

3.20 NORWAY

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INTRODUCTION TO THE NORWEGIAN COVERED BOND MARKET

Covered Bonds

The Norwegian covered bond legislation was adopted in June 2007. It came as a result of a lengthy study and reviews sponsored by the government and with strong support by the financial industry. It is a modern and up to date legislation that provides investors strong protection from the cover pool. The legislation is closely matching corresponding EU directives and regulation, and the Norwegian covered bonds are seen as being among the best in class of European covered bonds. The high quality of Norwegian covered bonds is supported by the Kingdom of Norway's very strong macroeconomic position.

Issuance of the first Norwegian covered bonds started with euro denominated bonds in second half 2007, and had thus just barely started when the crisis hit the international financial markets the following year. In order to provide liquidity to the Norwegian banking market the authorities opted to swap treasury bills against covered bonds with Norwegian banks and mortgages institutions. This gave an impetus to the fledgling domestic market of covered bonds; a large number of banks established new subsidiaries in order to take advantage of this liquidity window.

During 2008 and 2009 a total NOK 230 bn. (ca. EUR 30 bn.) of Norwegian covered bonds were lodged in swap agreements with the Government. These bonds must be refinanced in the market during the coming years, and this refinancing began in the beginning of 2011.

Specialized credit institutions

Today more than 20 Norwegian specialized credit institutions are licensed to issue covered bonds. Norwegian covered bonds are protected by law, and the issuers are subject to a particular supervisory regime involving both an independent inspector and the public supervisor, Finanstilsynet. The smallest ones only operate in the domestic market. The largest issuers already have been, and are expected to continue to be, present in the international capital markets on a regular basis.

Cover pools are dominated by residential mortgages; issuers tend to specialize, and the large majority of the issuers are specialized residential mortgage institutions (cf. the name "Boligkreditt"). Just a small number of issuers are specialized on commercial mortgages or on public sector loans.

Trading of covered bonds

The covered bonds are listed. The domestic issues listed on Oslo Børs may be traded on the exchange, but more often are traded off exchange and then reported to and publicized by Oslo Børs. International issues may be listed anywhere, usually somewhere within the currency zone in which the bonds are denominated. Some of the issuers supplement their bond issuance with private placements. Private placements and bondholders' claims rank pari passu in the cover pool.

NORWEGIAN COVERED BOND LEGISLATION

Background

The Norwegian Covered Bond legislation entered into force on 1 June 2007. Relevant amendments were made to the Financial Services Act, hereafter "the Act", and on 25 May 2007 the Ministry of Finance adopted a supplementary regulation, hereafter "the Regulation", to the Act.

The legislation fulfils and is in compliance with the relevant EU legislation, i.e. EU UCITS 52(4) and Directive 2006/48/EC. Hence the Norwegian Covered Bonds are in compliance with the UCITS, the CRD directive, and are eligible for reduced (10 %) risk weighting under the standard method for capital adequacy requirement. The Norwegian Covered Bonds are also eligible as collateral in ECB.

The issuance of covered bonds – a specialist banking principle

The legislation permits specialised mortgage credit institution to raise loans by issuing covered bonds. These institutions are licensed credit institutions, supervised by the Financial Supervisory Authority of Norway – Finanstilsynet, hereafter the FSA. They are subject to the same type of regulations as other Norwegian financial institutions, for example capital adequacy requirements, general requirements for liquidity management etc.

A commercial bank or a savings bank will not be allowed to issue such bonds in its own name, but may establish a mortgage credit institution as a subsidiary. Alternatively, a mortgage credit institution may be established as an independent institution with several shareholders.

A licensed mortgage credit institution may raise loans by issuing covered bonds where the object of the institution, as laid down in the articles of association, is (1) to grant or acquire specified types of mortgages and public sector loans and (2) to finance its lending business primarily by issuing covered bonds. The articles of association of the institution shall state which types of loans that shall be granted or acquired by the institution. The scope of the business will therefore be restricted and the institution will have a very narrow mandate. Thus, Norwegian issuers of covered bonds are transparent companies.

Regulation and supervision

Mortgage and other credit institutions are regulated under chapter 3 of the Act. This chapter sets out the general provisions for a credit institution, i.e. the obligation to obtain a license and to fulfill capital requirements and undertake organizational measures etc.

The issuing of covered bonds is regulated by chapter 2, subchapter IV of the Act. The issuance of such bonds is not subject to any further governmental approvals. However the articles of association shall be approved by the FSA. Furthermore, the institution shall notify the FSA no later than 30 days prior to the initial issuance of covered bonds. The FSA has the power to instruct licensed mortgage institutions not to issue covered bonds whenever the financial strength of the institution gives rise to concern.

The Act gives the bondholders a preferential claim over the cover pool in case of bankruptcy. The term "covered bonds", or literally "bonds with preferential claim" (in Norwegian "obligasjoner med fortrinnsrett") is protected by law. The assets in the pool remain with the estate in case of bankruptcy, but the bondholders have exclusive, equal and proportionate preferential claim over the cover pool, and the administrator is bound to assure timely payment, provided the pool gives full cover to the said claims.

Eligible assets – loan to value ratios

According to the Act the cover pool may consist of the following assets:

- a. Residential mortgages
- b. Commercial mortgages
- c. Loans secured on other registered assets (subject to further regulations)
- d. Public sector loans

e. Assets in form of derivative agreements (in accordance with the Regulation)

f. Substitute assets (in accordance with the Regulation)

The mortgage loans have to be collateralized with real estate or other eligible assets within the EEA or OECD, and the public sector loan borrowers have to be located within the EEA or OECD. The Regulation adds rating requirements on the individual national government of the country where the mortgaged property or the borrower has its location.

Loan to value ratios (LTV) and monitoring are fixed by the Regulation, in accordance with the EU Directive 2006/48/EC. For residential mortgages the LTV is 75 %, and for commercial mortgages 60 %. The mortgage credit institution shall monitor the development of the LTV of the individual asset as well as the market of the underlying assets, according to the Act, and in accordance with the said directive.

Upon inclusion of loans in the cover pool, a prudent market value shall be set. The market value for a property shall be set individually by an independent and competent person. The valuation shall be documented. However, valuation of residential properties may be based on general price levels.

Predominantly, residential properties in Norway are sold in an open auction in the market. Hence the actual selling price in principle reflects the market value and a recent sales contract may serve as documentation of the market value of a property.

The mortgage institution shall establish systems for monitoring subsequent price developments. Should property prices later fall, that part of a mortgage that exceeds the relevant LTV limit is still part of the cover pool and protects the holders of preferential claims. However, that part of a loan that exceeds the LTV limit is not taken into account when calculating the value of the cover pool to compare it with outstanding covered bonds, ref the matching regulations, described below. The same principle applies to loans that are in default, i.e. more than 90 days in arrears.

Derivative agreements and substitute assets

The derivative agreements and the substitute assets are, logically, accessory to the loans. The substitute assets may only amount to 20 % of the cover pool (30 % for a limited period of time with the consent of the FSA). In addition, the substitute assets ought to be secure and liquid. The Regulation adds requirements necessary in order to comply with the description of covered bonds given in EU Directive 2006/48/EC. Counterparty and rating regulations in accordance with the directive apply to these two asset classes, as well as to the public sector loans.

Matching regulations

The Act establishes a strict balance principle, i.e. the value of the cover pool shall at all times exceed the value of the covered bonds with a preferential claim over the pool. The Regulation establishes a strict mark to market principle of both assets and liabilities. Only the value of mortgages within the LTV limits is taken into account in this context. Also, the act caps the maximum exposure to one single borrower at 5 % of the cover pool when compliance with the matching requirement is assessed.

There is no requirement in the legislation for a certain percentage of overcollateralization. However, if an issuer chooses to provide voluntary overcollateralization, these assets are part of the cover pool, and bankruptcy remote in case of the issuer going into bankruptcy proceedings. Equally, the mortgage credit institution shall ensure that the payment flows from the cover pool enable the institution to honour its payment obligations.

The mortgage institution may enter into derivative agreements in order to secure the balance principle and payment obligations. If it has a positive market value, a derivative agreement will be part of the cover pool, if negative, the counterparties to derivative agreements will have a preferential claim over the pool, pari passu with the holders of covered bonds. As a corollary to this, the counterparties in the derivative agreements will be subject to same restrictions with respect to declaration of default as the bondholders. In addition to this, the mortgage institution will have to adopt strict internal regulations with respect to liquidity risk, interest rate risk and currency risk.

Register and inspector

The mortgage institution shall maintain a register of issued covered bonds, and of the cover assets assigned thereto, including derivative agreements. To oversee that the register is correctly maintained, an independent inspector shall be appointed by the FSA. The inspector shall also regularly review compliance with the requirements concerning the balance principle, and report to the FSA, yearly or whenever the institution does not comply.

Timely payment

As long as the cover pool fulfils the matching requirements, the bondholders and counterparties in derivative agreements have the right to timely payment, even in case of the issuer going into bankruptcy proceedings. The preferential claim also applies to payments that accrue to the institution from the cover pool. And, as long as they receive timely payments, the creditors have no right to declare default. Details about this may be reflected in the individual agreements between the issuer and (the trustee of) the bondholders. These provisions will also apply to any netting agreements between the institution and its counterparties in derivative transactions.

Bankruptcy proceedings

In case of bankruptcy of the mortgage credit institution an administrator shall be appointed by the court. The bankruptcy manager shall ensure proper management of the cover pool and also ensure that holders of covered bonds and derivative counterparties receive agreed and timely payments. Bankruptcy or insolvency does not in itself give holders of covered bonds and derivative counterparties right to accelerate their claims. Should it not be possible to make contractual payments when claims fall due, and an imminent change that will ensure that such contractual payments are unlikely, the bankruptcy manager shall introduce a halt to payments. Thereafter further administration of the cover pool shall proceed under the general bankruptcy legislation.

LEGISLATION SUPPLEMENTING THE COVERED BOND LEGISLATION

The legal framework regulating the housing market is well developed. This framework provides legal certainty and foreseeability for both consumers as borrowers and owners of housing, and for credit institutions as lenders and creditors. This includes specific consumer protection legislation, a centralized electronic registry system for the ownership of and rights (mortgage etc) in real property, and an effectively and expedient forced sale procedure.

The Financial Contracts Act (Act 1999-06-25 no. 46) regulates the contractual conditions in respect of a loan agreement between financial institutions and their customers, both consumers and corporate clients. The Act applies in principle to all types of loans, whether they are secured or not. This also includes mortgage backed loans included in a cover pool. The act is invariable in respect of consumer contracts, i.e. it cannot be dispensed with by agreement that is detrimental to the customer.

The Mortgage Act (Act of 8 February 1980 no. 2) regulates mortgages on real property. Mortgage rights acquire legal protection by registration in the Land Registry/Register of Deeds.

The Forced Sales Act (Act of 26 June 1992 no.86) provides for an effectively and expedient forced sale procedure. A lender may, if a loan is accelerated and the borrower fails to pay any due amount, file an application before the county court for a forced sale of the property that backs the mortgage loan. The registered mortgage contract will itself constitute basis for such application. The court will normally appoint a real estate broker to administer the sale in order to obtain a reasonable price. Normally, nine to twelve months are required to repossess the property and satisfy the holder of a mortgage.

NORWEGIAN COVERED BOND MARKET REVIEW

The year 2010 represented a normalization of the market after the international financial crisis and the very serious liquidity problems facing all bond markets. The Norwegian Government had, already by end 2009, as the market improved, discontinued the swap program, by which the Norwegian banks swapped covered bonds against treasury bills with the Government. Thus, there was no government sponsored program stimulating the market in 2010.

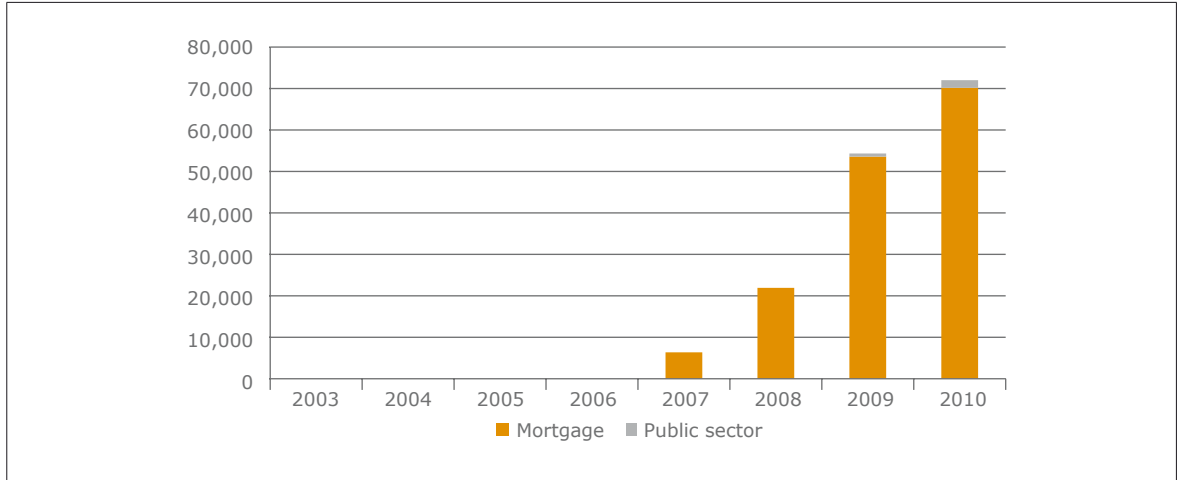
Thanks to the market improvement Norwegian issuers were able to issue new covered bonds totalling EUR 23 bn. during 2010, bringing the total outstanding to EUR 72 bn. by the end of the year. Of the total issuance EUR 11 bn., or close to the half, was euro denominated. A bit more than a third, or an amount corresponding to EUR 8 bn., was denominated in NOK (national currency). The rest was issued in other foreign currencies, mainly USD.

Of the total outstanding by the end of the year an amount corresponding to EUR 46 bn. was denominated in NOK, of which about EUR 30 bn. was lodged in the swap program with the Government. These bonds must be refinanced in the market as the swap agreements reach their term. The agreements, booked in last quarter 2008 and in 2009, have three to five years duration, but the banks have the option to terminate earlier, and early termination started in first half year 2011.

Today more than 20 Norwegian specialised credit institutions are licensed to issue covered bonds. The smallest ones only operate in the domestic market. The largest issuers already have been, and are expected to continue to be, present in the international capital markets on a regular basis. Cover pools are dominated by residential mortgages, and the large majority of the issuers are specialized residential mortgage institutions (cf. the name "Boligkreditt"). Just a small number of issuers are specialized in commercial mortgages or in public sector loans.

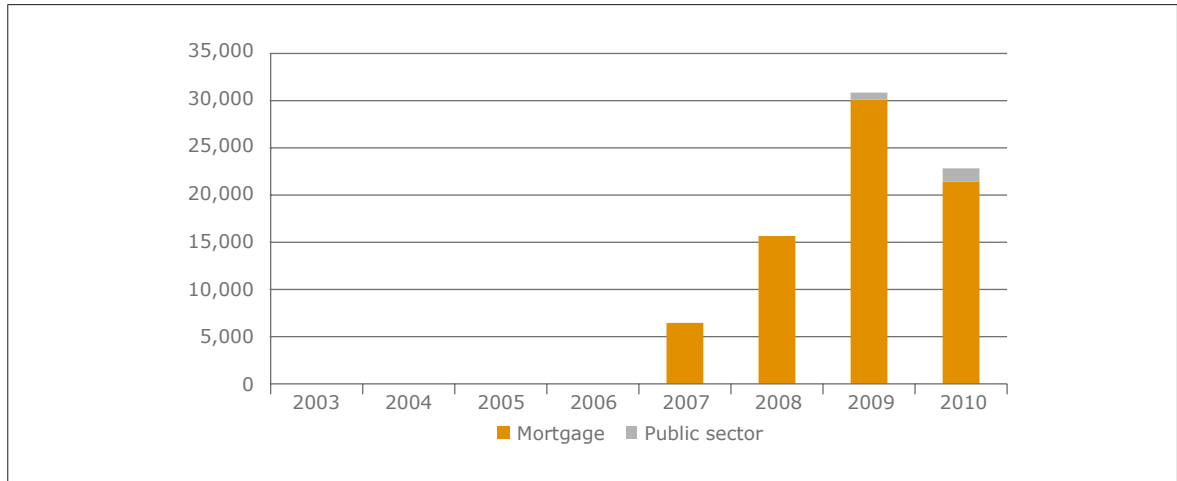
The covered bonds are listed. Virtually all active issuers have issues listed on the Norwegian market places offered by Oslo Børs, either on the regulated market or on the non-regulated market place run by Oslo Børs. The activity in the Norwegian market increased during 2010, and has showed an increasing trend so far in 2011. Today (June 2011) 18 issuers with more than 110 issues are traded on the Norwegian market places. International issues may be listed anywhere, usually somewhere within the currency zone in which the bonds are denominated. Some of the issuers supplement their bond issuance with private placements. Private placements and bondholders' claims rank pari passu in the cover pool.

> FIGURE 1: COVERED BONDS OUTSTANDING, 2003-2010, EUR M



Source: EMF/ECBC

> FIGURE 2: COVERED BONDS ISSUANCE, 2003-2010, EUR M



Source: EMF/ECBC