

Profitability Analysis of the Finnish Banking Sector in 2010-2014

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ABSTRACT

This thesis aims to introduce the most important financial ratios and methods used to analyze profitability of banks. Furthermore, this thesis determines the most profitable major Finnish bank in the years 2010-2014 by analyzing the financial statements of Danske Bank Plc, Nordea Bank Finland Plc and the OP Financial Group. In addition, this thesis aims to find out the drivers affecting the profitability of banks.

In the theoretical part of the thesis the financial statements of banks are introduced and methods of financial analysis explained. Knowledge for the theoretical part was gathered from literature and online sources related to the fields of banking and accounting.

In the empirical part both qualitative and quantitative approaches were used. The most profitable major Finnish bank was determined using financial ratio analysis. Further data was collected by interviewing employees from two of the case banks.

The result of the analysis is that Nordea Bank Finland was the most profitable bank in 2010-2014 out of the three banks being analyzed. Nordea Bank Finland Plc had the highest ROE and the highest profit in absolute terms.

It is concluded that even though the industry as a whole has managed to improve profitability significantly, there are differences between single banks. The future outlook for banks is challenging as interest rates are expected to remain low and regulation is expected to increase.

Key words: banking, financial statement analysis, ratio analysis, profitability

Lahden ammattikorkeakoulu
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TIIVISTELMÄ

Tämä opinnäytetyö esittelee tärkeimmät taloudelliset tunnusluvut ja menetelmät, joita käytetään pankkien kannattavuuden analysoimiseen. Lisäksi opinnäytetyössä selvitetään, mikä suurista suomalaisista pankeista oli kannattavin vuosina 2010-2014 analysoimalla Danske Bank Oyj:n, Nordea Pankki Suomen ja OP Ryhmän tilinpäätöstietoja. Samalla opinnäytetyössä pyritään tunnistamaan pankkien kannattavuuteen vaikuttavia tekijöitä.

Opinnäytetyön teoriaosuudessa esitellään pankkien tuloslaskelma ja tase ja käydään läpi tilinpäätösanalyysin menetelmiä. Teoriaosuuden lähteenä on käytetty kirjanpitoon ja pankkialaan liittyvää kirjallisuutta sekä internet-lähteitä.

Empiirisessä osuudessa aihetta on lähestytty sekä kvalitatiivisesta, että kvantitatiivisesta näkökulmasta. Kannattavin suomalainen pankki määriteltiin tunnuslukuanalyysin avulla. Lisäksi kahta pankkityöntekijää haastateltiin lisätietojen ja alan ammattilaisten näkemyksen saamiseksi.

Analyysin tulokset osoittavat Nordea Pankki Suomen olleen tässä opinnäytetyössä tutkituista pankeista kannattavin vuosina 2010-2014. Nordea Pankki Suomen oman pääoman tuotto sekä euromääräinen tulos olivat korkeimmat ajanjakson aikana.

Yhteenvetona todetaan, että pankit ovat parantaneet kannattavuuttaan, mutta yksittäisten pankkien välillä on isoja eroja kannattavuudessa. Pankkien tulevaisuuden näkymät pysyvät haastavina, sillä viitekorkojen odotetaan pysyvän matalina ja sääntelyn alalla kiristyvän.

Avainsanat: pankit, tilinpäätösanalyysi, tunnuslukuanalyysi, kannattavuus

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1 INTRODUCTION

This chapter provides the reader with a general idea about the topic and the scope of this thesis. The research questions are listed and the research methods used are examined. Furthermore, the structure of the thesis will be explained. The reasons the author had for choosing this topic will also be gone through.

1.1 Background

Since the financial crisis of 2007 - 2009 the world of banking has changed drastically. The last few years have been a time of weak economic growth in many developed countries. Moreover, interest rates have been unusually low, driven by the quantitative easing of central banks in the US, Japan, Europe and China. This has created a challenging environment for banks to operate in.

Low interest rates are generally unfavorable for banks, as their major profit driver, net interest income is negatively affected by low rates. The margin between interest paid for deposits and what banks charge for loans from borrowers is historically low. Loans have become cheaper and cheaper, but rates for deposits have stayed at zero, as banks have not yet introduced negative rates for deposits. (The economist 2013) For example Nordea stated in January that they have no plans to introduce negative rates for their customers in Finland. Some of Nordea's corporate customers in Denmark have negative rates on their deposits though. (Nordea 2015)

Along with the low interest rates, weak economic growth has been seen especially in Europe, as the GDP levels of some countries are still below the pre-crisis levels. (The Economist 2013) This is also the case for Finland, who's banking industry this thesis deals with. Finland's GDP at current prices has grown since 2007-2008 (due to inflation), but at reference year 2010 prices the GDP has gone down. (Statistics Finland 2015)

Anyhow, in an environment of low interest rates and struggling economic growth, banks have managed to remain profitable after the credit crisis. Banks have improved their profitability even after having to meet the higher capital requirements imposed upon them by the new Basel III rules. (Bank for International Settlements 2015)

In 2015 banks have posted profits at near record highs. Nordea (group) Q1 2015 profit was €1082 million, an increase of 31% year-to-year and an increase of 54,3% compared to Q1 2007. (Nordea, 2015) Furthermore, the OP Financial Group posted highest quarterly profit ever in its history in Q1 2015. (OP Financial Group 2015)

So, despite of the challenging operating environment, the profitability of banks has improved. How have banks achieved their higher profitability levels? Is it only a result of cost cuts and labor force reductions or have banks actually found ways to grow their business?

Personally, as an employee of one of the three Finnish banks this thesis covers, the author was naturally interested to learn more about the banking industry. That is also why he chose this topic for his thesis, along with the fact that he enjoys financial analysis.

What differentiates this thesis from earlier theses is that it concentrates on profitability and on comparing the major banks in Finland. Earlier theses have concentrated on single, small banks, for example Juho Ryyänen in his 2012 thesis "Financial statement analysis of a bank, Case: Bank X" analyzes the financial statements of a small Finnish bank. His thesis examines the years 2005-2010, including the years of the financial crisis, whereas this thesis examines the years after the crisis. (Ryyänen, J. 2012)

Sirje Räsänen in her thesis from 2011 covers Finnish banking sector's profitability during the financial crisis of the late 2000s. She compares Finnish banks to the British Northern Rock and aims to find reasons for the good performance of Finnish banks during the financial crisis. (Räsänen,

S. 2011) Overall, profitability has not been analyzed or compared between multiple large Finnish banks in these earlier theses.

1.2 Research objectives, questions and limitations

This thesis aims to examine the reasons behind the good profitability of major banks in Finland in the years after the financial crisis of 2007 -2009 by analyzing the financial statements of three case banks. The case banks are Danske Bank Plc (Finland), Nordea Bank Finland and the OP Financial Group.

The analysis is done from an investor's point of view, using ratios and measures most commonly used by investors. The ratios used are cost to income ratio, return on equity, return on assets and equity ratio.

The main research question of this thesis is:

- Which one of the three banks (Nordea, Danske Bank, OP Financial Group) was the most profitable during the years 2010-2014 and why?

The sub research questions of this thesis are:

- What are the key financial measures of profitability for banks?
- What are the factors affecting these financial measures?

The main limitation of this thesis is that the statement of cash flows and its analysis is left out of the research. The thesis only examines large banks operating in Finland and the results and findings do not necessarily apply to other banks.

1.3 Research approach, research methods and data collection

The research approach of this thesis is deductive. Deduction emphasizes moving from theory to data and the collection of quantitative data. (Lewis,

P., Saunders, M. & Thornhill, A 2009, 127) Theory is explained first in this thesis, before analyzing the data.

Both quantitative and qualitative research methods are used in this thesis. Quantitative is commonly used to describe any data collection method or data analysis procedure that generates or uses numerical data. Qualitative is used to describe data collection methods or data analysis procedures that uses or generates non-numerical data. Qualitative data can be words, but also pictures or video. (Lewis, P., Saunders, M. & Thornhill, A. 2009, 151) Figure 1 summarizes the research approach, research methods and data collection of the thesis.

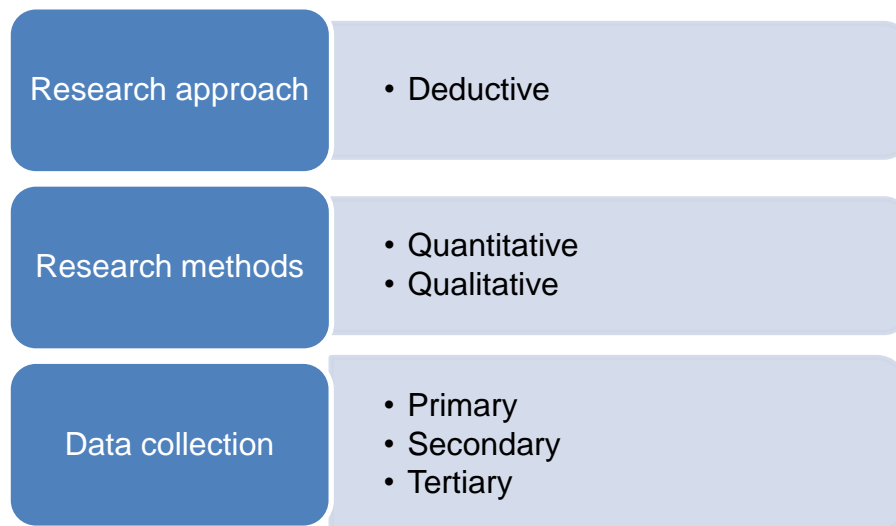


FIGURE 1: Research approach, research methods and data collection (Lewis, P., Saunders, M. & Thornhill, A. 2009, 127 & 151)

The quantitative side of this thesis is represented by the profitability analysis of major Finnish banks in chapter four. Financial statements contain numerical data and this data is analyzed by calculating ratios, generating new numerical data.

The qualitative side of this thesis is represented by semi structured interviews that were conducted via email with employees of the major Finnish banks. The data from the interviews is analyzed in chapter four after the quantitative analysis of the financial statements.

Interviews can be divided into three categories based on their level of formality and structure. The categories are structured, semi-structured and unstructured interviews. (Lewis, P., Saunders, M. & Thornhill, A. 2009, 320)

In a semi-structured interview, the researcher has a set of themes and questions to cover, but these can vary between interviews. The order of the questions can be changed, questions can be left out and additional questions can be asked in order to research some areas further. A semi-structured interview is not strictly formal, rather more like a guided discussion. The nature of such interviews requires recording the data by taking notes, audio-recording the discussion or a mixture of both. (Lewis, P., Saunders, M. & Thornhill, A. 2009, 320)

This thesis includes secondary and tertiary data collected from books, articles, journals and various online sources. Also primary data was collected as per the interviews.

1.4 Structure of the thesis

This thesis is divided into a theoretical part and an empirical part. The theoretical part comes first, followed by the empirical research and finally the summary. The structure is illustrated in figure 2.

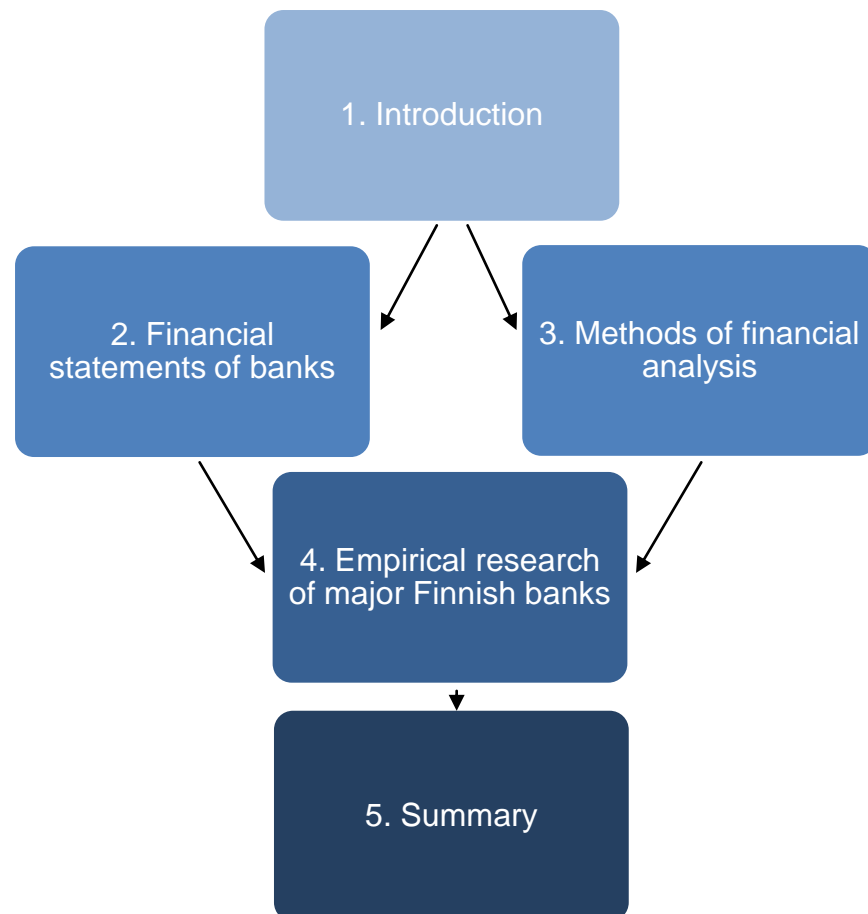


FIGURE 2: structure of the thesis

The theoretical part consists of chapters two and three. Chapter two deals with the financial statements of banks and their structure in detail. Chapter three explains financial analysis and the reasons for doing it. Some of the most common methods are examined, while concentrating on how to analyze profitability. The income statement and the balance sheet are covered, leaving the statement of cash flows out of the scope of this thesis.

The empirical part consists of chapter four. In chapter four the income statements and balance sheets of the three case banks are analyzed using the financial ratios covered in the theoretical part. The profitability measures of the banks are compared in order to figure out the most profitable bank. In order to expand on the findings of the financial statement analysis, interviews have been conducted with employees of the banks. The interviews are also shown and analyzed in chapter four.

Finally, in chapter five the thesis is summarized. A future outlook for the Finnish banks is given based on the findings of the analysis. Suggestions for further research are also given in this chapter.

2 FINANCIAL STATEMENTS OF BANKS

Financial statements provide a bank and its stakeholders valuable information on the result and the financial position of the bank. The information derived from the financial statements is crucial in analyzing the risks associated for example with depositing money in a bank, lending money to a bank or investing in a bank's shares. Furthermore, managers need financial statements to be able to follow the performance of the bank. (Kontkanen, E. 2011, 80)

The main financial statements are the income statement, the balance sheet and the statement of cash flows. In financial reports, supplemental information is published together with these financial statements, including audit reports, the statement of changes in owners' equity and details on how the statements were produced. (Kontkanen, E. 2011, 80)

The financial statements of a bank, like any other company, should be complete, accurate, reliable and timely (Tracy & Tracy 2014, 4). Moreover, the information in the statements should be easy to understand, meaningful and comparable between companies. (Kontkanen, E. 2011, 80)

In Finland, public companies listed on the stock exchange produce their financial statements according to the International Financial Reporting Standards (IFRS). This is the case for the three banks analyzed in this thesis (even though the OP Financial Group is not listed on the stock exchange it still follows IFRS). Other banks follow the national accounting laws of Finland, which are based on the IFRS. (Kontkanen, E. 2011, 81)

2.1 Income statement

The income statement measures the financial performance of a business by presenting revenues, expenses and net income for an accounting period, generally a year or a quarter. The income statement is also known as the profit and loss statement and statement of revenue and expense. (Fraser, L. & Ormiston, A. 213, 117) Banks' income statements differ from those of many other companies in various ways.

Consolidated statement of profit or loss and other comprehensive income^a			
For the year ended 31 December			
In millions of euro	Note	2014	2013
Interest income	8	3,341	3,528
Interest expense	8	(1,406)	(1,686)
Net interest income		1,935	1,842
Fee and commission income	9	854	759
Fee and commission expense	9	(179)	(135)
Net fee and commission income		675	624
Net trading income	10	1,434	1,087
Net income from other financial instruments at fair value through profit or loss	11	21	81
Other revenue	12	123	186
Revenue^b		4,188	3,820
Other income		18	10
Net impairment loss on financial assets	21, 22, 23	(336)	(233)
Personnel expenses	13	(2,264)	(1,974)
Operating lease expenses		(338)	(327)
Depreciation and amortisation	24, 25	(47)	(39)
Other expenses	14	(397)	(585)
Profit before tax		824	672
Income tax expense	16	(187)	(118)
Profit		637	554
Other comprehensive income			
Items that will never be reclassified to profit or loss			
Remeasurements of defined benefit liability (asset)		7	9
Related tax		(2)	(3)
		5	6
Items that are or may be reclassified to profit or loss			
Foreign currency translation differences for foreign operations		(45)	17
Net gain (loss) on hedges of net investments in foreign operations		30	(15)
Cash flow hedges:			
Effective portion of changes in fair value		(25)	(21)
Net amount transferred to profit or loss		15	12
Fair value reserve (available-for-sale financial assets):			
Net change in fair value		(361)	(160)
Net amount transferred to profit or loss		329	125
Related tax		14	15
		(43)	(27)
Other comprehensive income, net of tax		(38)	(21)
Total comprehensive income		599	533

The notes on pages 16 to 147 are an integral part of these consolidated financial statements.

FIGURE 3: illustrative example of an IFRS consolidated income statement of a bank. (KPMG, 2014)

As seen from the illustrative example of a consolidated income statement of a bank in pictures 1 and 2, there is no line item for the traditional revenue from sales. Instead, there are such line items as interest income, fee and commission income, and net trading income. A consolidated income statement is the combined income statement of the parent company and all its subsidiaries.

Consolidated statement of profit or loss and other comprehensive income (continued)			
For the year ended 31 December			
<i>In millions of euro</i>	<i>Note</i>	2014	2013
Profit attributable to:			
Equity holders of the Bank		610	528
Non-controlling interests		27	26
Profit		637	554
Total comprehensive income attributable to:			
Equity holders of the Bank		572	507
Non-controlling interests		27	26
Total comprehensive income		599	533
Earnings per share			
Basic earnings per share (euro)	<i>15</i>	0.34	0.29
Diluted earnings per share (euro)	<i>15</i>	0.33	0.29

The notes on pages 16 to 147 are an integral part of these consolidated financial statements.

FIGURE 4: illustrative example of an IFRS consolidated income statement of a bank. (KPMG, 2014)

Please note that in pictures 1 and 2 the consolidated income statement is reported together with the statement of comprehensive income. The line items related to comprehensive income are excluded from further examination.

More detailed explanations of the items on a bank's income statement are found below. Only the most important items will be explained, more information on the income statement can be found for example on the IFRS website ifrs.org.

2.1.1 Net interest income

Net interest income is the difference between interest income and interest expense of a bank. Traditionally, interest income has been the main source of income for banks. (Kontkanen, E. 2011, 11) Interest-bearing assets such as commercial loans, mortgages, bonds and treasury bills generate interest income for the bank.

Interest expense is the total of all interest payments made by the bank. Most of interest expense consists of interest paid on customers' deposits.

According to the IFRS, only interest income and interest expense from those financial assets that are not measured through fair value are listed under interest income or interest expense. In other words, income or expenses from assets held for trading are not listed under interest income or interest expense. (IFRS 7 — Financial Instruments: Disclosures 2015)

2.1.2 Net fee and commission income

Net fee and commission income is the difference between fee and commission income and expense. Especially when interest rates are low, various fees charged from customers can be important to make up for the decline in interest income.

Fee income consists of charges such as charges for early repayment of loans, overdraft charges, transaction fees, trading fees, fees for arranging initial public offerings, mutual fund fees, asset management fees and monthly or yearly service charges of bank accounts. (Regulations and guidelines 1/2013 2013) Fee and commission expense consists of fees that have been paid to a third party, related to fee income that the bank has charged from customers.

2.1.3 Net trading income

Net trading income consists of the difference between the selling price of securities obtained for trading purposes and their book value. It also includes changes in the fair value of securities held for trading. Interest income and dividends gained from securities are not included in trading income, as they are listed separately. (Regulations and guidelines 1/2013 2013)

2.1.4 Other items

Impairment of assets means writing down the value of assets so that the value represents their recoverable value (fair value less costs of disposal and value in use). (IAS 36 — Impairment of Assets 2015) This is done to ensure that the balance sheet gives a realistic picture of the value of the company's assets. Net impairment loss of financial assets includes the impairments done for financial assets, for example debt or equity securities. (IAS 39 — Financial Instruments: Recognition and Measurement 2015)

Personnel expenses make up for a large part of a bank's expenses. Wages, salaries, pension expenses, employee rewards and benefits and other employer contributions are shown under personnel expenses. (Statistics Finland 2015)

Like any other companies, banks need to depreciate and amortize their assets. Depreciation and amortization mean dividing the cost of assets over their useful life. A portion of the cost is then expensed each accounting period. These expensed parts of the costs of assets are shown under depreciation and amortization on the income statement. Depreciation usually refers to tangible assets, whereas amortization usually refers to intangible assets. (McClure, B. 2015)

In addition to personnel expenses, banks also incur various administrative expenses. Other expenses include network and phone fees, postal fees, marketing costs, consulting fees and legal fees.

2.2 Balance sheet

Balance sheet, also known as the statement of financial position summarizes a company's assets, liabilities and owners' equity at a point of time, usually at the end of an accounting period. (Tracy, J & Tracy, T. 2014, 5) The basic rule regarding the balance sheet is that it must always balance, meaning that total assets must equal the sum of total liabilities and equity. (Fraser, L. & Ormiston, A. 2013, 67). This is also expressed in the commonly seen equation:

$$\text{Assets} = \text{liabilities} + \text{owners' equity}$$

Consolidated balance sheets are the combined balance sheets of a parent company and its subsidiaries. They are necessary for evaluating a group of companies as a whole.

A bank's balance sheet includes some items that are not seen on balance sheets of other companies, such as deposits. In the next sub-chapters the main items of a bank's balance sheet are shortly explained.

2.2.1 Assets

Assets are what a bank owns. They generate revenue for the bank in the form of interest, dividends and capital gains. Assets also include cash and property, IT-systems and other equipment needed to operate the bank. Picture 3 is an example of how the asset side of a consolidated balance sheet of a bank looks like. Next, the main items on the asset side are explained in the order they appear in picture 3.

Consolidated statement of financial position^{a, b}			
<i>In millions of euro</i>	<i>Note</i>	31 December 2014	31 December 2013
Assets			
Cash and cash equivalents	18	2,907	2,992
Pledged trading assets	19	540	519
Non-pledged trading assets	19	16,122	15,249
Derivative assets held for risk management	20	858	726
Loans and advances to banks	21	5,572	4,707
Loans and advances to customers	22	63,070	56,805
Investment securities	23	6,302	5,269
Current tax assets		49	53
Property and equipment	24	409	378
Intangible assets	25	275	259
Deferred tax assets	16	316	296
Other assets	26	689	563
Total assets		97,109	87,816

FIGURE 5: illustrative example of the asset side of a consolidated balance sheet of a bank (KPMG, 2014)

A bank needs to hold a certain level of cash compared to its liabilities and to cover the withdrawals made by its customers. Banks also hold cash reserves in order to be able to keep operating in case of heavy losses. There are minimum legal requirements of reserves set for banks by authorities. Holding cash earns nothing, so banks aim to minimize the amount of cash they hold. (Pond, K. 2009, 41)

Trading assets are securities held for the purpose of reselling, in order to profit from short term price movements. This is in contrast of investment securities that are held long term for dividends, interest gain and capital gain. (Trading assets 2015)

For most banks, loans are the asset that generates most of their income. Borrowers pay more interest to the bank than the bank pays to its deposit customers. This difference or the spread is called net interest income, which usually makes up the largest part of a bank's profit. (Pond, K. 2009, 41)

On the balance sheet, loans are shown under loans and advances to customers and loans and advances to banks. Most loans are made to corporate and personal customers. These loans include mortgages, credit cards, business and industrial loans and such. Part of this type of lending is secured, but not all of it. Banks also lend money short-term to other banks. This is called inter-bank lending. Inter-bank loans' costs consist of very low margins added on top of a market rate. (Pond, K. 2009, 41)

Investment securities include securities that banks buy for holding, in contrast of trading assets that are bought for reselling. Investment securities are usually the second most important source of income for banks after loans. (Investment securities 2015) Banks hold securities that can be easily and quickly sold and turned into cash in order to maintain liquidity. These securities include treasury bills and bonds of national governments, which are seen as one of the safest alternatives for cash. Furthermore, banks buy bonds and equity shares as a way of offering financing to companies or simply to take a stake in a business for their own benefit. (Pond, K. 2009, 42)

2.2.2 Liabilities

Banks use a variety of financing types to fund their revenue earning assets. The own funds and reserves of a bank alone are not enough to operate successfully in a large scale and be profitable. That is why debt is used to finance assets. (Pond, K. 2009, 44)

Picture 4 illustrates the liability side of a bank's consolidated balance sheet. The line items on the liability side are explained next, in the order they appear on the consolidated balance sheet in picture 4.

Consolidated statement of financial position (continued)			
<i>In millions of euro</i>	<i>Note</i>	31 December 2014	31 December 2013
Liabilities			
Trading liabilities	19	7,026	6,052
Derivative liabilities held for risk management	20	828	789
Deposits from banks	27	11,678	10,230
Deposits from customers	28	53,646	48,904
Debt securities issued	29	11,227	10,248
Subordinated liabilities	30	5,642	4,985
Provisions	31	90	84
Deferred tax liabilities	16	132	123
Other liabilities	32	450	431
Total liabilities		90,719	81,846

FIGURE 6: illustrative example of the liability side of a consolidated balance sheet of a bank (KPMG, 2014)

On a bank's balance sheet, deposits are shown under deposits from banks and deposits from customers. Banks deposit excess funds to other banks via the inter-bank market to maximize return on funds held. The deposits are like short term loans to the bank receiving the cash and they have to be paid back. The availability, terms and costs of inter-bank loans are determined by the credit rating of the borrowing bank. (Pond, K. 2009, 45)

Customers of a bank deposit money to their accounts in the bank. The accounts can be current accounts, where money can be withdrawn at any time or different kind of savings accounts with limited or no possibility to withdraw the money until a set date. (Pond, K. 2009, 45)

Deposits generally make up for the largest part of funding for a bank. They can be a very cheap way to finance assets. Especially current accounts yield very low interest rates or no interest at all. The low cost comes with the risk that customers can withdraw their deposits at any time, sometimes unexpectedly. (Pond, K. 2009, 45)

In addition to deposits, banks can issue various kinds of debt securities to raise funds. These securities are shown under debt securities issued.

Covered bonds are shown under debt securities issued and are one common way for raising funds for banks. According to the European Covered Bond Council, Covered bonds are “debt instruments secured by a cover pool of mortgage loans (property as collateral) or public-sector debt to which investors have a preferential claim in the event of default”. As covered bonds are secured, they offer lower funding costs for the issuer and a chance for investors to invest in lower risk bonds with relatively high yields. (Introducing covered bonds, summary 2014)

Senior unsecured debt is also shown under debt securities in issue. Senior unsecured debt is debt that has priority for payment over all unsecured debt or subordinated debt in case the borrower defaults. (Financial Glossary: Senior Unsecured Debt 2015)

2.2.3 Equity

Share capital, reserves and retained earnings make up the equity part of a bank’s balance sheet. Picture 5 illustrates the equity part of a consolidated balance sheet of a bank. Short introductions of the items follow next.

Equity		
Share capital and share premium	2,725	2,695
Reserves	160	203
Retained earnings	3,350	2,944
Total equity attributable to equity holders of the Bank	6,235	5,842
Non-controlling interests	155	128
Total equity	6,390	5,970

FIGURE 7: illustrative example of the equity part of a consolidated balance sheet of a bank (KPMG 2014)

Share capital represents the equity shares in issue at their par value. Banks can get funding by issuing and selling more shares, if they operate as corporations. Shares are also sometimes given to staff as part of employee profit-sharing programs. (Pond, K. 2009, 46)

Part of a bank's profit is taken to be held as reserves. Reserves offer banks safety in times of extremely weak liquidity, for example in the case of a bank run. Money in reserves is not to be used in regular operations and activities, but only for the reason they are intended to be used for. (Capital Reserve 2015)

Retained earnings represent all the accumulated earnings of a company since the start of the operations after any payments to shareholders. Retained earnings should not be confused with cash or other financial resources at hand, it is only a running measurement of how much has been invested back to the business instead of paid out as dividends. (Fraser, L. & Ormiston, A. 2013, 93)

3 METHODS OF FINANCIAL ANALYSIS

In the previous chapters the financial statements of banks and their content was explained. This chapter explains the purpose of financial analysis and introduces the key profitability ratios used in the next chapter to analyze our case banks.

3.1 Purpose

Financial analysis is done by many different parties for many different reasons. Before analyzing a company's financial statements, it is necessary to set the objectives of the analysis. The objectives will depend on the perspective of the user of the financial statements. (Fraser, L. & Ormiston, A. 2013, 213)

Three main user groups of financial statements are creditors, investors and management. Every user has a different perspective for their analysis and thus different objectives.

Creditors are concerned with the borrowers' ability to pay interest and principal payments on the borrowed funds. They should seek answers to questions such as

- What will the borrowed funds be used to?
- How much debt does the company already have?
- Has the company made its debt payments in the past?
- What is the source of debt repayment? (Fraser, L. & Ormiston. A. 2013, 214)

Based on these questions, the creditor will either grant a loan to the borrower or if the risk seems too high, refuse to grant a loan. The lower the borrower's ability to pay back its debts seems, the higher the risk and thus the higher the interest charged on the loan. The higher interest payments compensate the creditor for the higher risk level. (Fraser, L. & Ormiston, A. 2013, 214)

Investors analyze financial statements in order to estimate the future earnings of a company and then derive a value to the shares of the company. They use the historical data in the financial statements to forecast future performance of a company. Investors seek answers to questions such as

- How has the company performed in the past and what are the future expectations?
- How have the growth and stability of earnings been in the past?
- What kind of returns can be expected given the company's current condition and future outlook?
- How is the capital structure of the company? Is there a risk of issuing more equity shares, leading to dilution of the investment? (Fraser, L. & Ormiston, A. 2013, 214)

Based on their analysis, investors can decide to buy, hold, sell or short sell the shares of the company in question. If the value for the shares derived from the analysis is higher than the current market price, the shares are seen undervalued and should be bought. If the market price is higher than the value derived from the analysis, the shares should be sold or even shorted.

Management is interested in the same questions as creditors and investors, as both groups need to be satisfied in order to obtain funding as needed. Through analyzing the financial statements, management gains insight to the current situation of the company, which helps them develop plans and strategies for the future. Management seeks answers to questions such as:

- How is the company performing and why?
- Which operating areas are doing well and which are not?
- How is the financial position of the company and are there weaknesses?
- How could the performance of the company be improved in the future? (Fraser, L. & Ormiston, A. 2013, 214)

It is important to note that management has the responsibility of preparing the financial statements and as such, has the possibility to influence their content. (Fraser, L. & Ormiston, A. 2013, 214)

3.2 Ratio analysis

Financial ratios standardize data of the financial statements as mathematical relationships expressed in the form of percentages or times. (Fraser, L. & Ormiston, A. 2013, 218) There are a large number of ratios used by analysts and they can be categorized by the aspect of a company's performance they evaluate. These categories are efficiency, liquidity, profitability and solvency. Additionally, there are so called market ratios, which compare a company's performance to the market value of the company's shares. (Fraser, L. & Ormiston, A. 2013, 219)

Financial ratios can be used to compare a company's recent performance to the past or to compare a company's performance with its industry peers. They can indicate the strengths and weaknesses of a company and point to areas needing further investigation. (Fraser, L. & Ormiston, A. 2013, 219)

While a useful analytical tool, financial ratios have their limitations. Firstly, ratios calculated for companies from different sectors/industries should not be directly compared, as each industry has its own characteristics. The condition of the company, industry and the economic environment should be taken into consideration when interpreting financial ratios. (Fraser, L. & Ormiston, A. 2013, 219)

Secondly, ratios do not provide answers only by themselves. They should be used together with other information. (Fraser, L. & Ormiston, A. 2013, 219)

Thirdly, there is no definitive set of ratios that should always be calculated for the best result. Furthermore, formulas of ratios vary and there can be many variations of the same ratio being used by different analysts. (Fraser, L. & Ormiston, A. 2013, 219)

3.2.1 Profitability ratios

Profitability ratios measure the overall performance of a company. They measure the efficiency in managing assets, liabilities, equity and costs. (Fraser, L. & Ormiston, A. 2013, 219)

The following profitability ratios will be used to analyze the case banks in the next chapter. The formulas shown here have been taken from the Financial Supervisory Authority's website.

$$\text{Cost/income ratio, \%} = \frac{(\text{Administrative expenses} + \text{depreciation})}{\text{Total operating income, net}} * 100$$

The cost to income ratio is used especially to analyze banks. It tells how efficiently the bank is run. The lower the ratio, the higher the profitability of the bank will be. (Cost/Income ratio 2013)

ROE is one of the most important and most commonly used ratios for owners and investors. It measures the return to shareholders. (Fraser, L. & Ormiston, A. 2013, 230)

$$\text{Return on equity (ROE), \%} = \frac{\text{Profit/-loss for the year}}{\text{average total equity from the beginning and end of period}} * 100$$

As the shareholders have made a risky equity investment, they expect a return higher than what could be expected from so called risk-free investments. Government bonds with a high credit rating are thought to be risk-free. (Balance Consulting 2015) Generally, a ROE of 10% or higher is

a sign of a profitable bank, whereas a ROE of 15% or more is seen as excellent for banks. (Kontkanen, E. 2015, 85)

ROA tells about the ability of the company to use its assets to create profit. A company should be able to create value for the resources that it holds. Like ROE, ROA can be compared to returns of risk-free investments. If ROA is higher than the risk-free return, the company has managed to add value. (Balance Consulting 2015)

Return on total assets (ROA), % =

*Profit/-loss for the year /average total assets from the beginning and end of period *100*

Generally, a ROA less than 5% is seen as weak, a ROA of 5-10% as satisfactory and a ROA higher than 10% as good. (Balance Consulting, 2015) For banks though, a ROA of just 1% is seen as a sign of good profitability as they are highly leveraged and carry a large amount of assets. (Kontkanen, E. 2015, 85) Average ROA of all Finnish banks was 1% in 2005-2006 and 1.2% in 2007, in the better years of profitability before the financial crisis. The average has been 0.4% after the crisis in 2009-2014. (Federation of Finnish Financial Services 2014)

3.2.2 Leverage ratios

Leverage ratios measure the company's use of debt relative to equity to finance the company's assets. There are also ratios that measure the ability to pay interest.

Using debt involves risk as interest and principal payments have to be made and the failure to do so can lead to bankruptcy. Also, the more debt a company has, the more difficult and more expensive it will get to obtain additional credit. (Fraser, L. & Ormiston, A. 2013, 227)

While having its risks, if operating earnings are enough to cover the loan repayments, use of debt can leverage the profitability of a company to a much higher level. (Fraser, L. & Ormiston, A. 2013, 227)

In the analysis in the next chapter, equity ratio is shown for the case banks in order to examine the proportion of equity vs. debt. Equity ratio measures the proportion of equity used to finance a company's assets. It also shows how much debt is used as the assets not financed with equity are financed with debt.

<p><i>Equity ratio, % =</i></p> $\frac{\text{Total shareholder equity} + \text{minority interests}}{\text{total assets}} * 100$

Equity ratio is not to be mixed up with the capital ratio. Capital ratio is calculated using regulatory capital and risk-weighted assets. As per Basel I rules, the capital ratio of banks has to be at minimum 8%. Banks do not have such requirements regarding equity ratio though. (Part 2: The First Pillar - Minimum Capital Requirements 2006)

3.3 Alternative methods

In addition to ratio analysis, there are various other methods used to analyze a company's financials. Two important ones include common size financial statements and trend analysis. These two methods are explained next.

3.3.1 Common size financial statements

Common size financial statements express each item as a percentage of a common item, which allows the easy comparison between companies and also between industries. They can also be used to examine the growth of different items between periods of time. (Fraser, L. & Ormiston, A. 2013, 68)

A common size balance sheet expresses each item on the balance sheet as a percentage of total assets. This way the relative sizes of different items on the balance sheet can be compared easily to find out and analyze the distribution of assets, the capital structure and the debt structure of a company. (Fraser, L. & Ormiston, A. 2013, 68)

A common size income statement expresses each item on the income statement as a percentage of net sales. This allows for the analysis of the relative impact of different types of expenses and income. Furthermore, profit margins such as gross profit, operating profit and net profit margins can be easily compared by using common size income statements. (Fraser, L. & Ormiston, A. 2013, 68)

While common size financial statements are a great tool, it should be remembered that the absolute growth or decrease in euros cannot be seen from the relative percentages.

3.3.2 Trend analysis

In trend analysis, the changes in financial statement items of a company over time are examined and any visible trends can be evaluated. Most commonly quarters or years are compared, but trend analysis can be done on a weekly or monthly basis too. Trend analysis is not suitable for comparing companies between each other.

Trend analysis is performed using the financial statements from multiple accounting periods. The earliest period is chosen as a base period and all items on the base period statements are given the value 100. The values of items from later periods are then compared to the base period values and the differences are calculated as percentages to see the growth or decrease in the items. (Niskanen, J. & Niskanen, M. 2003, 96)

4 EMPIRICAL ANALYSIS OF MAJOR FINNISH BANKS

In this chapter the financial statements of Danske Bank plc, Nordea Bank plc and the OP Financial Group are analyzed and compared between each other both in absolute and relative terms. The objective is to find the most profitable bank by comparing the key profitability ratios for each bank for the years 2010-2014. In addition, the theme interviews that were conducted with Robin Hjelgaard from Danske Bank investor relations and with Eerikki Holst from Pohjola Bank (subsidiary of the OP Financial Group) investor relations are examined in this chapter.

All of the financial ratios and other information found in tables 1-10 later in this chapter have been taken from the annual reports of the case banks or calculated based on data in their annual reports. The financial statements of the banks are seen in appendices 1-14.

4.1 Introduction of the major Finnish banks

Danske Bank plc, Nordea Bank Finland plc and the OP Financial Group are the three largest commercial banks in Finland measured by balance sheet size and number of employees. Nordea and the OP Financial Group are noticeably larger than Danske. (Finnish Banking 2014 2015)

Nordea Bank Finland Plc is part of the Nordea group, the largest financial services group in the Nordic and Baltic region. Nordea operates in its eight home markets in Sweden, Norway, Finland, Denmark, Estonia, Latvia, Lithuania and Russia, with a presence in many more countries. Nordea's shares are traded at the stock exchanges in Stockholm, Helsinki and Copenhagen. (Our position 2015)

The OP Financial group is the largest financial services group in Finland. Together, the about 180 independent cooperative member banks and the OP cooperative (including subsidiaries), which the banks own form the group. The group's operational area covers whole Finland. (OP Financial group 2015)

Danske Bank plc is part of the Danske Bank group that operates in 15 countries. The bank serves about 1 million personal customers and 90 000 business and institutional customers in Finland. (Danske Bank in Finland 2015)

In tables 1 and 2 the annual net interest income and average number of employees of the case banks are shown. These tables illustrate the size of the banks and the scale of their operations.

Table 1: net interest income in €

Net interest income ,EURm	2010	2011	2012	2013	2014
Danske Bank	322	346	358	318	315
OP Financial Group	917	1030	1003	831	955
Nordea Bank Finland	1182	1355	1258	1183	1189
Total	2421	2731	2619	2332	2459

As seen from table 1, the total net interest income of the case banks peaked in 2011 and 2012, but has since then returned to lower levels, ending up largely unchanged during the five year period. Furthermore, Nordea's and OP Financial Group's larger size can be seen from this table, as their net interest income is multiple times larger than Danske Bank's.

The number of employees in all of the three banks except the OP Financial Group has fallen quite dramatically, as seen from table 2. The OP Financial Group actually had more employees in 2014 than in 2010, which is surprising and against the industry trend. The total number of employees of all three banks has decreased by 3121 or 12.2%. Danske Bank's number of employees has decreased by almost 31%, which is the largest decline in relative terms. Again, the larger size of Nordea and the OP Financial Group can be seen here in employing a lot more people than Danske.

Table 2: average number of employees during the year

Average number of employees	2010	2011	2012	2013	2014
Danske Bank	3026	3035	2765	2286	2097
OP Financial Group	12504	12858	13411	13461	12548
Nordea Bank Finland	10038	10014	9269	8937	7802
Total	25568	25907	25445	24684	22447

The major reduction in employees has surely had an impact on Danske's and Nordea's profitability as staff costs have gone down. This is seen from the improvement of the cost to income ratio in table 3.

4.2 Cost/income ratio

Looking at the cost/income ratios in table 3, it can be seen that the profitability of the three banks has improved as the cost/income ratio average has gone down from 57.43% to 55.60% over the five year period. Although the average has gone down, Nordea's cost/income ratio has increased by five percentage points from 43% to 48%.

Table 3: cost to income ratio, percentage

Cost/income ratio	2010	2011	2012	2013	2014
Danske Bank	70,30 %	69,10 %	65,40 %	68,30 %	61,80 %
OP Financial Group	59,00 %	63,00 %	62,00 %	62,00 %	57,00 %
Nordea Bank Finland	43,00 %	41,00 %	38,00 %	48,00 %	48,00 %
Average	57,43 %	57,70 %	55,13 %	59,43 %	55,60 %

Even though Danske and the OP Financial Group have both managed to reduce their cost/income ratio, Nordea remains the most profitable out of the three based on this ratio. The differences in the cost/income ratios of the three banks have decreased since 2010 though, as Danske and the OP Financial Group have closed in on Nordea.

The employee reductions noted earlier are probably one main reason for the favorable development of the cost/income ratio for Danske. The OP Financial Group has found other ways to cut cost as the group added employees during the period, but still improved its cost/income ratio.

4.3 Return on equity, net income and equity ratio

According to the cost/income ratio, the case banks' profitability improved during the five year period. As seen from table 4, ROE supports this claim further, as the average ROE of the banks has increased from 6.73% to 8.13%.

Table 4: return on equity, percentage

ROE	2010	2011	2012	2013	2014
Danske Bank	5,60 %	5,00 %	5,00 %	6,10 %	6,90 %
OP Financial Group	6,90 %	6,80 %	7,20 %	8,90 %	8,10 %
Nordea Bank Finland	7,70 %	9,70 %	11,30 %	8,80 %	9,40 %
Average	6,73 %	7,17 %	7,83 %	7,93 %	8,13 %

All of the three banks managed to improve their ROE during the period. In relative terms, Danske's ROE improved the most. Nordea had the highest ROE in every year except for 2013, when the OP Financial Group had a slightly higher ROE.

The ROE of Danske can be said to be tolerable, whereas Nordea's and the OP Financial Group's ROE can be said to be satisfactory. The average ROE of the banks is below 10%, the level of good profitability for banks. Based on ROE, the banks are not very profitable, but have slowly and surely improved their profitability. There is still room for improvement, especially for Danske.

To put ROE into perspective, net income in euros and equity ratios of the banks are shown in tables 5 and 6, in order to evaluate the changes in absolute profitability and changes in the equity and debt structures of the banks.

Table 5 shows the development of net income over the period. Total net income of the three banks has increased from 1411 million in 2010 to 1624 million in 2014. The OP Financial Group has increased its profits the most. Nordea's net income increased slightly and Danske's net income remained flat during the period. Increase in net income and growth of ROE of the banks seem to go hand in hand.

Table 5: net profit in €

Net profit, EURm	2010	2011	2012	2013	2014
Danske Bank	117	110	115	145	169
OP Financial Group	440	436	482	665	607
Nordea Bank Finland	854	1101	1181	828	902
Total	1411	1647	1778	1638	1624

It is good to note that even while Nordea and the OP Financial group had almost similar relative profitability levels according to ROE, Nordea is making much more money in absolute terms, as it has more assets to create income. The total assets of the three banks can be seen in table 8.

As seen from table 6, Danske's equity ratio is at the same level in 2014 as it was in 2010. The OP Financial Group's equity ratio decreased slightly, indicating moderate increase in use of debt leverage. Nordea's equity ratio is the lowest of the three banks and it has decreased during the five year period.

Table 6: equity ratio, percentage

Equity ratio, %	2010	2011	2012	2013	2014
Danske Bank	8,30 %	8,30 %	7,50 %	8,90 %	8,40 %
OP Financial Group	7,80 %	6,80 %	7,20 %	7,65 %	6,53 %
Nordea Bank Finland	3,90 %	2,90 %	2,70 %	3,10 %	2,80 %
Average	6,67 %	6,00 %	5,80 %	6,55 %	5,91 %

The equity ratio of Nordea suggests a higher level of debt leverage compared to Danske and the OP Financial Group. As less of the bank's assets are financed by equity, more debt is used and thus more debt repayments have to be made, increasing risk. It can be said that Nordea's debt structure is more risky than that of Danske or the OP Financial Group.

Use of leverage enhances ROE in good times, but deteriorates it in bad times. Nordea's ROE has been positively influenced by the diminished equity ratio, as profit has been spread to a smaller amount of equity when calculating ROE.

4.4 Return on assets

As banks are highly leveraged, their ROA is generally low. Banks have a lot of assets, so even a relatively low ROA compared to other industries means high profits in absolute terms.

Table 7: return on assets, percentage

ROA	2010	2011	2012	2013	2014
Danske Bank	0,50 %	0,40 %	0,40 %	0,50 %	0,60 %
OP Financial Group	0,50 %	0,50 %	0,50 %	0,66 %	0,57 %
Nordea Bank Finland	0,30 %	0,30 %	0,30 %	0,30 %	0,30 %
Average	0,43 %	0,40 %	0,40 %	0,49 %	0,49 %

As seen from table 7, the OP Financial Group had the highest ROA in most of the years during the period. Danske had the highest ROA in 2014 and was able to increase ROA the most during the period. Nordea's ROA stayed flat at 0.3%. Nordea's relatively low ROA could be explained by the fact that it has more assets than Danske or the OP Financial Group.

The average ROA of the three banks increased only slightly. When looking at ROA, the evolution of total assets should also be examined. Even though ROA has remained fairly stable for the three banks, their assets have increased, resulting in higher net income.

Table 8 shows that Nordea's assets grew during the period. At the same time ROA remained constant at 0.3% resulting in an increase in net income as seen in table 5.

Table 8: total assets in EUR millions at the end of the year

Total assets, EURm	2010	2011	2012	2013	2014
Danske Bank	26158	27406	31813	26680	29692
OP Financial Group	83715	91905	99769	100991	110427
Nordea Bank Finland	286086	393824	335461	304761	346198
Total	395959	513135	467043	432432	486317

Both Danske and the OP Financial Group have also grown their assets during the period. The OP Financial Group's assets increased the most out of the three banks and as its ROA also increased, it can be said that the management did an excellent job to achieve profitable growth during the period.

4.5 Interviews

As mentioned earlier, interviews with banking industry professionals were conducted to gain further insight on the topic of the thesis. Two interviews were conducted, with employees from the investor relations departments of Danske Bank Plc and OP Financial Group's subsidiary Pohjola Bank Plc. The questions can be seen in appendix 15.

The interviews support the choice of financial ratios included in this thesis as the interviewees listed mainly the same ratios in their answers to question one as those that were introduced earlier in chapter three and utilized in the analysis. Hjelgaard listed ROE, ROA, cost to income ratio, net interest margin and loan loss ratio to be the most important measures of profitability for banks. Holst named ROE, ROA and the cost to income ratio and added that especially debt investors look at other things than profitability as well.

Leaving the statement of cash flows out of the scope of this thesis is also supported as a cash flow perspective was deemed not relevant when analyzing banks by Robin Hjelgaard in his answer to question number two. He added that as banks are more asset heavy compared to other industries, ROA and net interest margin are more relevant when analyzing banks. According to Holst, the main financial ratios used to analyze banks are the same as those used with other industries, but banks do have some unique income and cost items that need to be considered.

As the ratio analysis in chapter four showed, the profitability of the case banks increased in years 2010-2014. This was confirmed by both of the interviewees in their answers to question three. Hjelgaard stated that profitability has increased significantly and Holst commented that there has been a trend of continuous improvement in profitability during the five years. According to Hjelgaard's answer to question three the factors behind improved profitability were mostly internal factors such as cost efficiencies and changes in product pricing that countered the negative effects of external factors such as low interest rates, increased regulation and macroeconomic conditions. Holst said that the change has been driven by increased efficiency, reduced costs, increased income and an overall good profit development.

In their answers to question four, both interviewees said that the current profitability level was not reached by cost cuts only, but instead income also increased. According to Hjelgaard, for example branch mergers have changed the cost structure and the income composition of banks has become more fee driven and more capital efficient than before.

Both interviewees mentioned increasing regulation as a challenge for banks, as higher capital requirements could put pressure on ROE. Very low or negative interest rates were mentioned as a challenge to banks by Hjelgaard as deposit margins would be under pressure and thereby interest income would decrease. Holst said that banks could further

improve their profitability by improving efficiency of operations and continuously improving procedures for example through digitalization.

4.6 Conclusions

The ratio analysis shows that Nordea was the most profitable bank out of the three banks during 2010-2014 as it had the best cost/income ratio and ROE during the period. Furthermore, Nordea was the most profitable out of the three in absolute terms.

Nordea seems to have its costs well under control with its cost/income ratio being the best out of the three banks; only 48% in 2014. ROE grew a moderate 1.7 percentage points to 9.4% going from 2010 to 2014, but was still under the 10% that is seen as a sign of a profitable bank, as mentioned earlier. Nordea's ROA remained flat at 0.3% during the five year period, while assets of the bank grew 21%. In other words, Nordea managed to grow and keep its profitability level constant while doing so.

Nordea's profitability was not overwhelmingly better than Danske's and even less so than the OP Financial Group's though. Nordea also had the lowest ROA out of the case banks, although this is partly explained by Nordea's bigger asset base.

There seems to be a clear division to two levels of profitability between the case banks: satisfactory and poor. Nordea and the OP Financial Group represent the satisfactory level and Danske Bank the poor level. The economies of scale of the larger sized Nordea and OP Financial Group could be one reason for their better profitability compared to the smaller Danske Bank.

Danske Bank's weakness and the rather large difference to Nordea and the OP Financial Group is even a bit surprising. After all, Danske's ROE% in 2014 was only about 73% Nordea's ROE%. Part of the difference can be explained by Danske's smaller size as noted earlier. In addition, Danske's equity ratio is the highest out of the case banks, signaling

smaller use of debt leverage and less risk. Danske could be able to increase its ROE by increasing the use of leverage and taking on more risk.

The analysis and the interviews provided interesting answers to the research questions. Next, the answers to the sub research questions are explained first, followed by the main research question.

The first sub research question was defined in the introduction as "What are the key financial measures of profitability for banks?". This question does not have one simple answer. Based on the research and the interviews, return on equity, return on assets and the cost to income ratio are the basic and most used measures of profitability for banks. These ratios were mentioned by both of the interviewees. They are also mentioned in banking industry publications (for example Kontkanen, E.) and are reported by banks in their annual reports.

In addition, net interest margin and loan loss ratio, which were not used in the analysis in chapter four were mentioned by Hjelgaard in his interview. Although net interest margin was not used, net interest income was included in the analysis. Net interest income and net interest margin are definitely key measures of profitability for banks, as they measure their most important source of income.

The second sub research question was defined as "What are the factors affecting these financial measures?". To start with return on equity, high net income, but also high use of leverage can improve ROE. The amounts of debt and equity used to finance assets should be examined when looking at ROE. As seen in the analysis in chapter four, the three case banks all had different equity ratios, or in other words, different levels of risk. The more debt used to finance assets, the higher the ROE will be.

ROA is affected by the number of assets and the profit of a company. Banks generally have a low ROA, as they are highly leveraged. This

means they have a lot of assets though, so even a low ROA can mean high profits in absolute terms.

The cost to income ratio is used for evaluating how well banks keep their costs under control. Lowering costs and increasing income makes for a better cost to income ratio. Both of the interviewees commented that banks have managed to cut costs and increase their incomes and the effect was seen in the banks' cost to income ratios in chapter four.

The main research question was defined as "Which one of the three banks (Nordea Bank Finland, Danske Bank, OP Financial Group) was the most profitable during the years 2010-2014 and why?". Based on the analysis done in chapter four, Nordea Bank Finland was the most profitable during the years 2010-2014. Nordea had the best cost to income ratio and ROE during the period. Furthermore, Nordea had the highest net income during the period.

The higher relative profitability compared to Danske Bank and the OP Financial group could be partly due to Nordea's larger size and the economies of scale brought by it. Nordea's equity ratio was noticeably lower than Danske Bank's or the OP Financial Group's which should explain part of the difference.

5 SUMMARY

This final chapter summarizes the thesis. Suggestions for further research are given in the end of this chapter.

The thesis first covered the theory regarding the financial statements of banks in chapter two. The income statement and the balance sheet were introduced and their contents explained. This was followed by theory regarding methods of financial analysis in chapter three, concentrating on ratio analysis and profitability ratios. The theoretical part was based on accounting and banking related books and online sources.

The theoretical part was followed by the empirical analysis of the major Finnish banks in chapter four. The analysis included profitability ratios and the equity ratio, which were compared between the banks to determine the most profitable one. The result of the analysis was that Nordea Bank Finland was the most profitable large Finnish bank. Furthermore, to support the analysis and bring professional insight on the topic into the thesis, interviews were conducted with two investor relations employees. The interviews were also covered in chapter four.

The future outlook of the case banks looks challenging, as interest rates are expected to stay low. Furthermore, increasing regulation can increase pressure on banks' profitability. Banks have been able to cut costs but also increase their income. It is important that profitability has not been improved only by cost cuts, as they can only be reduced to a certain level. Digitalization and increasing use of technology could bring further savings in the future.

Regarding the validity of this thesis, it can be said that all the research questions were answered, meaning that the objectives of the thesis were fulfilled. The theoretical part is based on knowledge extracted from books and articles from well-known authors as well as trusted online sources. The empirical part would benefit from more case banks in regards to validity, as results from a larger sample would be more significant.

Regarding reliability, it can be noted that increasing the number of interviewees would add reliability as with a larger sample different answers and varying opinions could appear. The author notes that there were difficulties in finding employees that would have time to be interviewed as the thesis was done during a time when the banks were preparing to publish their interim financial reports.

Further research should be made in regard to banks from other countries than Finland to be able to compare and analyze differences caused by operating areas. Larger scale studies could be made on EU or Eurozone levels, for example. It could also be useful to analyze and compare, for example, the profitability of Nordea's operations in Finland with the profitability of operations in Sweden or Norway.

Profitability of small and medium sized banks is also something that needs further research. This thesis only concentrated on large banks. The findings could be different for small or medium sized banks. For example, the member cooperative banks of the OP Financial Group could be analyzed separately and the profitability of member banks from different regions could be compared.

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APPENDICES

APPENDIX 1: Nordea Bank Finland income statement 2010-2014

Nordea Bank Finland Group**Five-year overview of the Directors' Report****Income statement¹**

EURm	2014	2013	2012	2011	2010
Net interest income	1,189	1,183	1,258	1,355	1,182
Net fee and commission income	75	-113	295	309	289
Net result from items at fair value	970	1,114	1,217	937	979
Profit from companies accounted for under the equity method	3	8	18	9	6
Other operating income	41	32	36	34	43
Total operating income	2,278	2,224	2,824	2,644	2,499
General administrative expenses:					
Staff costs	-559	-553	-574	-592	-553
Other expenses	-433	-466	-447	-457	-479
Depreciation, amortisation and impairment charges of tangible and intangible assets	-92	-40	-50	-43	-41
Total operating expenses	-1,084	-1,059	-1,071	-1,092	-1,073
Profit before loan losses	1,194	1,165	1,753	1,552	1,426
Net loan losses	-60	-53	-144	-70	-272
Impairment of securities held as financial non-current assets	-	1	-	-	2
Operating profit	1,134	1,113	1,609	1,482	1,156
Income tax expense	-232	-285	-428	-381	-302
Net profit for the year	902	828	1,181	1,101	854

APPENDIX 2: Nordea Bank Finland balance sheet 2010-2014

Balance sheet²

EURm	2014	2013	2012	2011	2010
Loans to central banks and credit institutions	35,351	35,767	36,827	79,350	67,751
Loans to the public	113,748	113,779	100,765	99,331	73,607
Interest-bearing securities and pledged instruments	45,701	34,246	37,896	33,764	29,241
Derivatives	105,254	70,234	117,213	170,228	97,251
Other assets	46,144	50,735	42,760	11,151	18,236
Total assets	346,198	304,761	335,461	393,824	286,086
Deposits by credit institutions	87,368	79,426	74,666	76,007	60,549
Deposits and borrowings from the public	76,879	80,909	70,212	68,260	55,459
Debt securities in issue	48,472	47,130	48,999	49,153	39,846
Derivatives	102,876	67,109	115,836	168,436	95,676
Subordinated liabilities	620	429	514	503	477
Other liabilities	20,365	20,244	16,017	19,864	22,855
Equity	9,618	9,514	9,217	11,601	11,224
Total liabilities and equity	346,198	304,761	335,461	393,824	286,086

APPENDIX 3: Danske Bank Plc consolidated statement of comprehensive income 2013-2014

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME		Group	
EURm	Note	1-12/2014	1-12/2013
Interest income	1	495.8	524.9
Interest expense	1	-180.7	-206.6
Net interest income		315.1	318.3
Fee income	2	298.7	288.7
Fee expenses	2	-66.1	-58.8
Net trading income	3	31.7	34.9
Other operating income	4	23.2	37.6
Share of profit from associated undertakings	17	0.9	1.0
Dividends	5	-	-
Total operating income		603.5	621.7
Staff costs	6	-140.7	-163.5
Other operating expenses	8	-223.2	-248.7
Depreciations and impairments	8	-9.1	-12.4
Total operating expenses		-373.0	-424.7
Loan impairment charges	10	-16.7	2.7
Profit before taxes		213.7	199.7
Taxes	11	-44.4	-54.4
Total comprehensive income for the year		169.3	145.3
Attributable to			
Equity holders of parent company		169.1	145.3
Non-controlling interest		0.3	0.0

APPENDIX 4: Danske Bank Plc consolidated statement of comprehensive income 2011-2012

CONSOLIDATED STATEMENT OF COMPREHENSIVE INCOME		1-12/2012	1-12/2011
EURm	Note		
Interest income	1	665.2	723.0
Interest expense	1	-307.1	-377.3
Net interest income		358.1	345.7
Fee income	2	252.9	261.7
Fee expenses	2	-56.6	-59.5
Net trading income	3	41.6	40.1
Other operating income	4	39.1	58.9
Net income from investments	5	2.2	2.9
Total operating income		637.5	649.8
Staff costs	6	-169.2	-175.8
Other operating expenses	8	-221.8	-237.2
Depreciations and impairments	8	-25.7	-36.0
Total operating expenses		-416.7	-449.0
Loan impairment charges	10	-63.9	-53.4
Profit before taxes		156.8	147.3
Taxes	11	-41.6	-37.5
Total comprehensive income for the year		115.3	109.8
Attributable to			
Equity holders of parent company		114.7	108.3
Non-controlling interest		0.6	1.5

APPENDIX 5: Danske Bank Plc (Sampo Bank Plc) consolidated income statement 2010

CONSOLIDATED INCOME STATEMENT

EURm	Note	1-12/2010
Interest income	1	592,5
Interest expense	1	-270,6
Net interest income	1	321,9
Net trading income	2	55,7
Fee income	3	253,8
Fee expenses	3	-65,1
Net income from investments	4	2,0
Other operating income	5	55,0
Total operating income		623,3
Staff costs	6	-165,3
Other operating expenses	8	-273,0
Total operating expenses		-438,3
Loan impairment charges	10	-32,7
Profit before taxes		152,3
Taxes	24	-35,1
Profit for the period		117,1
Attributable to		
Equity holders of parent company		116,8
Non-controlling interests		0,4

APPENDIX 6: Danske Bank Plc consolidated balance sheet 2013-2014

CONSOLIDATED BALANCE SHEET		Group	
EURm	Note	12/2014	12/2013
Assets			
Cash and balances at central banks	14	1,060.1	1,599.2
Loans and receivables	15	23,828.3	22,278.6
Trading portfolio assets	13	4,640.2	2,588.1
Investments in associated undertakings	17	7.7	8.0
Investments in subsidiaries	18	.	.
Intangible assets	19	1.9	3.6
Property, plant and equipment	20	10.1	13.2
Other assets	21	135.6	161.0
Current tax assets	22	0.0	15.7
Deferred tax assets	22	8.0	12.6
Total assets		29,691.8	26,679.9
Liabilities			
Due to credit institutions and central banks	23	2,480.5	1,317.6
Amounts owed to customers and public entities	23	15,734.3	16,098.3
Debt securities in issue	24	4,528.6	4,670.0
Financial liabilities at fair value through p/l	24	717.8	307.7
Trading portfolio liabilities	13	3,310.1	1,544.5
Other liabilities	25	405.0	347.3
Current tax liabilities	22	13.2	11.1
Deferred tax liabilities	22	.	.
Total liabilities		27,189.4	24,296.4
Equity			
Share capital	28	106.0	106.0
Reserves	28	271.1	271.1
Retained earnings	28	2,125.0	2,006.3
Equity attributable to parent company's equityholders		2,502.1	2,383.4
Non-controlling interest		0.4	0.1
Total equity		2,502.4	2,383.5
Total equity and liabilities		29,691.8	26,679.9

APPENDIX 7: Danske Bank Plc consolidated balance sheet 2011-2012

CONSOLIDATED BALANCE SHEET			
EURm	Note	12/2012	12/2011
Assets			
Cash and balances at central banks	14	3 034.9	814.1
Loans and receivables	15	25 672.0	24 733.6
Trading portfolio assets	13	2 781.0	1 646.8
Investments in associated undertakings	17	12.7	8.2
Intangible assets	18	2.7	3.7
Investment property	19	0.0	33.7
Property, plant and equipment	20	19.3	37.2
Other assets	21	263.7	103.1
Current tax assets	22	0.8	23.6
Deferred tax assets	22	25.7	2.0
Total assets		31 812.8	27 406.1
Liabilities			
Due to credit institutions and central banks	23	2 404.8	1 954.7
Amounts owed to customers and public entities	23	16 462.9	15 234.6
Debt securities in issue	24	6 645.0	4 514.5
Financial liabilities at fair value through p/l	24	1 231.6	1 697.0
Trading portfolio liabilities	13	2 203.1	1 312.4
Other liabilities	25, 26	481.0	421.4
Current tax liabilities	22	5.5	0.0
Deferred tax liabilities	22	0.0	0.0
Total liabilities		29 434.0	25 134.5
Equity			
Share capital	29	106.0	106.0
Reserves	29	271.1	271.1
Retained earnings	29	2 001.0	1 886.3
Equity attributable to parent company's equityholders		2 378.1	2 263.4
Non-controlling interest		0.6	8.2
Total equity		2 378.8	2 271.6
Total equity and liabilities		31 812.8	27 406.1

APPENDIX 8: Danske Bank Plc (Sampo Bank Plc) consolidated balance sheet 2010

CONSOLIDATED BALANCE SHEET

EURm	Note	12/2010
Assets		
Cash and balances at central banks	13	1 292,7
Trading portfolio assets	14	1 156,1
Loans and receivables	15,16	23 316,1
Investments	17	8,0
Intangible assets	19	6,6
Investment property	20	34,4
Property, plant and equipment	21	64,9
Other assets	22	256,6
Tax assets	23	22,7
Total assets		26 158,0
Liabilities		
Financial liabilities at fair value through p/l	14	1 070,5
Trading portfolio liabilities	14	908,2
Amounts owed to credit institutions and customers	25	17 565,1
Debt securities in issue	26	4 083,8
Other liabilities	27,16	372,5
Tax liabilities	23	0,6
Total liabilities		24 000,8
Equity		
Share capital	32	106,0
Reserves	32	271,1
Retained earnings	32	1 778,0
Equity attributable to parent company's equityholders		2 155,1
Non-controlling interests		2,1
Total equity		2 157,2
Total equity and liabilities		26 158,0

APPENDIX 9: OP Financial Group consolidated income statement 2013-2014

OP Financial Group income statement

EUR million	Note	Q1-Q4/ 2014	Q1-Q4/2013 Restated*
Interest income		2,685	2,514
Interest expenses		1,642	1,599
Net interest income before impairment	4	1,043	915
Impairments of receivables	5	88	84
Net interest income after impairments		955	831
Net income from Non-life Insurance operations	6	593	524
Net income from Life Insurance operations	7	197	175
Net commissions and fees	8	727	694
Net trading income	9	88	114
Net investment income	10	74	68
Other operating income	11	64	86
Total net income		2,698	2,493
Personnel costs		741	791
Other administrative expenses		414	384
Other operating expenses		437	422
Total expenses		1,592	1,598
Returns to owner-members		195	193
Share of associates' profits/losses accounted for using the equity method		3	-1
Earnings before tax for the period		915	701
Income tax expense		308	36
Profit for the period		607	665
Attributable to, EUR million			
Profit for the period attributable to owners		599	661
Profit for the period attributable to non- controlling interest		8	4
Total		607	665

APPENDIX 10: OP Financial Group (OP-Pohjola group) consolidated income statement 2011-2012

OP-POHJOLA GROUP INCOME STATEMENT

EUR million	Notes	2012	2011
Interest income		3,174	3,294
Interest expenses		2,171	2,264
Net interest income before impairment losses	5	1,003	1,030
Impairment losses on receivables	6	99	101
Net interest income after impairment losses		904	928
Net income from Non-life Insurance	7	433	312
Net income from Life Insurance	8	108	72
Net commissions and fees	9	584	574
Net trading income	10	81	17
Net investment income	11	52	63
Other operating income	12	109	90
Personnel costs	13	749	689
Other administrative expenses	14	378	351
Other operating expenses	15	352	318
Returns to owner-members	16	192	176
Share of associates' profits/losses		2	4
Earnings before tax		601	525
Income tax expense	17	119	89
Profit for the financial year		483	436
Attributable to, EUR million			
Profit for the period attributable to owners		483	436
Profit for the period attributable to non-controlling interest		-1	0
Total		482	436

APPENDIX 11: OP Financial Group (OP-Pohjola group) consolidated income statement 2010-2011

OP-Pohjola group income statement

EUR million	Notes	2010
Interest income		2,412
Interest expenses		1,495
Net interest income before impairment losses	3	917
Impairment losses on receivables	4	149
Net interest income after impairment losses		768
Net income from Non-life Insurance	5	382
Net income from Life Insurance	6	100
Net commissions and fees	7	563
Net trading income	8	46
Net investment income	9	62
Other operating income	10	99
Personnel costs	11	643
Other administrative expenses	12	319
Other operating expenses	13	324
Returns to owner-members	14	163
Share of associates' profits/losses		2
Earnings before tax		575
Income tax expense	15	135
Profit for the financial year		440

APPENDIX 12: OP Financial Group consolidated balance sheet 2013-2014

OP Financial Group balance sheet

EUR million	Note	31 Dec 2014	31 Dec 2013 Restated*
Cash and cash equivalents		3,888	2,172
Receivables from credit institutions		686	849
Financial assets at fair value through profit or loss		427	537
Derivative contracts		5,920	3,423
Receivables from customers		70,683	68,142
Non-life Insurance assets	14	3,797	3,479
Life Insurance assets	15	11,238	9,872
Investment assets		9,500	8,753
Investment accounted for using the equity method		56	54
Intangible assets		1,332	1,339
Property, plant and equipment (PPE)		781	726
Other assets		1,951	1,554
Tax assets		168	91
Total assets		110,427	100,991
Liabilities to credit institutions		1,776	1,039
Financial liabilities at fair value through profit or loss		4	4
Derivative contracts		5,489	3,157
Liabilities to customers		51,163	50,157
Non-life Insurance liabilities	16	2,972	2,746
Life Insurance liabilities	17	11,230	9,771
Debt securities issued to the public	18	24,956	21,428
Provisions and other liabilities		3,447	2,691
Tax liabilities		964	808
Supplementary cooperative capital		192	606
Subordinated liabilities		1,020	861
Total liabilities		103,214	93,267
Equity capital			
Share of OP Financial Group's owners			
Share and cooperative capital		1,709	339
Share capital		0	199
Membership capital contributions		148	140
Profit shares		1,561	-
Fair value reserve	19	425	328
Other reserves		1,996	2,739
Retained earnings		3,014	4,218
Non-controlling interests		69	100
Total equity capital		7,213	7,724
Total liabilities and equity capital		110,427	100,991

APPENDIX 13: OP Financial Group (OP-Pohjola group) consolidated balance sheet 2011-2012

OP-POHJOLA GROUP BALANCE SHEET

EUR million	Notes	31 Dec. 2012	31 Dec. 2011
Liquid assets	18	5,784	4,376
Receivables from credit institutions	19	840	1,104
Financial assets at fair value through profit or loss	20	358	281
Derivative contracts	21	4,436	3,307
Receivables from customers	22	65,161	60,331
Non-life Insurance assets	23	3,492	3,205
Life Insurance assets	24	9,173	7,006
Investment assets	25	6,596	8,343
Investment in associates	27	39	40
Intangible assets	28	1,320	1,169
Property, plant and equipment (PPE)	29	710	702
Other assets	30	1,745	1,884
Tax assets	31	115	158
Total assets		99,769	91,905
Liabilities to credit institutions	32	1,965	1,783
Financial liabilities at fair value through profit or loss	33	3	1
Derivative contracts	34	4,162	3,232
Liabilities to customers	35	49,650	45,974
Non-life Insurance liabilities	36	2,592	2,508
Life Insurance liabilities	37	8,970	6,932
Debt securities issued to the public	38	19,270	20,005
Provisions and other liabilities	39	3,297	2,840
Tax liabilities	40	990	834
Cooperative capital	41	622	624
Subordinated liabilities	42	1,114	931
Total liabilities		92,635	85,663
Equity capital			
Capital and reserves attributable to OP-Pohjola Group's owners			
Share and cooperative capital		336	333
Share issue account		-	-
Translation differences		0	0
Reserves		3,022	2,433
Retained earnings		3,752	3,474
Non-controlling interests		24	3
Total equity capital	43	7,134	6,242
Total liabilities and equity capital		99,769	91,905

APPENDIX 14: OP Financial Group (OP-Pohjola group) consolidated
balance sheet 2010

OP-Pohjola group balance sheet

EUR million	Notes	31 Dec. 2010
Liquid assets	16	1,628
Receivables from financial institutions	17	1,121
Financial assets at fair value through profit or loss	18	519
Derivative contracts	19	1,933
Receivables from customers	20	56,834
Non-life Insurance assets	21	3,164
Life Insurance assets	22	7,544
Investment assets	23	7,438
Investment in associates	25	38
Intangible assets	26	1,159
Property, plant and equipment (PPE)	27	716
Other assets	28	1,749
Tax assets	29	125
Total assets		83,969
Liabilities to financial institutions	30	1,696
Financial liabilities at fair value through profit or loss	31	0
Derivative contracts	32	1,951
Liabilities to customers	33	39,205
Non-life Insurance liabilities	34	2,350
Life Insurance liabilities	35	7,290
Debt securities issued to the public	36	19,577
Provisions and other liabilities	37	2,333
Tax liabilities	38	1,014
Cooperative capital	39	647
Subordinated liabilities	40	1,178
Total liabilities		77,243
Equity capital		
Capital and reserves attributable to OP-Pohjola Group's owners		
Share and cooperative capital		368
Share issue account		-
Translation differences		0
Reserves		2,768
Retained earnings		3,590
Total equity capital	41	6,726
Total liabilities and equity capital		83,969

APPENDIX 15: Theme interview questions

1. What are the most important financial measures of profitability of banks used by investors and by banks themselves?
2. In regards of profitability, what are the main differences between analyzing banks and analyzing companies from other industries than banking? What should investors especially keep in mind when analyzing banks' profitability?
3. How has the profitability of Danske Bank/Pohjola Bank and banks in general evolved in the past five years (2010-2014) and what factors have affected the profitability of banks the most? Have these factors been external or internal?
4. Has the current profitability level of banks been reached by cost cuts, increased income or a combination of both? How have the income and cost structures of banks changed in the past five years?
5. What are the main challenges currently for banks in regards of profitability? How could banks further improve their profitability?