



Financial Market Report

1 • 2013

- Margins on smaller loans have widened the most
- Change in structure of corporate financing
- Nordic countries to tighten regulation on housing loans
- Continued disruptions in payment transmission



Bank of Finland

Financial Stability and Statistics

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1 Financial intermediation

1.1 Banks in crisis countries funding their home countries

Kimmo Koskinen and Hanna Putkuri

The fatal link between banks and their home countries has become increasingly closer, particularly in the crisis countries in the euro area. The amount of domestic sovereign debt securities held by the crisis countries' banks has increased significantly, as the role of banks in funding their home countries' debt has been emphasised.

General government entities in the so-called GIIPS countries¹ in the centre of the euro area debt crisis have become highly indebted as the crisis has unfolded. At the same time, the role of banks in funding their home countries has been emphasised as foreign investors have steered clear of the risk related to the crisis countries' sovereign bonds. On the back of these developments, the proportion of securities-based debt issued by the crisis countries' general government held by monetary financial institutions (MFIs) in the respective countries has risen significantly since 2008 (Chart 1). Before the onset of the debt crisis, the trend in most countries was the opposite, as the introduction of the euro eliminated the currency risk within the euro area, and country risks were generally considered low.

¹ GIIPS countries comprise Greece, Ireland, Italy, Portugal and Spain, and general government comprises central government, local

Due to the so-called home bias phenomenon, or favouring of the domestic markets, which has been emphasised in the securities investments activities of the crisis countries' banks, the amount of domestic sovereign debt securities has increased materially in these banks' balance sheets. This was particularly salient in Spain and Italy for example in the first half of 2012, when banks increased their investments in securities issued by domestic general government entities (Chart 2). In Spain, banks' domestic sovereign exposures have been reduced somewhat since then.

Chart 1. Proportion of general government's securities-based debt held by domestic MFIs in GIIPS countries and Finland

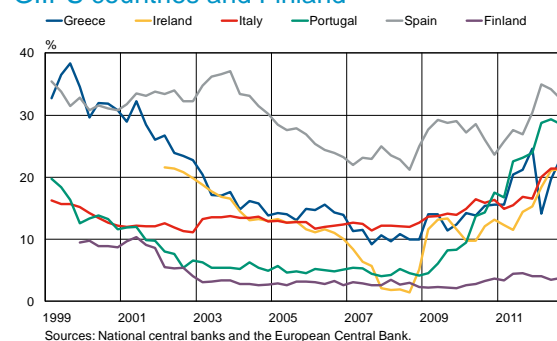
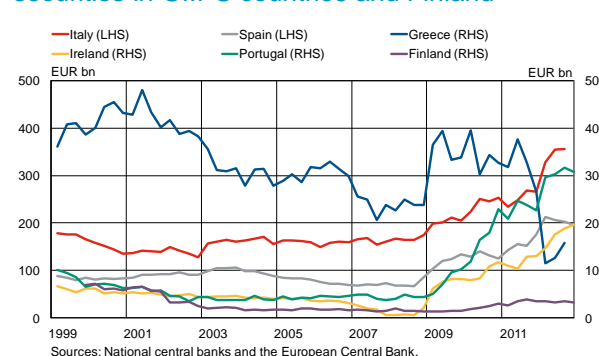


Chart 2. MFIs' domestic general government debt securities in GIIPS countries and Finland



However, there are also significant differences between the euro area countries. In Greece, the amount of banks' sovereign debt securities decreased

significantly due to the debt arrangements concerning Greek government bonds. In high-rated countries, the debt crisis has not increased banks' claims on the domestic public sector to any significant degree. For example, the bulk of Finnish sovereign securities-based debt is held by foreign investors (Chart 1).

Factors related to the crisis and regulation underlying banks' investments in sovereign debt

There are many parallel factors underlying the emphasised home bias phenomenon in banks' securities investment activities and more generally, the increase in banks' sovereign exposures. These factors are related both to the ongoing euro area sovereign debt crisis and bank regulation.²

Firstly, governments and national banking systems are interdependent in many ways. Banks depend on direct and implicit support by their home country, and banks' funding costs are related to the creditworthiness of their home country. In addition, a stable banking system and financial intermediation are prerequisites for supporting balanced development of the entire economy. Due to these linkages, banks have an incentive to invest primarily in domestic sovereign bonds and avoid additional foreign country risk.

Secondly, banks have used sovereign debt securities as collateral for market-based and central bank funding when the significance of collateralised funding has been emphasised during the crisis. The third factor related to the crisis is the public capitalisation of banks, which has increased the interlinkages between banks and their home countries. As counter items for the equity investments made by

² In some countries, the large amount of loans granted by credit institutions to general government is also explained by special credit institutions included in the credit institution sector, financing solely general government.

the home country, loan or bond assets have been entered in the banks' balance sheets.

According to the EU's Credit Institutions Directive, a general zero risk weighting may be applied to banks' claims on central governments, when the sovereign debt securities are denominated in the domestic currency and funded in the same currency. Hence, an increase in sovereign exposures does not increase banks' risk-weighted assets or the regulatory requirements for own funds based on these exposures.³

Another factor related to bank regulation favouring sovereign debt investments is the liquidity coverage ratio (LCR) entering into force in the EU gradually as of 2015. It requires banks to hold a higher amount than previously in high-quality liquid assets, such as sovereign debt, to secure their short-term liquidity.

Fatal link between banks and governments sustains divergence of financing conditions in the euro area

The close linkage between banks and their home countries has contributed to the uneven transmission of monetary policy and financing in the euro area. The loan interest rates for banks, non-financial corporations and households are strongly correlated in each country, but the interest rate differentials between countries of high and low credit ratings have widened to exceptional levels.

In addition, the increased financing of general government by banks may have crowded out financing of the private sector. In the bank-centered financial markets of the euro area, this may have tightened the credit conditions and the availability of finance, particularly in the crisis countries where the state of the banking sector is the weakest and the need for

³ In autumn 2011, the European Banking Authority gave a recommendation that large European banks accumulate an additional capital buffer for risks related to sovereign exposures.

balance sheet adjustment by deleveraging is the highest.

The increase in sovereign risks is not fully apparent in banks' financial reporting. A majority of sovereign bonds held by European banks has been entered in their banking book, which means that these are not valued at fair value through profit and loss.

Requirements of the European Banking Authority on the strengthening and monitoring of banks' capital, however, have contributed to a decrease in the uncertainty related to the quality of banks' balance sheets and sovereign risks.

1.2 Household indebtedness and increase in house prices in Finland most moderate among Nordic countries

Kimmo Koskinen and Hanna Putkuri

Household indebtedness in the Nordic countries has continued to increase even during the financial crisis. Growth in household loans has slowed down the strongest in Denmark and Iceland, where house prices have decreased significantly after the onset of the crisis. There are also considerable structural differences in the developments across the Nordic countries.

The rate of growth of the household loan stock decelerated after the onset of the financial crisis in all Nordic countries. In Finland, Sweden and Norway, the growth rate has slowed down to the level of 4–6%, while in Denmark it came to a temporary halt in 2011 and has been rather sluggish since then (Chart 3). In Iceland, comparison is complicated by the steep increase in the value of foreign-currency loans before 2009 and the subsequent measures by authorities to alleviate households' debt load and debt servicing burden.⁴

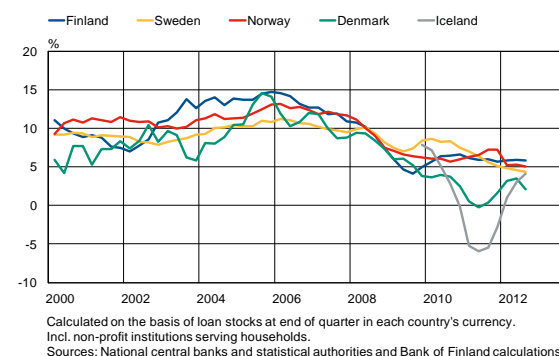
Average interest rates on the housing loan stock have shown similar developments across the Nordic countries, but interest rate differentials between the

⁴ For more information on developments in Iceland, see eg IMF (April 2012) Dealing with household debt, World economic outlook, (Chapter 3). Regulatory reforms on housing lending implemented and being planned in other Nordic countries are discussed in article 5.1 of this report.

countries have widened since 2008 (Chart 4).

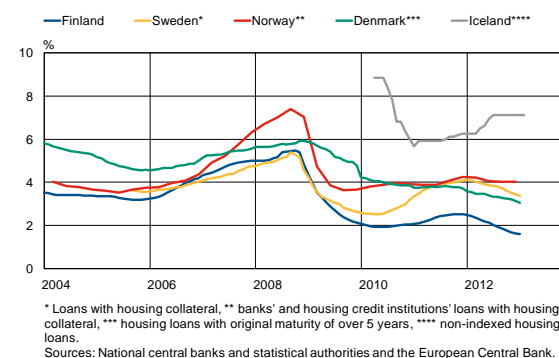
However, different pricing practices complicate any cross-country comparisons.

Chart 3. Annual change in household loan stock



In Finland, a majority of housing loans has variable interest rates, and therefore the average interest rate on the loan stock has sunk to historical lows due to the decrease in the Euribor rates. In Sweden and Norway, housing loans also have mostly variable interest rates, but the policy rates of the Swedish and Norwegian central banks and as well as the interbank money market rates⁵ commonly used as reference rates are higher than the comparative rates in the euro area. Furthermore, a higher proportion of housing loans in Sweden has fixed interest rates, which tends to keep the average interest rate on housing loans higher in the context of low market rates.

Chart 4. Average interest rate on housing loan stock



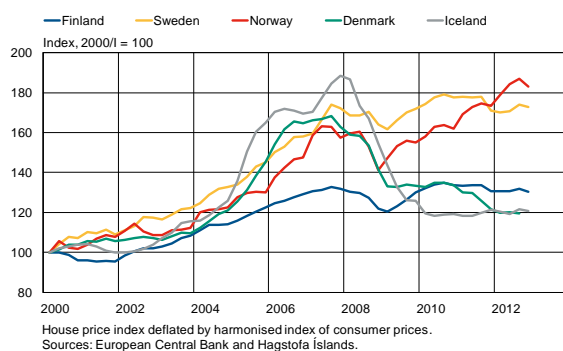
⁵ Swedish stibor and Norwegian nibor rates.

In Denmark, a majority of housing loans has fixed interest rates, reflecting the significant role of mortgage banks specialising in housing lending and relying on long-term funding. Therefore, the interest rates on housing loans have shown more stable developments in Denmark compared to Finland, Sweden and Norway.⁶

In Iceland, the pricing of housing loans has diverged significantly from the other Nordic countries. Before the financial crisis, a majority of Icelander's housing loans was either indexed to inflation or linked to foreign currencies. Loans linked to foreign currencies were prohibited after the onset of the financial crisis, and non-indexed housing loans have been granted increasingly.⁷

Real house prices deflated by the harmonised index of consumer prices increased before the financial crisis in all Nordic countries, the fastest in Denmark and Iceland (Chart 5).

Chart 5. Real house prices



After the onset of the crisis, house prices have declined by almost a third in Denmark and by a good third in Iceland from the most expensive levels in 2007. In

⁶ There are also differences across the countries in how easily a bank may change the loan margin during the loan period.

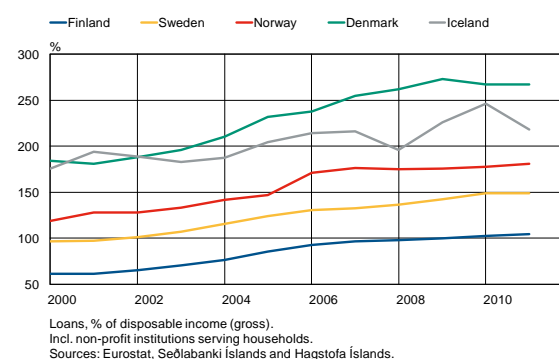
⁷ In an indexed loan, the cost of inflation is added to the loan capital, and the changes are not reflected in the nominal rate. At the beginning of 2012, the proportion of non-indexed housing loans already stood at 90% of all new housing loans, and a majority of the loans has variable interest rates.

Denmark, there are also factors related to property taxation underlying the dampening of the housing markets.⁸

In Finland and Sweden, real house prices have decreased only slightly from the end of 2007. In Finland, developments in house prices have been clearly more moderate than in the other Nordic countries throughout the 2000s. In Norway, house prices have risen steeply since the dip in 2008, as high oil prices have supported the Norwegian economy and the rapid growth of households' real income.⁹

Household indebtedness has risen steadily in the Nordic countries in the 2000s, while cross-country differences have remained large (Chart 6).¹⁰

Chart 6. Household indebtedness



These significant structural differences are explained by different forms of housing finance (specialised mortgage banks in Sweden and particularly Denmark), differences in the average housing loan repayment periods and amortisation practices (long loan periods in Sweden and Denmark, and loans linked to the consumer price index in Iceland), differences in the

⁸ Danmarks Nationalbank (2012) Financial stability 2012.

⁹ Norges Bank (2012) Financial stability report 2/2012.

¹⁰ The debt-to-income ratio can be defined in different ways. In this context, we rely on an indicator often used in international comparisons where the households' loan stock according to financial accounts is compared with households' disposable income adjusted by the pension fund component before imputed capital depreciation.

prevalence of owner-occupied housing and room density as well as household wealth.¹¹

¹¹ For more information, see Heidi Schauman (2012)

Asuntomarkkinat ja kotitalouksien velka – pohjoismainen vertailu.
(*Housing market and household debt - a Nordic comparison*) BoF
Online 5/2012 (in Finnish).

1.3 Finnish consumer credit market is highly bank-centered

Kimmo Koskinen and Eero Savolainen

Almost 90% of households' consumer credit is granted through monetary financial institutions. The growth in consumer credit has slowed down in recent years but continues to be faster than in the euro area on average. Margins on consumer credit have been on an upward trend. MFI consumer credit has resulted in fairly low credit losses.

Consumption is the largest single demand component in Finland's gross domestic product. In 2011, private consumption accounted for 55% of the GDP.¹² Hence, households' consumption has a major impact on economic growth. Future developments in consumption are anticipated among other things by the consumer barometer, in which households estimate their future consumption intentions. Consumer credit can also be utilised as a leading indicator for future consumption.

In Finnish financial statistics, household loans are broken down by the purpose of use into housing loans, consumer credit, student loans and other loans. These purpose-of-use definitions derived on the basis of national accounts concepts are unambiguous as such, but their application may be subject to interpretation in some cases.

Application of the definitions of housing loan and student loans is largely unproblematic. On the other

¹² Private consumption includes the consumption expenditure of households and non-profit institutions serving households.

hand, a loan drawn as a housing loan may be partly used for consumption or other purposes, since the issuer of the loan is not necessarily aware of the ultimate use of the loan. Some other countries, such as Sweden, classify loans by collateral, which is always known by the issuer of the loan.

What is included in consumer credit?

In Finland, consumer credit is defined as loans granted for the purchase of consumer goods and services for personal use by households.¹³ In the context of national accounts, consumption includes for example food, clothing, rent, energy, durable consumer goods, health care services and leisure time services. Car loans are also included in consumer credit, since cars are counted as durable consumer goods in the national accounts. In contrast, houses are fixed assets and securities are financial assets, and therefore loans granted to purchase these items do not constitute consumer credit.

In Finland, the household loan stock at the end of September 2012 stood at EUR 114 bn.¹⁴ A majority of household loans are housing loans (74.5%). At the end of September, consumer credit amounted to EUR 14.9 bn, and it accounted for 13.1% of the total household loan stock.

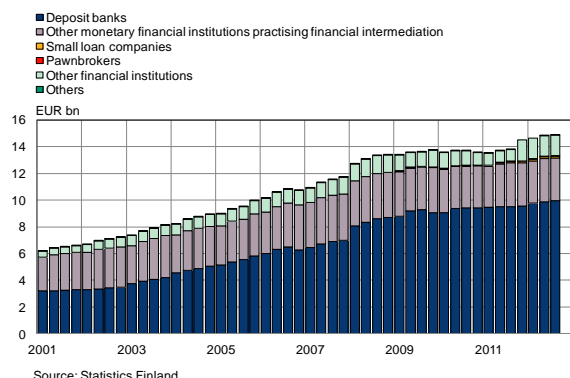
The Finnish consumer credit market is highly bank-centered (Chart 7). Banks and other MFIs accounted for 89% of the consumer credit stock at end-September 2012. MFIs grant, in addition to one-time loans, also different credit card credits and overdrafts, which may be marketed with different

¹³ Loans granted to households acting as private entrepreneurs to pursue business activities are not considered consumer credit. In practice, it may be hard to distinguish between business activities and consumption.

¹⁴ Loan stock statistics of Statistics Finland.

product or service names. A majority of such loans are granted by banks or their financing companies.

Chart 7. Finnish households' stock of consumer credit by lender



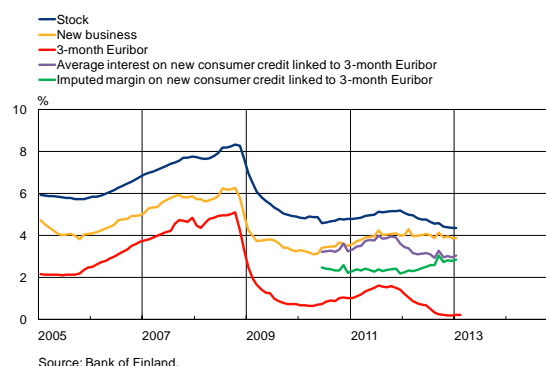
Financing companies operating without a credit institution's authorisation are the second-largest lender group with a market share of 10%. The combined share of small-loan companies and pawnbrokers remains below 1% of the value of consumer credit. There is much less statistical information available on the activities of these lenders compared to MFIs.

Out of the stock of consumer credit granted by MFIs, 70% consists of one-time loans, and 70% of that is collateralised. The collateral consists primarily of residential real-estate assets. Credit card credit accounts for about 20% and overdrafts for about 10% of all consumer credit.

Interest on consumer credit varies by product

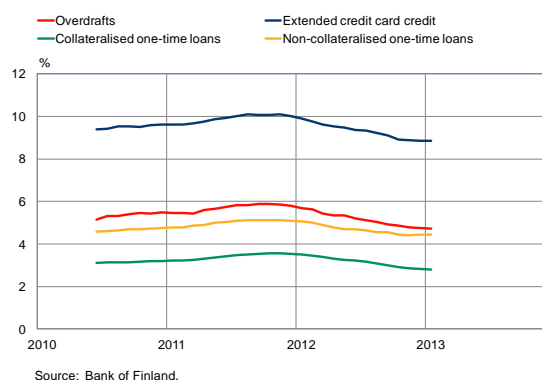
In January 2013, the average interest rate on the stock of consumer credit granted by MFIs stood at 4.3% and the interest rate on new consumer credit at 3.9%. Similarly to housing loans, the recent decline in reference rates is not fully reflected on the prices of consumer credit, since margins on consumer credit have also risen. For example, the interest rate differential between a newly drawn consumer credit linked to the 3-month Euribor and the reference rate has risen by about 0.4 percentage points in one year (Chart 8).

Chart 8. Interest rates on consumer credit granted by MFIs and imputed margin on loans linked to 3-month Euribor



Depending on the bank, non-collateralised consumer credit is typically available in sums up to EUR 10,000–25,000.¹⁵ Non-collateralised consumer credit is usually granted for relatively small purchases and on average with clearly shorter maturities than collateralised loans. The average maturity of non-collateralised one-time loans is 5–6 years, compared to almost 10 years for collateralised loans. In January 2013, the average interest rate on collateralised consumer credit stood at 2.8% and on non-collateralised consumer credit at 4.4% (Chart 9). In January, the average interest rate on overdrafts stood at 4.7% and on interest-bearing extended credit card credit at 8.8%.

Chart 9. Average interest rate on consumer credit granted by banks by claim in Finland



About 60% of one-time loans are linked to Euribor rates. The proportion of loans linked to banks' own

¹⁵ Based on information published at banks' websites.

reference rates stood at about 20%, while consumer credit with fixed interest rates amounted to about 19%. The proportion of one-time loans with fixed interest rates has been increasing, particularly in non-collateralised loans. This is particularly explained by the low level of interest rates on collateralised loans relative to corresponding loans linked to Euribor rates.

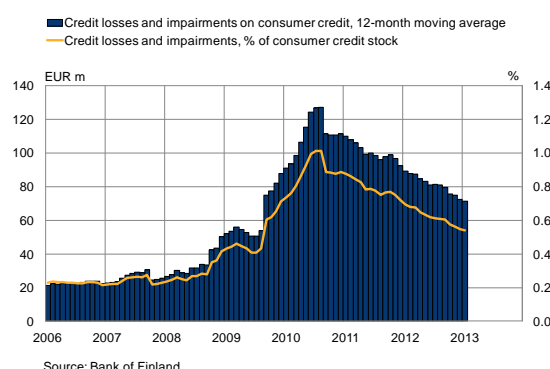
Up until August 2011, almost half of newly drawn Euribor-linked consumer credit was linked to the 3-month Euribor, but by the end of 2012, the 12-month Euribor had superseded it as the most widely used reference rate, although it was about 0.5 percentage points higher.

Slower growth in consumer credit than before the crisis

In recent years, growth in consumer credit granted by MFIs to households has been clearly slower than before the financial crisis, when the annual growth rate varied at about 8–14%. On the other hand, the growth rate has accelerated somewhat since 2010, yet remaining at a moderate level. At the end of 2010, the annual growth of the stock of consumer credit stood at about 4%, which is slightly slower than in the first year-half. The slowdown reflected particularly a slowdown in the annual growth of collateralised one-time loans.

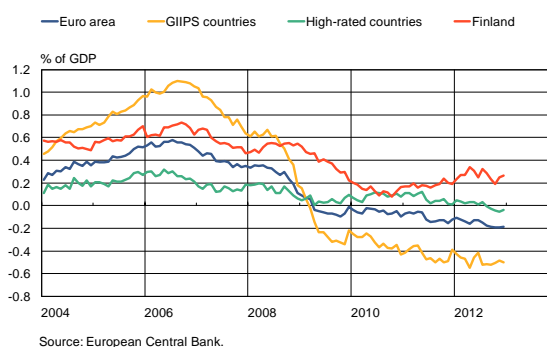
Consumer credit typically results in more credit losses than for example housing loans. In Finland, however, credit losses recorded on consumer credit granted by MFIs have been relatively low. Before the financial crisis, the credit loss level (credit losses as % of the consumer credit stock) stood at about 0.2%. Credit losses began to increase in 2008, peaking in 2010 at 0.9%. After that, credit losses have diminished, yet remaining at higher levels than before the crisis (Chart 10).

Chart 10. Credit losses and impairments on consumer credit granted by MFIs¹⁶



The growth of consumer credit in the euro area has diverged during the crisis (Chart 11). The demand for consumer credit contracted in many countries faster than the GDP in relative terms. The changes were particularly pronounced in the GIIPS countries, where consumer credit grew during the pre-crisis years faster than in the euro area on average and correspondingly contracted faster after the onset of the crisis. In high-rated countries, the developments have been relatively stable. Developments in Finland deviate from most other countries, since the stock of consumer credit has not contracted at any stage.

Chart 11. Moving 12-month flow of consumer credit relative to GDP in the euro area and certain country groups in it



¹⁶ Bank of Finland's data collection changed in June 2010, and therefore information on credit losses and impairments collected before that may not be fully comparable.

2 Banks and insurance companies

2.1 Profitability of Finnish financial groups improved in 2012

Eero Savolainen

The profitability of Finnish financial groups improved during 2012 despite the challenging operating environment. Net interest income decreased, while other income increased.

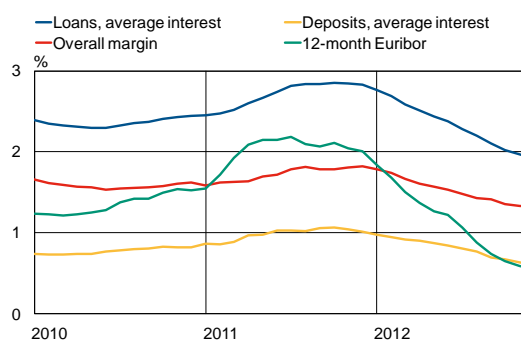
Finnish financial groups¹⁷ posted an aggregate operating profit of about EUR 2.5 bn in 2012. The aggregate operating profit was 11% higher than a year earlier. The combined operating profits of Nordea Bank Finland (EUR 1.6 bn) and the OP-Pohjola Group (EUR 0.6 bn) accounted for 87% of the financial groups' aggregated operating profit. None of the financial groups or banking groups recorded an operating loss, and all improved on their previous year's result.

The decline in short-term money market rates and decelerating loan and deposit growth reduced the net interest income during 2012. The overall margin, or the differential between the loan and deposit interest rates, which has a major impact on the net interest income, decreased throughout the year as loan interest rates declined more than deposit interest rates (Chart 12). The average overall margin of 1.52 percentage

¹⁷ In this review, Finnish financial groups comprise the Aktia Group, Danske Bank Plc Group, Evli Bank Group, Nordea Bank Finland Group, OP-Pohjola Group, POP Pankki Group, Savings Bank Group and the Ålandsbanken Group.

points was 12% lower than a year ago (1.72 percentage points). However, the financial groups' aggregate net interest income decreased clearly less in relative terms, by only 4%. This was due to a considerable increase in the net interest income from other products – derivatives in particular.

Chart 12. Finnish credit institutions' average interest rates on loan and deposit stock and overall margin



Sources: Bank of Finland and Reuters.

Underlying the 18% growth in other income was a solid development in net income from trading and investment activities in 2012. Expenses increased by a moderate 2%. Impairments on loans and other commitments grew by a third, but they remained small relative to the loan stock.

Financial groups' aggregated balance sheet contracted by 8% in 2012. This was solely due to Nordea Bank Finland, whose balance sheet decreased during the year by 14% (EUR 57 bn) among other things due to a decrease in the balance sheet values of derivatives contracts on the back of increased use of central counterparty clearing. The aggregated balance sheet of other financial groups increased by 9%.

Although financial groups' operating profit increased, the aggregated operating profit from banking activities in Finland was unchanged at about

EUR 1.0bn. This reflected the fact that banking income showed more sluggish developments than net income from insurance, trading and investment activities, which are not generally included in basic

banking activities in segment reporting. These items supported particularly the profitability of the largest agents.

Table 1. Operating profits of banks operating in Finland, EUR m

	2012	2011	Change
Nordea Group	4 117	3 547	16 %
Retail bank	1 834	1 546	19 %
Retail banking in Finland	357	344	4 %
Life and pension insurance	335	207	62 %
*Nordea Bank Finland Group	1 616	1 482	9 %
Danske Bank Group	1 151	564	104 %
Banking	268	-66	..
Retail banking in Finland	19	22	-15 %
*Danske Bank Finland Group	157	147	6 %
OP-Pohjola Group	601	525	14 %
Banking	437	447	-2 %
Non-life insurance	92	8	..
Asset management	101	47	115 %
*Pohjola Bank Group	374	258	45 %
Savings Banks	67.1	65.4	3 %
Aktia Group	56.0	44.6	26 %
Banking	39.2	35.6	10 %
Life insurance	14.7	10.3	43 %
POP Banks	29.4	28.0	5 %
Ålandsbanken Group	10.0	-5.7	..
Business activities in Finland	0.5	7.9	-94 %
Evli Bank Group	3.6	3.6	0 %
1. Banking in Finland	953	954	0 %
2. Finnish financial groups	2 540	2 290	11 %
3. Financial groups operating in Finland	6 035	4 772	26 %

1. Aktia's banking, Danske Bank's banking in Finland, Nordea's banking in Finland, OP-Pohjola Group's banking and investment Finland service activities, POP Bank Group, Savings Bank Group and Ålandsbanken's business in Finland.
2. Aktia Group, Danske Bank Plc Group, Evli Bank Group, Nordea Bank Finland Group, OP-Pohjola Group, POP Pankki Group, Savings Bank Group and Ålandsbanken Group.
3. Finnish financial groups, entire Danske Bank Group and Nordea Group.

Source: Banks' financial statements.

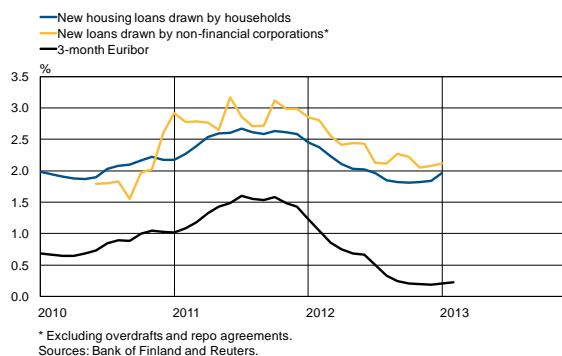
2.2 Margins on housing loans and small corporate loans widened the most

Kimmo Koskinen and Hanna Putkuri

Margins on new housing and corporate loans have widened in Finland since summer 2011. Margins on housing loans and smaller corporate loans have widened the most. However, interest rates on new loans continue to be low by historical standards and in comparison to the euro area average.

The average interest rate on new housing loans drawn by households in Finland increased in January to 1.97% (Chart 13). Despite the rise that began in autumn 2012, the average interest rate on new housing loans continues to be low by historical standards and clearly lower than in other euro area countries. The average interest rate on loans drawn by non-financial corporations¹⁸ remained in January at about 2.1%.

Chart 13. Average interest rates on Finnish MFIs' new housing and corporate loans and 3-month Euribor

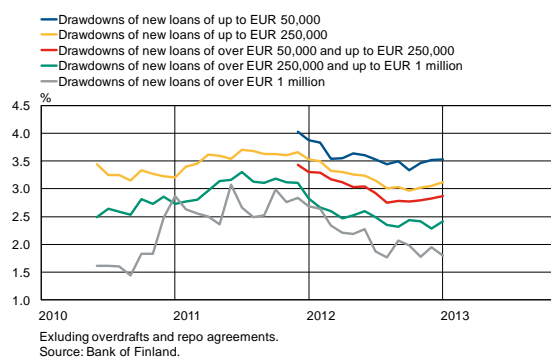


The average interest rate on new loans to non-financial corporations typically fluctuates more than the average

¹⁸ Without overdrafts and repo agreements.

interest on new housing loans. The variation reflects mostly new loans of more than EUR 1 million whose interest rates show more month-on-month volatility and which have a larger impact on the average interest rate than smaller loans (Chart 14).

Chart 14. Average interest rates on new corporate loans granted by Finnish MFIs by loan size



Smaller corporate loans of up to EUR 250,000 have clearly higher interest rates than larger corporate loans. The most expensive type of loans is those of up to EUR 50,000, and their interest rates have increased the most since October 2012. At the same time, the interest rate differential between small and large loans to non-financial corporations has increased.

Small corporate loans have the widest margins

The Euribor rates commonly used as reference rates for housing and corporate loans have sunk to historical lows. In contrast, the customer- and loan-specific margins¹⁹ charged in addition to the reference rate have been widening since summer 2011 (Chart 15). In January, the imputed margin on new housing loans stood at 1.44 percentage points on average and on loans to non-financial corporations at 1.76 percentage points.

¹⁹ The imputed margins presented in this article are based on Bank of Finland calculations and information on interest rates and amounts of new drawdowns of loans linked to different reference rates.

Margins have widened the most and are at the widest in new corporate loans of up to EUR 250,000; in January on average 2.63 percentage points (Chart 16). In January, the imputed margin on new corporate loans of up to EUR 50,000 stood at 3.05 percentage points, on loans of EUR 50,000–250,000 at 2.37 percentage points, on loans of EUR 250,000–1,000,000 at 1.97 percentage points and of larger corporate loans at 1.49 percentage points.

Loan pricing also reflects the fact that loans granted to small companies are typically perceived as riskier than loans to larger companies with established activities. Loans categorised as riskier have higher risk weights in banks' capital adequacy calculation, which causes more costs to the banks as they have to reserve more own funds for credit risks related to these loans.

Chart 15. Average margins on Finnish MFIs' new housing and corporate loans and 3-month Euribor

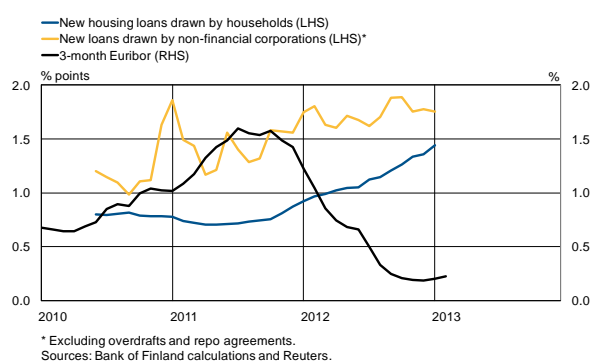
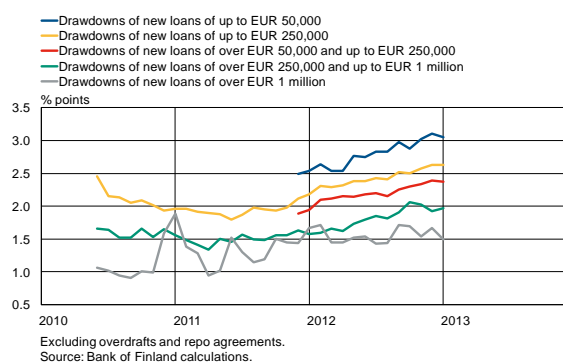


Chart 16. Average margins on new corporate loans granted by Finnish MFIs by loan size



Banks operating in Finland have justified the recent widening of loan margins among other things by their increased funding costs and anticipated costs resulting from tightening regulation. In addition, the decline in Euribor rates to historical lows has weakened the profitability of basic banking activities by reducing banks' net interest income.²⁰

Before the onset of the financial crisis, the margins on housing loans in Finland narrowed to historical lows as the treatment of these loans in banks' capital adequacy calculation eased²¹, the economy and employment developed favourably, the stock of housing loans grew at a rapid pace and there was intense competition between banks.

Euro area debt crisis has increased interest rate differentials

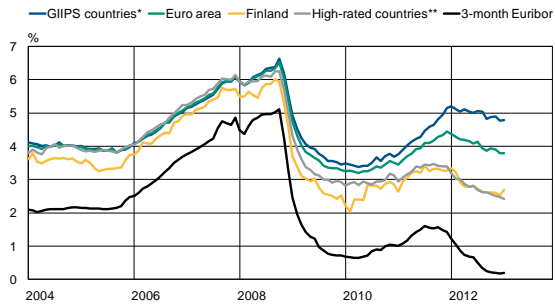
The euro area debt crisis has widened the margins on loans granted by banks particularly in the crisis countries. Loan terms have been tightened the most in loans to non-financial corporations and particularly small and medium-sized enterprises (Chart 17). In small corporate loans, the interest rate differential between the GIIPS countries and high-rated countries in the euro area has already risen to 2 percentage points, whereas before the crisis, bank loans were priced almost similarly across countries.

Interest rate differentials have grown also in housing loans, but clearly more moderately. Interest rate differentials across the euro area countries reflect particularly the weak economic development of the crisis countries, banks' increased funding costs and the increased credit risks in these countries.

²⁰ See Article 2.1 in this report.

²¹ See Article 5.1 in this report.

Chart 17. Average interest rates on new corporate loans of up to EUR 1 million with an original rate fixation of up to 1 year



* Greece, Ireland, Italy, Portugal and Spain.
 ** Germany, France, Netherlands, Belgium, Austria and Finland.
 Sources: European Central Bank and Bank of Finland calculations.

3 Securities markets

3.1 Is companies' financial structure changing?

Pertti Pylkkönen and Katja Taipalus

In Europe, banks' role in corporate finance has traditionally been very strong. The difficulties of banks in the crisis countries and disruptions in financial intermediation have intensified the impacts of the crisis and emphasised the fragmentation of European economic developments. At the same time, companies have begun to seek funding increasingly outside the banking system. The significance of market-based corporate finance has also increased in Finland over the past year.

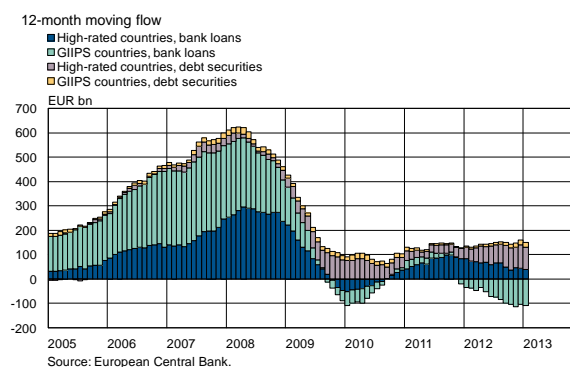
Corporate finance in Europe has traditionally been highly bank-centered compared for example to the United States. In Europe, bank loans have accounted for about 55% of even large companies' debt finance, compared to about 34% in the United States. Smaller companies', reliance on bank lending is even higher.

The financial crisis of the recent years and the subsequent regulatory initiatives have changed the financial structure of European companies so that the proportion of bank loans has decreased and the proportion of finance sought directly from the markets has increased. Problems in the banking sector of the crisis countries, weakness of banks' balance sheets and general distrust towards banks have increased the cost of banks' funding, which has weakened their ability to

grant loans. The financial conditions have tightened clearly, particularly in the GIIPS countries.

Large companies have sought to replace tightened bank lending by seeking finance directly from the markets. Small and medium-sized enterprises in the crisis countries have found themselves in the weakest position, since their ability to utilise market-based funding is relatively limited. In the GIIPS countries, banks have been able to replace only a small proportion of the contraction in lending with market-based funding, in contrast to high-rated countries (Chart 18). Underlying these developments, however, there are also factors related to demand, such as a reduction in investments.

Chart 18. Bank loans and debt securities issued by euro area non-financial corporations, 12-month moving flow



The reform of regulation on banking activities aims at securing the stable functioning of banking and preventing the large-scale impacts of future financial crises. In the short term, the regulatory reforms may increase banks' costs and transform their business models, which may increase the importance of market-based funding. There are significant differences in the degree of development of the capital markets in

Europe, which may limit the possibilities of companies to make use of alternative sources of funding.

Growth of corporate loan stock has stopped in Finland

The decline in economic growth and continued uncertainty in the financial markets have been reflected in Finland for example as caution in companies' investments and sluggishness in the demand for long-term debt. The amount of loans granted by banks to non-financial corporations has remained largely unchanged in the past year. Direct lending by employment pension companies to non-financial corporations has contracted.

Tightening banking regulation and profitability pressures have constrained the terms of loans granted by banks to non-financial corporations. For example, the average margins on corporate loans have widened already for a couple of years.²² For smaller companies, the availability of finance is also hindered by higher collateral requirements and the scarcity of eligible collateral. The increased use of covenants, or collateral assurance, may also contribute to the weakening demand for corporate loans.

Issuance of bonds by Finnish companies at record level in 2012

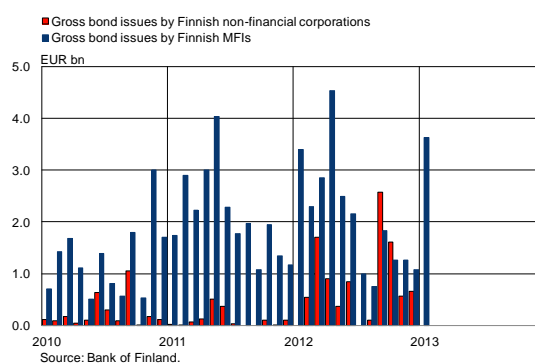
On the back of changes in the financial markets, particularly larger Finnish companies have begun to diversify their financial structures. The issuance of corporate bonds increased in 2012 exceptionally rapidly. In gross terms, it reached EUR 9.9 bn, compared to only slightly less than EUR 1.4 bn in the previous year (Chart 19). Almost a third of corporate bond issues was directed domestically.

The variety of corporate bond issuers is diverse. In addition to industrial companies, long-term market-

²² See Article 2.2 in this report.

based funding has been sought by many retail companies as well as construction and real-estate companies.

Chart 19. Private sector bond issues

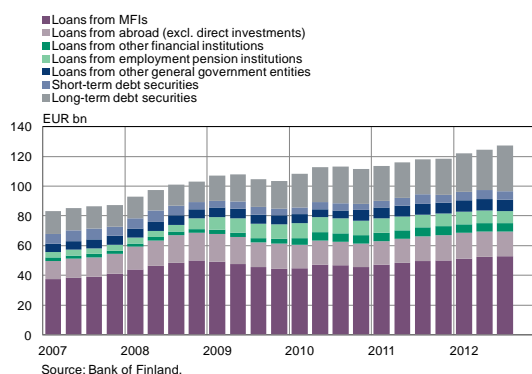


The domestic market for companies' short-term market-based funding, or commercial paper, has functioned relatively well. The stock of commercial paper outstanding has stood at EUR 5–6 bn for quite some time.

Commercial paper and corporate bonds accounted for about a quarter of the interest-bearing debt of Finnish non-financial corporations at the end of September 2012 (Chart 20). Banks operating in Finland account for about 40% of the funding, and they continue to be the most important single source of funding for companies.

In addition to the increasing market-based funding, the sources of funding for Finnish companies are diversified by the fact that the possibilities of the special financial institution Finnvera to increase its corporate finance have been strengthened. This supports the availability of funding particularly for small and medium-sized enterprises.

Chart 20. Structure of Finnish non-financial corporations' interest-bearing debt



Diversification of companies' financial structures as a challenge

Changes in the financial structure of the corporate sector are relatively slow, although there is a clear need to diversify the sources of finance. The shift of Finnish companies' financial structures to a more market-driven direction is slowed down by the fact that the domestic financial markets are limited by international standards. On the other hand, international issues are hindered by the fact that only a few Finnish companies have a credit rating. Furthermore, the average size of Finnish companies as measured by turnover, for example, is relatively small. Hence, with the present financial market structure, the number of companies seeking finance from the markets remains rather low.

Broadening of companies' domestic financing opportunities would necessitate a broadening of the functioning of the bond market, such as the establishment of a lighter alternative marketplace for regulated marketplaces. An example is the Entry Standards marketplace operating in connection with Deutsche Börse and offering a trading venue for corporate bonds, where the average issue size is EUR 30–50 mn, but the list also includes issues of EUR 10 mn. As a rule, the loans have a rating by an agency not

registered by the European Securities and Markets Authority (ESMA). The smallest trading lot for the loans is EUR 1,000, which means that investments by individual investors in these bond markets are also feasible.

4 Infrastructure

4.1 Final dash in SEPA migration

Marianne Palva

Less than a year remains until completion of the migration to SEPA in the euro area. With the exception of a few countries, the process has advanced sluggishly with respect to both credit transfer and particularly direct debit. Also in Finland work remains to replace the national direct debits.

An EU Regulation²³ requires that the euro area gives up national credit transfers and direct debits and migrates to credit transfers and direct debits under the SEPA (Single Euro Payments Area) format by 1 February 2014. The transition period for non-euro area SEPA countries²⁴ ends on 31 October 2016.

The Regulation includes a set of transitional provisions, according to which euro area member states may allow longer transitional periods in certain respects. However, the transitional provisions are exceptions and only apply to a limited part of payments or services offered. According to these provisions, banks may offer their customers credit transfer conversion and supplementation services if the

member state has decided so. In addition, member states may decide to allow the use of certain traditional niche products based on credit transfer or direct debit in very limited use until the end of January 2016.

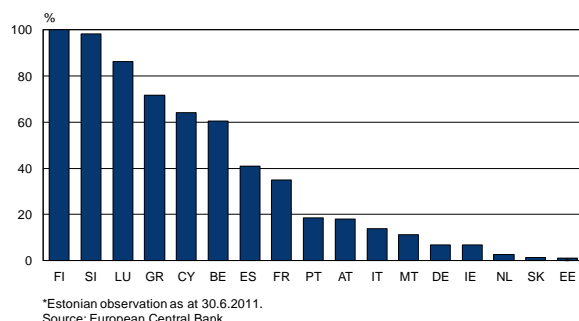
An example of a national niche product is the direct debit resembling a credit card transaction used in Germany and Austria. In this transaction, the customer uses a credit card at the point of sale to initiate a direct debit. The card reading provides the vendor an electronic authorisation for making a direct debit from the customer's account. Transitional periods for other types of national niche products have been granted in Spain, Italy, Austria, France and Cyprus.

Replacement of national means of payment by SEPA payment instruments is an arduous and time-consuming process. Only less than a year remains until the end of the transitional period. The migration is ongoing in all euro area countries, but the speed of progress varies greatly. In Finland, the migration was completed with respect to credit transfer during 2011. The proportion of SEPA credit transfers varies considerably across countries, and the migration rate is still very low in the large euro area countries (Chart 21).

²³ Regulation (EU) No 260/2012 of the European Parliament and of the Council establishing technical and business requirements for credit transfers and direct debits in euro.

²⁴ Bulgaria, Czech Republic, Denmark, Great Britain, Hungary, Iceland, Latvia, Liechtenstein, Lithuania, Norway, Poland, Romania, Sweden.

Chart 21. Proportion of SEPA credit transfers in all credit transfers in euro area by country as at 30.9.2012



Direct debit involves the most work in Finland and the rest of the euro area

In most countries, the national direct debit is replaced by the SEPA direct debit. However, Finland and Estonia adopted an alternative solution where the direct debits of private customers using online banking are replaced by e-invoicing developed by the banks. Other private customers' direct debits are replaced by direct payments. Billers adopting the replacement service take care of the migration together with the banks. If the payer accepts migration to the new service, he does not have to do anything. In some cases, small billers, such as housing corporations, may resume using paper invoices payable by the customer at his own initiative.

A conversion service for the national direct debit is not being offered when the payer is a corporate customers. Therefore, the biller and the payer have to agree on how to replace the defunct service. In this case, too, the recommended replacement service is e-invoicing. It enables the company to improve the efficiency of its financial administration and to generate cost savings. The electronic invoice also offers benefits to the consumer, such as electronic archiving of invoices.

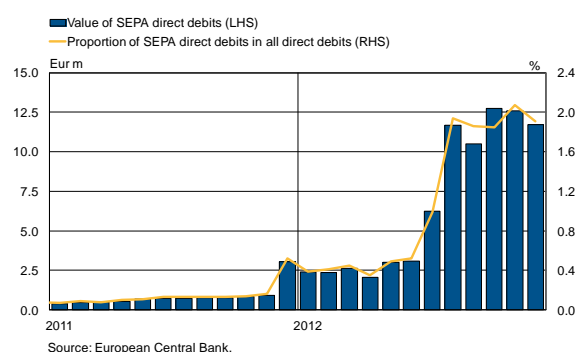
In Finland, banks are prepared to commence the process of converting direct debits, and the first billers

have already launched the process. Most companies begin with small invoice batches to ensure that everything runs according to plan. For each biller, the process takes at least two months, since according to the law, the consumer must be given this period to react to a notice concerning migration into the new service. Only after the period has lapsed, the biller may complete the process and adopt the new service.

Due to the duration and complexity of the process, billers should begin the conversion of direct debits as soon as possible. More information on SEPA direct debit and progress on the migration in Finland is available at the website of the Federation of Finnish Financial Services²⁵.

Disposal of the national direct debit has not proceeded in other euro countries much further than in Finland. There is no country-specific information on the developments, only information from euro area clearing houses is available (Chart 22 **Error!** **Reference source not found.**). At the end of 2012, SEPA direct debits only accounted for a good 2% of all direct debits. Hence, a lot of work remains to be done also in the rest of the euro area.

Chart 22. Proportion of SEPA direct debits in all direct debits at euro area clearing houses



²⁵ See <http://www.fkl.fi/teemasivut/sepa/ajankohtaista/SEPA- uutiskirjeet/Sivut/default.aspx>.

Benefits of SEPA to materialise gradually

The Eurosystem and national central banks increased their efforts to promote the SEPA migration after the Regulation on the migration entered into force on 14 March 2012. Progress in the process is being monitored more closely than before, and communication on SEPA has been increased. The European Central Bank has updated and expanded information on SEPA available online.²⁶ The ECB will shortly publish a SEPA migration report also presenting the transition situation at country level. The full benefits of SEPA will only be realised once the work has been completed in all respects.

²⁶ See <http://www.ecb.int/paym/sepa/html/index.en.html>.

4.2 Continued disruptions in payment transmission

Anne Nisén²⁷

Banks operating in Finland implemented the changes necessitated by the Single Euro Payments Area (SEPA) in credit transfers among the first countries in Europe. The transition phase increased disruptions in payment transmission, and their underlying causes are yet to be completely rectified.

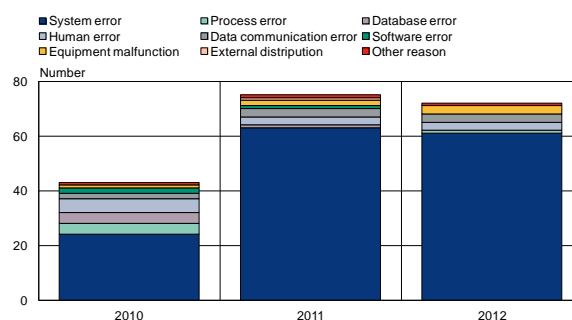
Migration into the Single Euro Payments Area increased the propensity of disruptions in payment transmission in Finland, as banks made extensive changes in their payment systems. During 2011, domestic credit transfers were shifted completely into the STEP2 system of EBA Clearing.

Although the participants in payment transmission have made efforts to identify, mitigate, monitor and report on the sources of disruptions, disruptions have not been completely eliminated in payment transmission. All disruptions have been caused by internal processes of individual banks, whereas the STEP2 clearing system has ran smoothly. In practice, the disruptions may be reflected on the payers and recipients as delays in payments. The disruptions are particularly visible in the customers' daily lives if they occur on the same days as recurrent transactions, such as wage payment days.

In 2011 and 2012 payment transmission disruptions occurred on more than 70 days, and there was no clear turn for the better (Chart 23). Systems errors have caused the most disruptions (Chart 24). However, the reasons underlying the disruptions vary, which is why it has been challenging for the banks to eliminate them. In 2012,

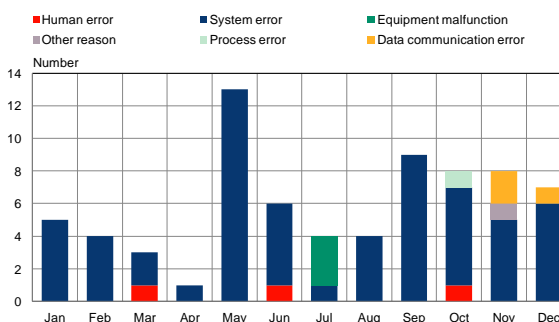
there have been a few cases where debiting of payments to the recipients' accounts has been delayed until the next banking day. In most cases, however, the delays have been rather short, and the delayed payments have been debited to the recipients during the same day.

Chart 23. Disruptions in payment transmission in Finland by disruption type in 2010–2012



Source: Financial Supervisory Authority.

Chart 24. Monthly breakdown of payment transmission disruptions in Finland in 2012



Source: Financial Supervisory Authority.

FIN-FSA requires that banks report disruptions to it, analyse the underlying reasons and correct any disruptions rapidly. FIN-FSA monitors the reliability of payment transmission among other things by inspecting banks' payment systems. In 2012, the Bank of Finland made a general supervision assessment on domestic payment system and has required that banks improve governance and processes in domestic payment transmission. The Bank of Finland and FIN-FSA continue to monitor payment transmission and banks' activities in order that the disruptions in banks' processes could be reduced.

²⁷ The author works at the Financial Supervisory Authority.

4.3 Consultation on access to payment accounts

Timo Iivarinen and Erja Pullinen²⁸

A joint working group of European national central banks and supervisors, the European Forum on the Security of Retail Payments, requests by means of a public consultation, feedback on recommendations on access to payment accounts. The recommendations are aimed at enabling information and payment services linked to customers' accounts and ensuring the security of these services.

As the use of the Internet increases continuously, many so-called third-party service providers have begun to develop new services related to payments. Since these services utilise customers' accounts at banks, parties developing new innovative services need some kind of access to the customers' account information.

The European Central Bank, national central banks in the EU area and supervisors participating in the SecuRe Pay cooperation have published a proposal for security recommendations²⁹ which would apply to these new services and their providers. The purpose of the recommendations is to contribute to the security of the services and to increase customers' trust towards new services. The proposal may be commented to the ECB until 12 April 2013.³⁰ The final security recommendations are published after the comments

²⁸ The latter author works at FIN-FSA.

²⁹ Recommendations for "payment account access" services.

³⁰ For further information on responding and the detailed security recommendations, see ECB's website: http://www.ecb.int/press/pr/date/2013/html/pr130131_1_response.en.html.

received through the public consultation have been processed.

New services are related to information and online payments

Typical payment-related services by third-party providers include account information services and online payment services.

An information service is generally an application facilitating the monitoring of personal finances by gathering information on the customer's various accounts (eg balances and cash assets) in a single interface even if the accounts are at different banks.

Online payment services typically concern purchases the customer makes at online stores. Third parties provide services independent of banks to pay these purchases from the customer's own bank account. However, making the payment requires that the required funds can be verified and reserved on the account. This requires that the service provider has real-time access to the customer's account.

Security recommendations serve many purposes

The security recommendations seek to ensure that the account owners' funds and account information are not abused. At the same time, however, there is an intention to provide the required operating framework for the new service providers. New service providers contribute to the creation of efficient and secure payment services for the entire society and also generate new competition in the field of payments.

By harmonising the security requirements for the interfaces between traditional banks and the new service providers in Europe, the road is paved for new service providers to launch and continue operation in payment transmission, thus promoting a single, European-wide payments area.

Many requirements for service providers

The service providers must have sufficient control and security procedures to ensure that the security of customers' bank accounts is not put at risk. The service providers must also be able to provide sufficient information on the service to the users of the services so that they can assess themselves the risks related to the service. All activities by parties involved in the service must leave sufficient log information so that the transactions can be traced when necessary. The parties must transmit information amongst themselves on any payment cancellations and breaches related to security. The use of accounts by the service providers must be limited in terms of time and volume to as little as possible, however, so that the service can be carried out. The service providers must also agree with e-merchants that they observe the same security requirements.

The objective has been to formulate the security requirements as generally as possible so that for example technological advancements would not immediately affect their content. However, the content will be developed as necessary to reflect changes in the operating environment. Local authorities such as the Bank of Finland and FIN-FSA will participate in supervising compliance with the final security recommendations. In addition, there is an initiative pending within the EU aiming to include the service providers in the future under the Payment Services Directive and consequently also the Finnish Payment Services Act.

5 Key regulatory and supervisory initiatives

5.1 Nordic countries to tighten regulation on housing loans

Jukka Vauhkonen

The Nordic countries are about to introduce stronger measures to reduce the risks related to housing lending and fluctuations in house prices. Sweden and Norway intend to increase the risk weights applied to housing loans in the calculation of capital adequacy requirements for banks. In Denmark, the rules on booking banks' provisions for credit losses were tightened. In Finland, the government is expected to issue a proposal for a law amendment which would enable a binding cap on the loan-to-value ratio for housing loans.

The global economic crisis of recent years has once again shown how excessive growth in housing lending and the bursting of house price bubbles may create and intensify financial crises and slow down the subsequent recovery. Risks related to housing lending grew before the crisis began in the Nordic countries and they materialised in Denmark and Iceland.³¹ As a lesson learned from the crisis, regulation on housing lending in the Nordic countries has already been tightened and is set to be tightened further.

³¹ See Article 1.2 in this report.

The objectives of the reforms carried out include the strengthening of banks against credit risks resulting from housing lending, reduction of banks' incentives to grant and households' incentives to take very large housing loans relative to the collateral and debt servicing capacity. If successful, the reforms may also dampen the volatility of house prices.

Capital requirements for housing loans decreased just before the financial crisis

The so-called Basel II capital adequacy requirements adopted in Europe in 2007 relaxed materially the treatment of housing loans in banks' capital adequacy calculation. The Basel II allowed banks to use, subject to approval by the banking supervisor, their own credit history material and internal credit ratings determined for their customers in calculating their risk-weighted assets and the related capital adequacy requirements.

As a result of the reform, the risk weights of housing loans and consequently the capital requirements for housing loans decreased at many banks to a fraction of the previous requirement.³² The change had the largest impact on banks with little credit losses in their recent history, such as Nordic banks. In particular, the average risk weights on housing loans granted by large Swedish banks in recent years have been smaller than the comparable weights at large European banks on average.

The non-transparency of capital adequacy calculation and large differences between banks in the

³² Basel II provisions also decreased the risk weight on housing loans for banks applying the standard approach to credit risk from 50% to 35%.

risk weights on housing loans and other asset items have internationally weakened investors' and supervisors' trust in banks' risk-weighted capital adequacy figures. Similarly, doubts have arisen that some banks may have intentionally underestimated the risks in their credit and trading portfolios, in which case the capital adequacy figure reported by the bank has given an overly positive view of the banks' loss-bearing capacity. Hence, the Basel Committee for Banking Supervision has launched a survey on the reliability of the calculation methods applied by banks to risk weights.³³

Financial supervisors set to tighten regulation

The **Swedish** banking supervisor Finansinspektionen has announced that it would set a 15% minimum for risk weights applicable to housing loans granted by Swedish banks.³⁴ According to Finansinspektionen, the increase is justified since risk weights based on historical performance do not sufficiently reflect the recent increase in risks related to housing lending in Sweden. These risks include, for example, the increased loan-to-value ratios³⁵ in housing loans, households' increased indebtedness, lengthening of housing loans and the increase in non-amortised housing loans.

Also **Norway** intends to increase the risk weights for housing loans. In December 2012, the Norwegian Ministry of Finance requested the Norwegian financial supervisor to issue a proposal on how the risk weights

³³ Press release of the Basel Committee for Banking Supervision on 31 January 2013, <http://www.bis.org/press/p130131.htm>.

³⁴ Riskviktsgolv för svenska bolån. Promemoria, Finansinspektionen, 26.11.2012. Finansinspektionen is going to implement the requirement as part of a comprehensive assessment of banks' own funds (so-called Pillar 2 process of capital adequacy regulation).

³⁵ The size of housing loan relative to the value of a house purchased with the loan and used as collateral on the date of granting the loan.

for housing loans granted by banks applying the internal ratings-based approach could be increased at least to 35%. The financial supervisor Finanstilsynet issued its proposal at the beginning of March 2013. A key component in the proposal is setting a lower limit of 25% for the so-called loss given default (LGD), the loss parameter used in the calculation of the risk weights for housing loans.³⁶

In Denmark, banks have suffered large losses on housing and real-estate lending in recent years, which has encouraged authorities to tighten the regulation on housing lending. In March 2012, the Danish banking supervisor specified the provisions on booking impairments on bank loans with a view to having banks book expected credit losses sooner than presently. In Denmark, a joint working group of the central bank, financial supervisor and the financial industry has been established to assess measures to prevent house price bubbles in the future. The working group is expected to complete its report in the first half of 2013.

In Finland, the government is expected to give its proposal this year on a binding maximum loan-to-value ratio, so-called loan cap, which could be issued by FIN-FSA on loans with housing or real-estate collateral, if necessary.

The tightening of regulation on housing lending already enforced or being prepared has mainly consisted of decisions made by financial supervisors in charge of so-called micro supervision within the scope of their present mandates. Going forward, the monitoring and prevention of systemic risks related to housing lending and markets will be increasingly vested with authorities responsible for macro prudential supervision as well as their cooperative bodies.

³⁶ Kapitalkrav og risikovekter for boliglån. Finanstilsynet's press release 4.3.2013.

5.2 Global legal entity identifier for entities operating in financial markets

Marko Myller

In the global financial markets, many agents may provide services or participate in different countries' payment and settlement systems, central securities depositories and central counterparties without having local activities in these countries. Many agents also have companies with broadly similar names in different countries. In order that counterparties could be reliably identified, a new global legal entity identifier is being developed.

In Finland, companies and other entities receive from authorities a numerical Business ID, which can be used by other companies, customers and authorities to easily identify the company. Another advantage of the numerical code is its ease of use in various information systems. A similar idea – on a global scale – underlies the development of a Legal Entity Identifier (LEI) for entities operating in the financial markets.

The initiative on the global identifier aims at developing a single global system which could be used to specifically identify for example the parties to financial market transactions. As global agents wound up in problems during the different phases of the financial crisis, other market participants and also authorities faced challenges in identifying these agents and the market networks they were involved in. A standardised identifier facilitates the identification of

counterparties and customers and is easier to utilise in information systems. The benefits extend beyond the parties, since the same identifier can be used in various types of reporting to the authorities.

The initiative received a boost in November 2011 when a meeting of the G20 decided to endorse the establishment of a global identifier and requested the Financial Stability Board (FSB) to take care of coordination of the efforts. In June 2012, the stability board published a report³⁷ including 15 high-level principles and 35 recommendations for a global legal entity identifier system.

The administration of the system consists of a Central Operating Unit (COU) governing Local Operating Units (LOU) in each country. The Local Operating Units may be authorities or private agents. Activities of the centralised unit are steered and monitored by a supervisory body, the Regulatory Oversight Committee for the Global Legal Entity Identifier System (ROC), including authorities from different countries. The members of the supervisory body were appointed in January 2013.

The system is relatively light in terms of the information maintained, and the basic information on the entities is to be maintained at the local level in accordance with common internationally specified standards. The actual legal entity identifier is a 20-digit code including alphabets and numbers based on the ISO 17442 standard issued in 2012. The identifier is determined as follows:

- Characters 1–4 comprise the identifier of the register issuing the LEI,
- Characters 5–6 are reserved characters set to zero,

³⁷ A Global Legal Entity Identifier for Financial Markets, 8.6.2012. See http://www.financialstabilityboard.org/list/fsb_publications/tid_156/index.htm.

- Characters 7–18 are reserved for the identifier of the entity assigned by the relevant LOU,
- Characters 19–20 are check digits.

In addition to the identifier, the system contains the official name of the entity, the address and country of its main office, and the register which assigned the identifier.