4	93,3	56,0	47,5	39,3
Capital adequacy, %	17,2 %	19,1 %	18,7 %	13,8 %	14,6 %	14,0 %
Tier 1 capital adequacy, %	15,0 %	16,5 %	16,1 %	11,7 %	12,4 %	12,1 %
Loss buffer	11,1	11,4	10,0	3,2	2,1	2,4

Measurement of financial assets at fair value raised own funds

An amendment of the Credit Institutions Act that entered into force at the beginning of 2005 and the transition to IFRS raised banks' own funds. The fair value reserve added EUR 187 million to banks' additional own funds.

FIN-FSA adjusted its instructions on maximum amount of capital loans

Capital loans almost doubled compared to the previous year. Their share of own funds increased to 7.3%, while the comparative figure for 2004 was 4.3%. In Finland the total amount of capital loans is concentrated to two banks. In both banks the capital loan share of original own funds exceeds the 15% recommended by the Basel Committee on Banking Supervision.

In spite of the growth in capital loans, the quality of bank funds was high at the end of 2005. Most of the banks' own funds (84%) were original own funds, such as equity, retained earnings and various reserves eligible as original own funds. Restrictions concerning own funds, such as ratio of original own funds to total own funds, were satisfactorily complied with except for the above-mentioned restrictions of capital loans. FIN-FSA has revised its position on capital loans and as a result new capital loans will not be approved to the present extent. The purpose is to ensure the stability of bank funds and harmonise the Finnish practice with the practice of the other Nordic countries and several European countries.

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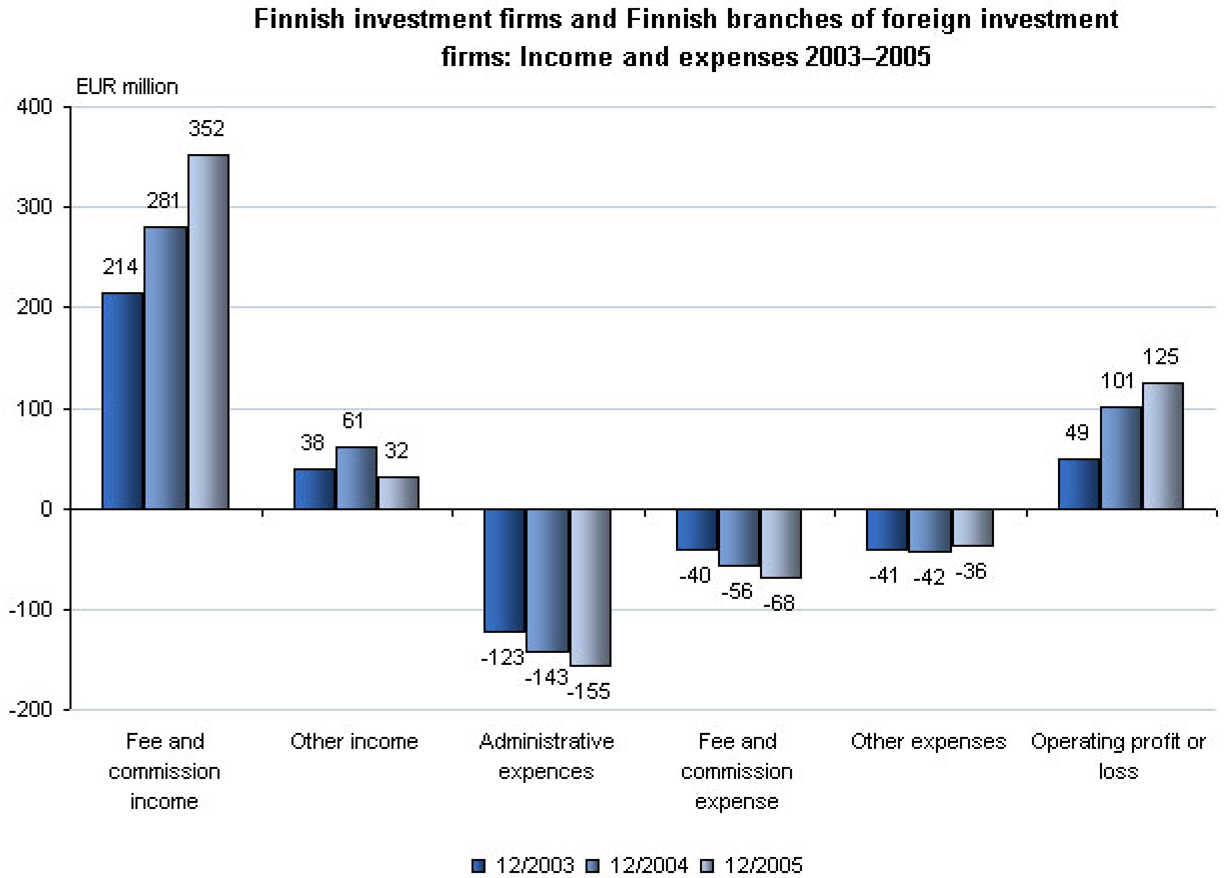
Investment firms' favourable financial performance continued

Investment firms' financial condition has developed favourably for the last three years. The improvement of profitability started in 2003 and has continued until and through 2005. Economic conditions affect investment firms' operations. Although the stock market upswing has raised the income of the industry, the growth rate of income slowed compared to 2004. At the same time the growth in expenses also slowed down. Even if the operating profit of altogether 12 investment firms decreased compared to the previous year, 2005 was as a rule profitable to the industry. The operating profit grew by 24% from the year before. However, in 2004 the growth exceeded 100%.

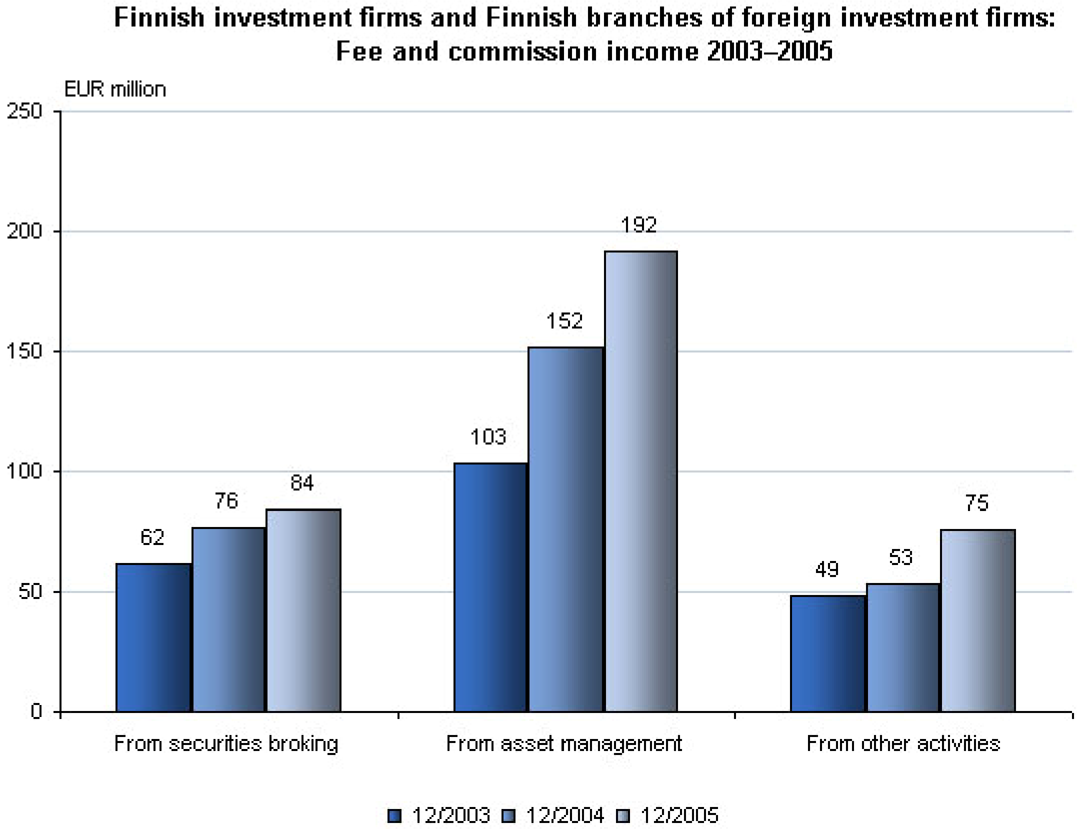


Other income comprises net gains on dealing in securities and foreign currencies, income from equity instruments, interest income and other operating income.

Source: Financial Supervision Authority.

The growth in investment firms' fee and commission income slowed in 2005. The fee and commission income increased by 25% compared to 31% in 2004. However, the structure of the fee and commission income remained more or less unchanged. The largest income incurred from asset management services. The income share incurred from them was still about 54% of all fee and commission income.

Investment firms' fee and commission income reveals the tight competition in securities broking services. The growth in fee and commission income from securities broking slowed and the broking income share of the total fee and commission income slightly contracted. In recent years the fee and commission income from broking has clearly decreased as a result of the tough competition, but in 2005 the buoyant exchange of stocks compensated for the lower fees and commissions.



Fee and commission income from other activities comprises such income from market making, arranging of issues, underwriting of issues, loan and financing arrangements, securities custody services and other fee and commission income.

Source: Financial Supervision Authority.

Investment firm operations concentrated and bank-related

The investment firm industry can be considered to be concentrated, as the total income from investment services of the eight largest investment firms operating in Finland represented 64% of all income from investment firms in 2005. The industry is also very closely integrated with banks, as only one of the eight largest firms is not bank-related. When the data describing the industry is surveyed, the significant restructuring of the investment firms carried out in 2005 should be taken into account. The largest changes were caused when Nordea Investment Management Oy and Alfred Berg Finland Oyj were transformed into Finnish branches subject to Swedish parent companies.

Remote members' share has increased

Finnish brokers' share of the exchange of stocks has decreased further. In 2005 Finnish brokers' share of the exchange of stocks dropped to 27.9%, when it had still been 32.8% in 2004. Thus remote members' share totalled at no less than 60.3%, which means that their share had increased by almost 5 percentage points.

Market shares of Finnish stock brokers[1]

	Market share, %		
	2005	2004	Change
Nordea Pankki Suomi Oyj	5,2	6,1	-0,9
Kaupthing Bank Oyj	4,2	5,9	-1,7
eQ Pankki Oyj	3,4	4,8	-1,4
Evli Pankki Oyj	2,9	3,8	-0,9
Alfred Berg SE	2,2	3,3	-1,1
Mandatum Pankkiiriliike Oyj	3,4	3,1	0,3
FIM Pankkiiriliike Oy	2,9	2,7	0,2
Opstock Oy	2,6	2,1	0,5
Estlander & Rönnlund Financial Products Oy	0,4	0,4	0
Ålandsbanken Abp	0,4	0,3	0,1
United Bankers Securities Oy	0,2	0,2	0
Aktia Säästöpankki Oyj	0,1	0,1	0
Finnish stock brokers	27,9	32,8	-4,9
Remote members	60,3	55,6	4,7
Branches of foreign firms	11,8	11,6	0,2

[1] A Finnish stock broker is a company whose registered office is in Finland. However, the company may be part of a foreign group. The market shares have been calculated from the exchange at the Helsinki stock exchange. In October 2005 Alfred Berg Pankkiiriliike Oy was transformed into a branch of a foreign investment firm.

Source: OMX

Mutual funds increase assets in asset management

Income from and volume of assets managed are growing rapidly. The major part of the growth still originates from management of mutual fund assets. Nowadays half of the assets in asset management are already assets of Finnish mutual funds.

Finnish investment firms and Finnish branches of foreign investment firms: Assets managed 2004–2005

	12/2005	12/2004	Change	
	EUR billion	EUR billion	EUR billion	%
Asset management with full power of attorney	76,6	62,0	14,6	23,5
of which Finnish mutual funds	39,0	27,1	11,9	44,1
Consultative asset management	16,5	12,6	3,9	30,5

Source: Financial Supervision Authority.

Both banks and investment firms provide asset management services. Whereas investment firms concentrate on providing asset management with full power of attorney, banks mainly provide consultative asset management.

Assets managed by banks 2004–2005

	12/2005 EUR billion	12/2004 EUR billion	Change EUR billion	%
Asset management with full power of attorney	2,8	2,1	0,7	31,6
of which Finnish mutual funds	0,3	0,1	0,2	170,2
Consultative asset management	14,4	12,0	2,4	20,0

Source: Financial Supervision Authority.

At the end of 2005 assets managed by banks and investment firms with full power of attorney and in consultative procedures amounted to EUR 110 billion. The three largest banking groups dominated the market, but there is not much difference between their market shares.

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Lending quality high, but housing market risks have increased

According to a survey conducted by the Financial Supervision Authority (FIN-FSA) in autumn 2005, housing market risks have increased. Individual banks have looked for increased market shares by permitting more lax loan criteria than their competitors or better terms for their customers (for instance flexible collateral arrangements and low-margin bargains).

Larger housing loans and longer maturities

The size of new housing loans has increased. Many new loans withdrawn are still in the category of EUR 50,000–100,000, but the share of larger loans is significant. The increased indebtedness due to larger housing loans mainly concerns younger debtors.

Housing loan maturities have increased in all banks. More than one third of new loans already have a maturity exceeding 20 years. In relative terms, most long, 30-year-plus maturities are provided by small banks.

Higher risks for housing loan customers

The Finnish practice of binding housing loans to short-term market rates expose households to changes in market rates. Thus the customer alone accepts the risk of changes in the interest rates. At increased interest rates the loan servicing costs of the households rapidly increase or the loan repayment period extends. The total effects of increased interest rates are significant, particularly in the case of long, slowly amortised loans.

Inspection findings strengthen our view of lowered margins

In its credit risk inspections FIN-FSA has found that customer-specific margins in housing loans have been lowered further. The pricing of loans to private customers is based on the customer relationship as a whole. In the present tight competition this may force banks to value their credit risk too low in the long term, ie they do not take sufficient account of the risk that customers pose to the bank. The tough competition has led to revalued interest rate terms of housing loans, which has built up further pressure to lower the margins.

Not only the tightening competition but also the new Basel II capital adequacy provisions lie behind the narrowing loan margins. With Basel II the capital requirements of housing loans decrease on average. In particular, this concerns banks introducing the internal ratings based approach. The final capital adequacy level is not yet clear, which banks should take into account in the pricing of their loans.

Increased stock of housing loans has raised risk management requirements

The long-lasting growth in housing loans increases banks' credit risks, and thus the significance of risk management becomes more and more emphasised. The noticed flexibility in collateral arrangements raises future bank risks. FIN-FSA pays increased supervisory attention to banks' risk management and compliance with supervisory provisions in the granting of housing and consumer loans. According to economic forecasts, no large changes are expected in customers' debt servicing ability, but the interest rate rise rapidly increases the strain of debt servicing.

Quality of credit portfolios still high

For the time being the quality of Finnish banking groups' credit portfolio can be considered high, as there are very few nonperforming assets; at the end of 2005 they amounted to EUR 331 million (EUR 372 million in 2004). The decrease from 2004 was EUR 41 million. In one year, nonperforming assets' relative share of the stock of loans and guarantees has shrunk to 0.27% (0.36% in 2004).

Finnish banking groups' impairment losses have increased and amounted to EUR 61 million in 2005 (EUR 16 million in 2004). The growth in gross impairment losses compared to 2004 was about 55%. Their share of the stock of loans and guarantees was 0.22% (0.16% in 2004). The low level of impairment losses is also part of the high quality of banks' credit portfolio, but the growth in gross impairment losses may be an indication of a turn for the worse.

No problems in household sector so far

In December, households' nonperforming assets were EUR 193.7 million (EUR 217.3 million in 2004) and their share of households' stock of loans and guarantees was 0.30% (0.39%). The amount has decreased by about 11% from 2004, although loans granted to the household sector have increased by about 15%.

However, problems with household customers do not quickly appear as growth in nonperforming assets, as banks relatively easily grant customers grace months and change loan repayment plans. The share that households' gross impairment losses represent of the stock of lending contracted a little and was 0.08% in December (0.09%).

Growing impairment losses in corporate sector

The share that the corporate sector's nonperforming assets represent of its exposures shrank to 0.30% in 2005 from 0.35% in the previous year. Thus the stock of lending to the corporate sector is in good condition measured in terms of nonperforming assets. Companies' propensity to invest has remained fairly low, which also can be seen in the slowdown of the growth in corporate loans.

The corporate sector's gross impairment losses increased by EUR 57 million, ie to EUR 162 million, in 2005. In the same period the sector's stock of loans and guarantees increased by about EUR 4.5 billion. The impairment losses' share of the corporate sector's stock of loans and guarantees increased to 0.41% (0.30 % in 2004). The growth was mainly due to recognised impairments in the processing of metals and manufacturing of metal products, machines and equipment. The relative share of impairment losses has also increased in the hotel and restaurant sector and the wholesale and retail trade. Although impairment losses increased last year, they are still exceptionally small.

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Deposit banks' liquidity deteriorated somewhat

The demand for bank loans continued to be brisk in 2005, and deposit banks' balance sheets improved in proportion to the growth of outstanding loans. The growing stock of lending was financed through increased deposits and debt securities issued to the public.

In 2005, the stock of deposits grew by just 10% (in 2004 only 5%). Although growth speeded up from last year, the share of deposit funding from claims on the public continued to decrease. End-of-year data shows that 77% of lending to the public was financed by deposits (81% at the end of 2004). Of deposits, growth was recorded both in deposits payable on demand and fixed-term deposits. The stock of bonds with longer maturities grew by just under 50% to EUR 10 billion, while short-term debt securities recorded growth of slightly more than a tenth to EUR 28 billion.

The strong growth in lending has lead to increased use of market-based funding, with its share accounting for a greater proportion of acquisition of funding. The cost of market-based funding has been covered by fee income. The inadequacy of deposits has forced banks to diversify their means of acquiring funds. Overall in 2005, banks' framework for the acquisition of funds was good and banks did not have any funding problems. Nevertheless, risks arising from the concentration of acquisition of funding were addressed in individual banks.

Mortgage bonds used to raise funds

Banks have been faced with the need to look for alternative and inexpensive channels of funding in response to the continuing demand for housing loans, with only a half of the growth of lending, on average, being able to have been financed by the growth of deposits.

Mortgage bonds offered by mortgage banks have emerged as an alternative channel of funding. Indeed, mass transfers of housing loans to mortgage banks have been made. Funding expenses have been low, because mortgage banks have a good credit rating, and international investors have been attracted by their large issues. Mortgage banks have also entered into cooperative agreements on the mortgage loans they are offering. Deposit-funded local banks have thus been able to respond to the demand for housing loans exceeding deposit funding by offering mortgage loans provided by mortgage banks.

Short-term liquidity risk heightened during 2005

Deposit banks' combined monthly funding deficit fluctuated strongly in 2005 and turned from surplus into deficit. The combined deficit at the end of the year amounted to EUR 3.2 billion, and was affected by the maturities and structuring arrangements of large issues. Recently, however, banks' funding deficits have shown a slight increase.

The amount of eligible debt securities remained virtually unchanged in 2005, at EUR 7.6 billion. The amounts of available-for-sale debt securities (EUR 3 billion) and of listed shares and mutual fund units (together EUR 105 billion) were slightly higher than at the beginning of the year. Banks' short-term liquidity remained good, as the amount of liquid assets used as buffers was somewhat higher than the year before. If market and deposit funding due to mature within a month were to continue, ie the contracts were to be renewed, the liquidity situation can be considered to be better than at the end of last year.

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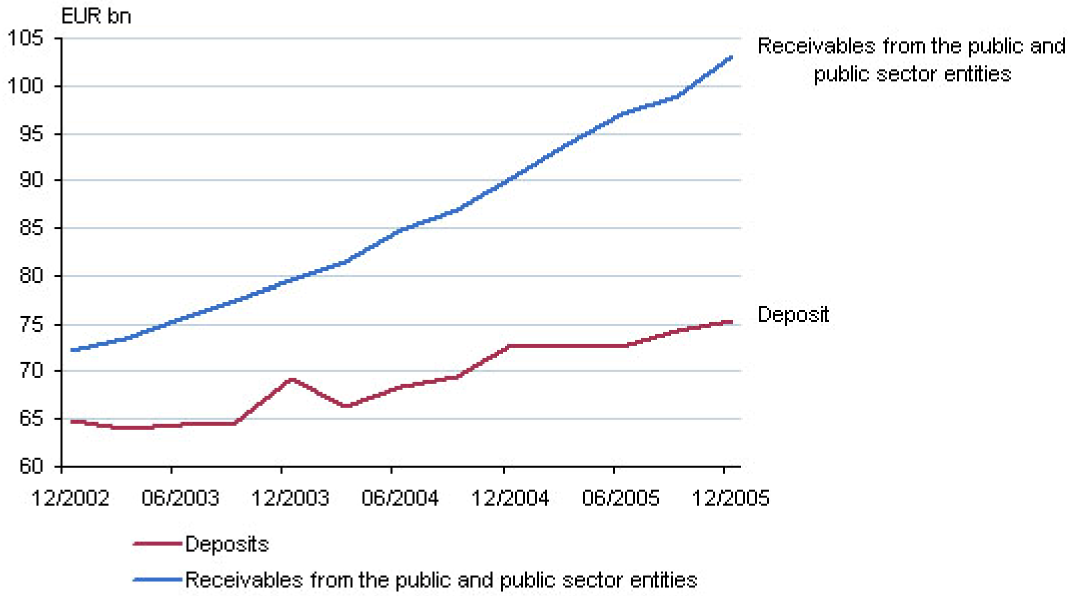
Funding risk

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

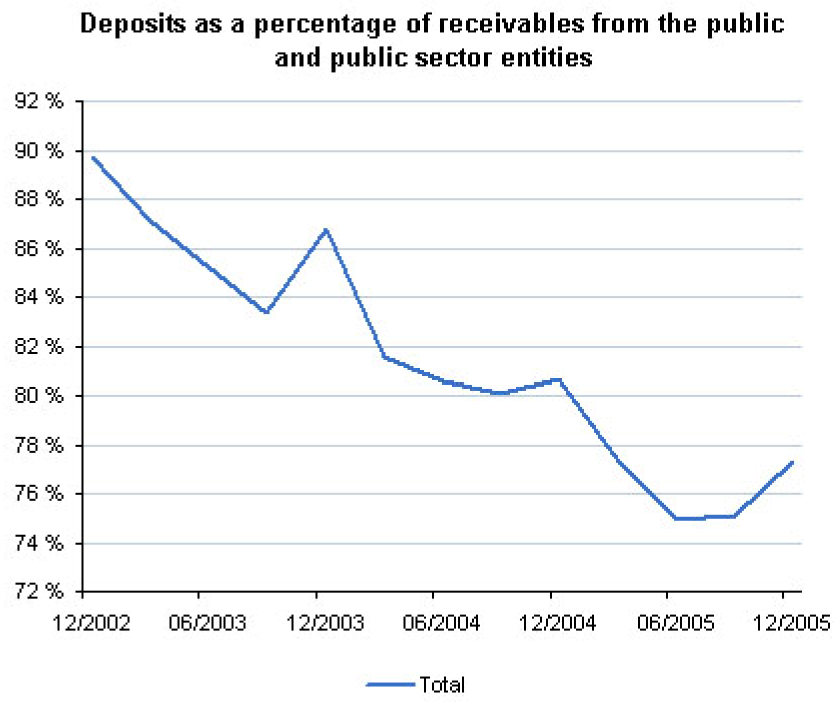
Structural funding risks are monitored by assessing the funding of balance sheet assets and in particular lending through deposits and market-term sources of debt capital.

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

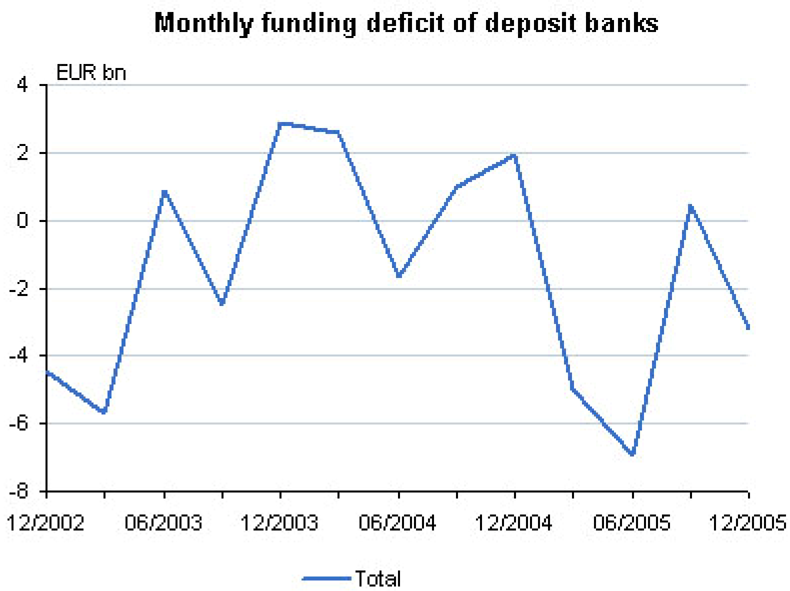
Deposits and receivables from the public and public sector entities, EUR bn



Source: Financial Supervision Authority.



Source: Financial Supervision Authority.



Source: Financial Supervision Authority.

Slight increase in banks' interest rate risks

Finnish deposit banks' total income risk increased in the second half of 2005, both in terms of the euro value and a measure of interest rate risk relative to net interest income. At the end of 2005, the income risk of the one percentage point increase in interest rates represented a 12.8% increase in net interest income ie an increase of EUR 318 million.

Changes in the structure of derivatives positions increased the income risk on the balance sheet

Banks' heightened income risk was due to changes in balance sheets and derivatives positions, arising mainly from the increase of imbalances relating to receivables and debts of derivatives, especially in short-term maturities. Nevertheless, the amount of receivables and debts of derivatives decreased in euro terms, with only an increase in the amount of forward contracts that hedge against a decrease in interest rates. Contrary to derivatives items, the amounts of receivables and debts in the balance sheet increased. The increase in income risk is thus not due to a noticeable increase in an individual item; rather it is due to the aggravation of imbalances in short maturities.

In the last quarter, growth in bank lending was not as heavily dominated by longer maturities as it was in June. Receivables from credit institutions and from the public increased in shorter maturities and decreased somewhat in longer maturities.

The distribution of receivables across several categories of maturity can be explained by the fact that the nearest revision date of interest rates, arising from the peak of lending at the beginning of 2005, "slid" into shorter maturities, and that the new loans were increasingly tied to wider range of market rates. Loans tied to market rates with a longer maturity than one year – ie to fixed rates – do not have a major impact on banks' income risk. That must be taken into account when analysing the effect of distribution of new loans' reference rates to income risk. For fixed rate loans, income risk is only affected by loan repayments and interest paid over the following year.

The proportion of income risk in foreign currency accounted for 4.4% of the total income risk, corresponding to about a half of what it was in June. The four major currencies in terms of exposure of income risk were the euro, US dollar, Danish krone and Swedish krona.

The sensitivity of the investment risk to the aggregated balance sheet has decreased

The interest rate sensitivity of bonds and derivatives in the balance sheet was EUR 137 million in December 2005. A negative figure means that the value of the portfolio will decline, if market rates increase by one percentage point in all the maturities of the yield curve. This sensitivity in the balance sheet had diminished by around EUR 50 million from the end of June to the end of December 2005.

In analysing the investment risk of the balance sheets, it becomes evident that banks did not use derivatives to hedge against decline in bond prices. This explanation comes from the negative investment risks of both derivatives and bonds. If the potential hedging impact of derivatives to income risk is not taken into account, derivatives positions can be considered speculative, at least partly.

Trading in derivatives denominated in Nordic currencies increased investment risk of the trading book

The investment risk of the trading book nearly doubled in the second half of 2005, amounting to EUR –306 in December 2005. The majority of this growth was due to trading in derivatives denominated in Nordic currencies.

The situation of derivatives in the trading book was the same as in the balance sheet, ie they were sensitive to interest rate hikes. The derivatives positions in the trading book can thus be interpreted in the same way as those in the balance sheet: banks did not hold derivatives in their positions to hedge against changes in bond prices.

Exceptional reference date for interest rate risk

The reference date for the analysis of interest rate risks was, exceptionally, June 2005, rather than the end of 2004. The reason for this was the transition to IFRS accounting and reporting after the turn of 2004, and the need to avoid problems in the comparison of figures between the reverence date and the observation date.

What is an interest rate risk?

An interest rate risk referred to here means the impact of change in interest rates to banks' net interest income and the impact to the value of interest rate instruments banks have in their positions. Interest rate risks here have been split into three parts: income risk and investment risk of the balance sheet and the investment risk of trading book.

An income risk measures the impact of maturity imbalances between receivables and debts to the net interest income during the one year period, in the situation where market rates increase by one percentage point.

An investment risk measures the immediate change in the market values of bonds and derivatives in the balance sheet or trading book when interest rates increase by one percentage point. In other words, an investment risk measures the sensitivity of the current values of portfolios to changes in interest rates.

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