

# NORGES BANK PAPERS

## NORWAY'S FINANCIAL SYSTEM

NO. 2 | 2016

AN OVERVIEW



NORGES BANK

# Norges Bank Papers no. 2 | 2016

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## Norges Bank

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NORWAY'S FINANCIAL  
SYSTEM

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# Preface and reader's guide

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NORWAY'S FINANCIAL  
SYSTEM

“Norway’s financial system” provides a general overview of the financial system in Norway, its tasks and how these tasks are carried out. This publication is meant as a reference guide and textbook and is intended for a broad audience. The focus is on presenting the financial system in a simplified manner, although financial system professionals should also be able to find useful information.

Section 1 provides an overall overview of all the components of the financial system and its tasks. Section 2 describes the various markets: the money, bond, foreign exchange and equity markets, and the financial derivatives markets. Section 3 discusses the most important financial undertakings: banks, mortgage companies, insurance companies, pension schemes and various funds, etc. Section 4 describes the financial system infrastructure, which includes the payment system and systems for the payment and transfer of financial instruments.

In 1973, Norges Bank published “The Norwegian Monetary and Credit System” as the first publication in the Bank’s *Occasional Papers* series. Revised versions were subsequently published in 1980, 1985, 1989, 1995 and finally in 2004 under the title “Norske finansmarkeder – pengepolitikk og finansiell stabilitet” [Norwegian financial markets – monetary policy and financial stability] (in Norwegian only). The current publication differs from the earlier publications in that it contains only limited information about Norges Bank’s responsibilities and tasks.

“Norway’s financial system” will be available online only. Hyperlinks to other publications and institutions have been inserted in the text (underlined).

The aim of this publication is to promote public understanding of the financial system. The financial system is continuously evolving. The publication will be revised annually to ensure that it is kept up to date and maintains its relevance as a reference and text book. Readers are encouraged to provide feedback, report errors, ambiguities or inadequate explanations and suggest improvements. All comments should be sent to: [dnfs@norges-bank.no](mailto:dnfs@norges-bank.no).

Oslo, 9 June 2016

# 1. The financial system

The three main tasks of the financial system are: 1) providing economic agents with borrowing and saving opportunities and channelling savings into profitable investment projects (intermediation), 2) making payment transactions possible and 3) managing risk. In a well-functioning financial system, these tasks are performed securely and efficiently.

## **The financial system consists of the following components:**

- **Financial undertakings** (banks, mortgage companies, pension funds, insurance companies, securities funds), which act as intermediaries between savers and borrowers (investors). Banks perform all of the financial system's three main tasks. Insurance companies do not execute payments.
- **Financial markets**, where suppliers of capital, such as investors, and users of capital, such as businesses or the government meet on a marketplace, such as a stock exchange, in order to trade financial instruments. The trades are contracts between the buyers and the sellers. A contract is the basis of a financial instrument and the terms of the contract vary with regard to return, risk, maturity, etc. As a result, there are many different instruments and consequently many different markets. The capital market is a general term for all markets in which buyers and sellers can trade medium to long-term financial instruments such as bonds (bond markets) and stocks (equity markets). The money market is a market for buying and selling short-term debt instruments with a maturity of less than one year. The foreign exchange (FX) market is a market for the purchase and sale of foreign currency. There are also various derivatives markets in which financial instruments with characteristics derived from underlying components such as stocks, FX or bonds are traded. A typical derivative is a contract whereby the seller sells Norwegian kroner (NOK) to a buyer for an agreed sum of US dollars (USD) to be received at a future date, thereby hedging the buyer against future USD appreciation.
- **The financial infrastructure**, which ensures that payments and trades in financial instruments are recorded and settled. The legislation and standard agreements governing these processes are part of the financial infrastructure, as are computer systems and systems of communication among financial system participants. The payment and securities settlement systems are important parts of the financial infrastructure. In this publication, cash is regarded as part of the financial infrastructure.

End-users of financial services are excluded in this definition of the financial system. All companies and most consumers are end-users of financial system services.

A broader definition of the financial system includes institutions and mechanisms that provide security for contracts that are entered into and that obtain and confirm the information needed for effective credit intermediation and risk management. These institutions and mechanisms perform supervision, regulation, registration of ownership rights, accounting, auditing, and credit ratings and other financial analyses.

Norges Bank is an important part of Norway's financial system. The Bank issues banknotes and coins and functions as bankers' bank. In practice, this means that banks hold accounts at the central bank and use them to settle interbank payments. Norges Bank is also an advisory and executive body for monetary policy, i.e. it sets the interest rate level in Norway, has supervisory and regulatory responsibilities with regard to the financial system and manages the country's foreign exchange reserves and the Government Pension Fund Global. A description of how Norway's financial system functions must include an explanation of Norges Bank's roles and tasks. This is included in this publication, although it is not the primary focus. More information on Norges Bank's objectives and tasks can be found on the Norges Bank [website](#).

Chart 1.1 What happens in the financial system?

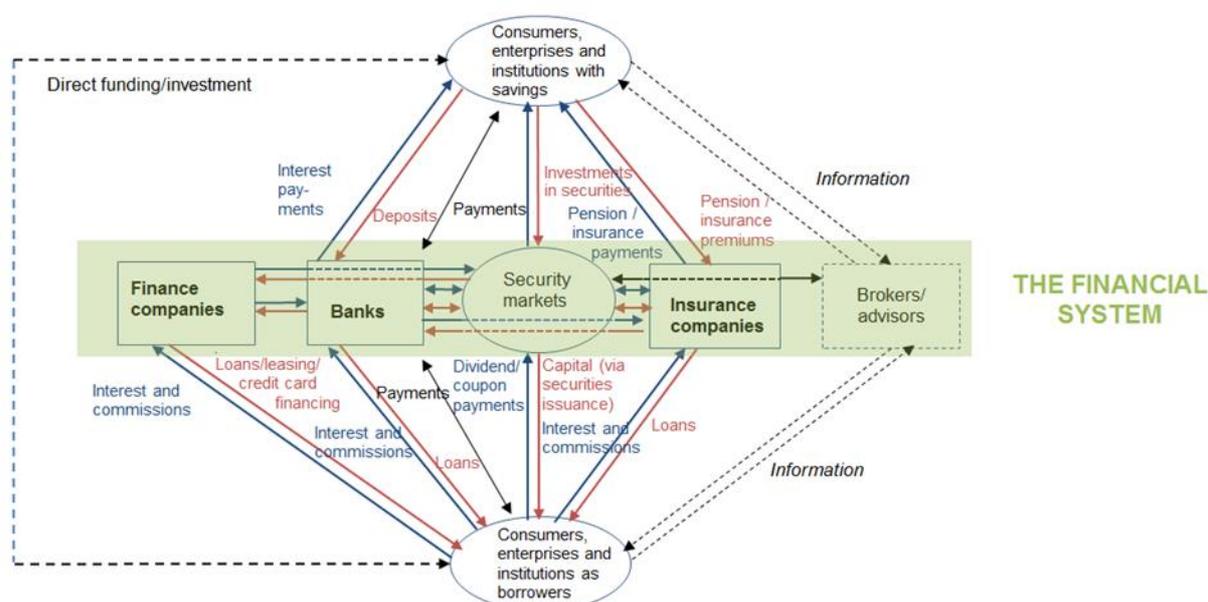


Chart 1.1 shows a diagram of the financial system. Consumers, enterprises and institutions with savings are circled at the top. Consumers, enterprises and institutions as borrowers are circled at the bottom. The financial system, where savings are channelled into investment through markets and institutions, is in the middle of the diagram. Payments and risk management also primarily take place in this intermediary segment.

## 1.1. Providing economic agents with borrowing and saving opportunities

Most people need to borrow money at some time or other. Consumers and households need to borrow money to buy a house, finance spending on other large consumption items, invest in education or finance a temporary decline in income. Similarly, most people need a place to store their money at times when income exceeds expenditure,

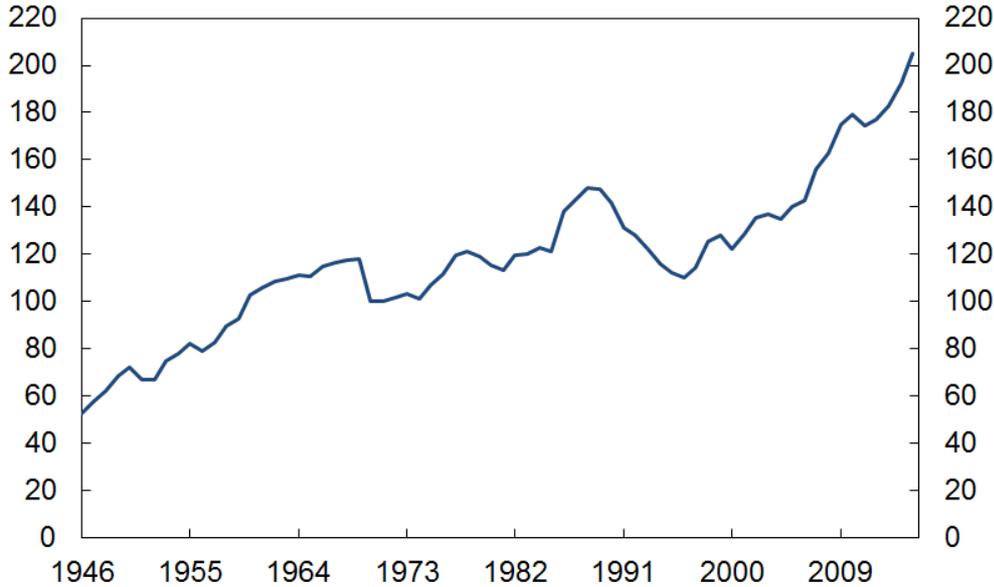
i.e. to save. They might also be saving for retirement or accumulating the equity required to obtain a loan. Borrowing and saving opportunities allow households to spread their consumption over a lifespan irrespective of when income is accrued.

Enterprises can borrow to make investments to increase or sustain output capacity or to finance deficits in lean periods. In times of prosperity, enterprises need saving opportunities in order to be better equipped for leaner times in the future and in order to fund some of their investments using their own capital.

Central and local governments can borrow to fund investment and important expenditure during economic downturns and need saving alternatives during upturns.

When a country's GDP rises, the total value of both financial assets and liabilities tend to rise even more. In Norway, the ratio of total private sector and local government debt (known as C3) to GDP has more than tripled since 1946 (Chart 1.2).

Chart 1.2 Total credit (C3) as a share of GDP in the period 1946–2015.  
Percent



Source: Norges Bank

At any one point in time, there will be both borrowers and savers among households, enterprises and government. Savings are channelled to investment both across and within these groups. If it is possible to borrow and save abroad, the sum of all the groups' savings will not necessarily be equal to the sum of the groups' investments.

Financial undertakings and marketplaces are intermediaries between savers and investors. Banks accept and hold savings in the form of deposits and they provide loans. They distribute savings across a large number of investments (borrowers), which reduces the risk that savers will incur losses. Banks have also specialised in credit risk assessment of borrowers. The government authorities have initiated various measures to protect banks' customers against risk, including deposit insurance (see Section 3.2.7 *Deposit insurance in Norway*). Savers can therefore make deposits

without needing to assess how these deposits are invested by banks. For the banks' customers and for society as a whole, this is a substantial cost saving measure that facilitates saving and investment. Some savings are earmarked as pensions, with pension providers acting as intermediaries.

Large enterprises and central and local governments can borrow or expand their share capital in securities markets, where they receive saved funds directly from savers without having to go through intermediary financial institutions. Such investments generally require more supervision by savers, but they also provide the possibility of higher returns.

Savers seek saving options with differing characteristics in terms of lock-in periods, risk and return. Financial institutions and securities markets offer an extensive range of saving products. This is an area in continuous evolution, with new products emerging and existing ones being discontinued.

Saving in a bank is a special form of saving because bank deposits are also used to make payments, i.e. bank deposits are a form of money. Today, bank deposits are the dominant means of payment in advanced economies. Most people with savings in banks therefore want their funds to be available quickly when needed, i.e. they should be liquid. (Read more in **Box: Liquidity** in Section 2.1.1.) At the same time, people that take out a mortgage, for example to purchase a house, usually want to repay the loan over a long period. In this regard, banks play an important role by converting short-term deposits into long-term loans. This is called maturity transformation. (Read more about maturity transformation in Section 3.2.1: *Banks' tasks*.)

## 1.2. Payment systems

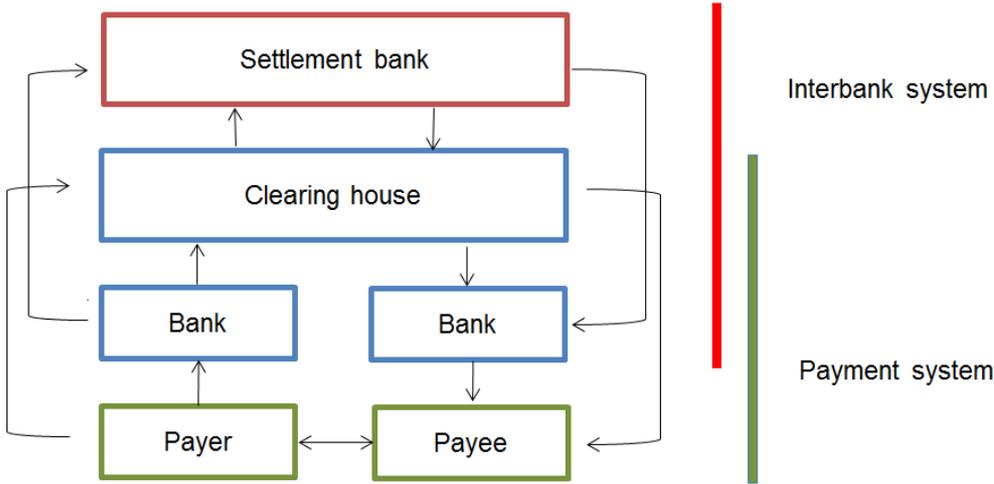
Most of us make payments on a daily basis. We pay our bills and we pay for goods in shops. We can pay using cash or using our bank deposits, i.e. deposit money in our bank accounts. Norges Bank issues cash based on user demand. Factors determining the quantity of deposit money are described in Section 3.2.1: *Banks' tasks*. Deposit money can be used for payments made with, for example, payment cards or mobile phones.

In a barter economy, both participants of a transaction must agree upon a medium of exchange. In a monetary economy, there is a universally acknowledged medium of exchange, money. Money can be in the form of banknotes or coins that are universally acknowledged because they are defined by law as legal tender. But money can also be in the form of deposit money, which is universally acknowledged to the extent it can be withdrawn in the form of banknotes and coins. Transactions in the economy are increasingly settled using deposit money. For deposit money to be universally acknowledged, a secure banking system is crucial.

There are a large number of banks and a very high number of transactions, including interbank transactions. Transactions using deposit money must be settled. Settlement is conducted in interbank systems, where, for example, 1000 payments between Bank A and Bank B can be collected together (netted) (Chart 1.3). All 1000 payments are settled and are acknowledged when B (or A) pays A (or B) the netted amount. Most

interbank payments are settled in Norges Bank with what is referred to as central bank money, which for the most part comprises banks' deposits in Norges Bank. This means that banks settle payments to each other by transferring funds between their accounts at Norges Bank. Norges Bank manages the quantity of central bank money through what are known as market operations, such as lending money to banks or buying securities including FX from banks. These transactions take place over banks' deposit accounts at Norges Bank.

Chart 1.3 The Norwegian payment system



A system based on money provides a considerably simplified form of exchange. It reduces transaction costs in the economy and facilitates a more effective division of labour in society. In a well-functioning payment system, money transfers are conducted securely, in a timely manner and at a low cost. The payment system is a central part of a country's infrastructure and important for the stability of the domestic currency, the financial system and the economy in general.

### 1.3. Risk management

Both private individuals and enterprises want to insure themselves against various risks. Fire, theft and auto insurance, for example, can be purchased from a non-life insurance company. Life insurance companies and pension funds sell insurance that guarantees payment to the insured in the event of disability, provides security for survivors in the event of the premature death of the insured, and individual pension plans and occupational pensions as a supplement to state pensions (the National Insurance Scheme).

Enterprises may also seek insurance against various economic risks associated with their activities. There may be risks associated with operational surpluses and future prices of both intermediate goods and final products. Exchange rate risk and the risk of a change in interest rates on debt are other examples. Enterprises can eliminate or mitigate such risks by means of commonly used financial instruments and derivatives. The sellers of derivatives can insure against, or hedge, their own risk by offering

derivatives contracts to buyers with opposite needs, cover risk by owning the underlying instruments or reselling risk to other institutions. Financial institutions and other financial sector participants account for a substantial share of the demand for derivatives to hedge the risk of unfavourable developments in exchange rates, equity prices and interest rates.

Banks are also experts at assessing the risk associated with the various investment projects for which they provide loans. Bank depositors can therefore entrust such assessments to the banks. The depositors' risk is also reduced because banks spread, or diversify, their lending across a large number of borrowers and, not least, because deposits are insured through a deposit insurance scheme. The current scheme in Norway covers deposits up to NOK 2m per depositor per bank.

Diversification also reduces risk for those who invest their savings in securities funds or asset management companies.

Capital markets also help to diversify and redistribute risk associated with investments. Investors can manage risk by owning securities with different levels of desired risk.

## 1.4. Supervision and regulation of the financial system

A well-functioning financial system is crucial to a modern economy. If making payments or obtaining loans becomes impossible, this could quickly have wide-reaching consequences for the entire economy. The financial system is therefore subject to more regulation and supervision by the authorities than most other sectors of the economy. (Read more about the most important types of risk in the financial system below, in **Box: Risks in Norway's financial system**.)

### Box: Risks in Norway's financial system

The purpose of the financial system is to contribute to more effective management of risk in the economy. One element of risk management is identifying the nature of a risk and how it can be prevented. Pricing of risk is an important part of this work. There are different kinds of risk:

**Credit risk** is the risk of losses when borrowers cannot settle their accounts. For commercial loans, credit risk can be associated with a sector (for example construction) or with individual borrowers.

**Liquidity risk** is the risk that a financial institution cannot meet its payment obligations when due without incurring substantial additional costs. This risk is especially associated with the differences in terms to maturity between banks' assets and liabilities. Deposits in banks are typically open-ended with no prior notice of termination required, while bank loans have long maturities. Liquidity risk is also used to refer to the risk of prices being influenced when securities or other assets are traded and is then associated with the term market liquidity (see **Box: Liquidity** in Section 2.1).

**Market risk** is a collective term for the risk of losses due to movements in market prices such as interest rates, exchange rates, commodity prices or share prices. These types of risk are often referred to as interest rate risk, foreign exchange risk, commodity price risk and equity risk.

**Operational risk** is associated with technical malfunctions, human error and inadequate control systems and can include faulty procedures, errors in IT systems, regulatory violations, fraud, fire, terror attacks, etc. Operational risk may cause or amplify credit or liquidity risk.

**Legal risk** can be defined as the risk of losses arising from a contract that cannot be honoured as planned, or from collateral that cannot be realised as envisaged. Legal risk arises not least in international business as legislation often varies across countries.

If one or more of these risks becomes substantial, the financial system may no longer function efficiently and securely. **Systemic risk** develops. The European Systemic Risk Board (ESRB) defines systemic risk as the risk of disruption in the financial system with the potential to have serious negative consequences for the real economy (see *Recommendations* from ESRB 4 April 2013). Systemic risk can vary over time or be more structural in nature. Time-varying systemic risk is especially associated with developments in debt, asset prices and the mismatch between the maturities of banks' assets and liabilities. Structural risk is particularly associated with the degree of concentration in the financial system, the number and size of systemically important institutions and weaknesses in the financial infrastructure.

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The financial system is primarily regulated through legislation. Authorisation from the authorities is required to establish institutions or perform specific services within this system. Authorisation implies that the institution is subject to extensive requirements to ensure that it can meet future obligations. The authorities monitor compliance through supervision, and authorisation can be revoked in the event of non-compliance.

Requirements can relate to the quantity of capital an institution should hold, the liquidity of their assets or the ability of their boards and administration to manage activities. Regulations may be direct in the form of, for example, a ban on certain activities. They may also be indirect, such as capital requirements based on the level of risk an institution takes on.

The objective of regulating banks is to provide both private individuals and enterprises access to liquid and secure stored value facilities and to ensure confidence in deposit money as a means of payment. Regulation is also intended to ensure that banks have sufficient capital to provide loans even during economic downturns with bank losses. Financial markets regulation often pertains to the marketplace itself, for example in the form of restrictions on which groups may participate. There are also clear reporting requirements.

The Ministry of Finance is responsible for submitting legislative proposals relating to the financial system to the Storting (Norwegian parliament). The establishment of new institutions or other undertakings is also primarily authorised by the Ministry of

Finance. Interbank systems, for the settlement of interbank payments, are an exception. Because of its central role in, and responsibility for, the payment system, Norges Bank is the licensing authority for interbank systems.

Finanstilsynet (Financial Supervisory Authority of Norway) is primarily responsible for supervising institutions in the financial system to ensure that they comply with the applicable legislation. Finanstilsynet can also impose new requirements on parts of the system where necessary. The goal of supervision is partly to ensure that the financial system's main tasks are conducted in a sound manner and partly to protect the interests of the consumer.

For the payment system to be efficient and secure, the banks must also be efficient and secure. Finanstilsynet has a particular responsibility for supervision related to banks' solvency, management and control. Norges Bank has a particular responsibility for clearing and settlement systems. Both institutions are responsible for ensuring that the system as a whole functions as intended.

As a disruption in the financial system can have severe consequences, it is important to be prepared to handle adverse scenarios. The aim is to mitigate the negative consequences if such a scenario should arise. The Ministry of Finance has an important role in coordinating the activities of the three authorities should a financial crisis arise. Norges Bank can contribute if there is a liquidity shortage by lending funds against approved collateral to participants in the financial system.

## 1.5. International perspectives

All three main tasks of the financial system involve extensive cross-border activities. There is therefore broad international cooperation on regulation and supervision. The *Financial Stability Board* (FSB) is a collaborative body that monitors and makes policy recommendations for the global financial system. FSB members include the largest countries and the most important international financial institutions. In banking, the *Basel Committee on Banking Supervision* is the most important international body. The Committee prepares regulatory proposals related to large international banks and seeks to promote international cooperation on banking supervision. Its regulatory proposals are implemented for both small and large banks in most countries. There are corresponding international collaborative bodies for insurance, securities, payment systems, etc.

Framework conditions for Norway's financial system are determined through the Agreement on the European Economic Area (EEA), which regulates Norway's relationship to the EU. In principle, financial system regulation is required to be the same for all the countries that are party to the EEA Agreement. There is also extensive cooperation on monitoring and supervision of the financial system through the EEA Agreement.

## 2. Financial markets

Financial markets are markets in which financial instruments are issued and traded. In these markets, savers can bypass financial institutions and lend directly to borrowers. The main financial instruments are debt instruments (bond and short-term paper markets), equity (stock markets), foreign exchange and derivatives. For debt and equity there is both a primary market, where equity securities, or stocks, and bonds are sold to investors, and a secondary market for the purchase and sale of existing bonds and stocks. The marketplace, or trading venue, may be a stock exchange where bid (buying) and ask (selling) prices are submitted and cleared. Most standardised instruments such as equities or government bonds are traded on a stock exchange. Many other instruments are not primarily traded on a stock exchange, but are traded either via alternative trading venues or bilaterally between buyers and sellers, called “over the counter” (OTC) trading. Corporate bonds, foreign exchange and derivatives are primarily traded OTC (for further details, see **Box: Turnover in securities: exchange-traded and OTC**).

### Box: Turnover in securities – exchange-traded and OTC

Financial instrument trades can take place on organised trading platforms or through bilateral agreements, referred to as “over-the-counter” (OTC). A stock exchange is the form of organised trading platform that is regulated most extensively to ensure that relevant information is available to investors. Norway’s stock exchange, Oslo Børs, is regulated by Finanstilsynet. Securities that are expected to be widely traded will usually be accepted for trading on a stock exchange. For a company to be listed, i.e. for its shares to be traded on a stock exchange, detailed information about the company and, if a bond is to be issued, information on the bond agreement, must be submitted. Once a company has been listed, it has an obligation to regularly provide updated information. This ensures that relevant information about all the securities traded on the stock exchange is available to investors. Securities listed on Oslo Børs can be traded through the exchange’s electronic trading system, which shows updated bid and offer prices with the associated trading volumes. Securities prices are continuously updated based on actual trades. Although the great majority of trades on Oslo Børs are in equities, bonds are also issued and traded on the exchange. Listed securities may also be traded off-exchange. If one of the parties to such a trade is a member of the stock exchange, the trade must be reported to Oslo Børs by 4 pm on the day the trade takes place.

There are electronic trading platforms that are not stock exchanges and that are subject to less stringent information and transparency requirements. These are often referred to as Multilateral Trading Facilities (MTFs). MTFs are generally owned and operated by banks or brokers to avoid paying transaction fees to a stock exchange. It is not normally possible to list securities on an MTF and the amount of information that is available to investors varies. Some MTFs are almost as open about their operations as stock exchanges, while others provide little information regarding prices and trading volumes. MTFs that only provide minimal information are called “dark pools”. MTFs primarily offer trading in equities that are also usually listed on an exchange. Parties to a trade will often agree to trade at the same price as the listed equity on the exchange.

As a result, large trades can be executed on an MTF without affecting prices on the exchange. Incentives for trading in an MTF rather than on a stock exchange may include lower transaction costs or the desire to avoid showing one's hand by displaying an order in the market.

In the simplest form of OTC trades, the buyer and seller contact each other directly to agree on a transaction. Since it can be difficult to find a counterparty, brokers are often used as intermediaries in these transactions. For securities with fairly high turnover, brokers provide indicative bid and offer prices. As a rule, trades cannot be made at these prices, and transactions are agreed upon by phone or instant messaging via a computer network. Many bonds are mainly traded in this manner.

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Financial markets are also important for distributing risk in the economy. When projects and businesses are funded by raising capital in equity and bond markets, risk is spread over many investors and lenders. This can provide both improved access to capital and better distribution of risk. Participants also use financial markets to manage risk through the purchase and sale of instruments featuring different kinds of risk. Money, FX and derivatives markets have important functions in that they redistribute liquidity and various forms of risk. These markets are also used for speculation in developments in macroeconomic variables and financial assets. This contributes to price formation in the market and is an element in the redistribution of risk. In markets with substantial turnover, new information is quickly reflected in prices for financial instruments. This gives important information to both savers and borrowers and can improve resource utilisation in the economy.

Activity in the markets and at trading venues is regulated by the authorities, albeit to a somewhat lesser extent than is the case for financial undertakings such as banks and insurance companies. For more information, see Appendix 1: *Regulation of Financial markets and trading venues*.

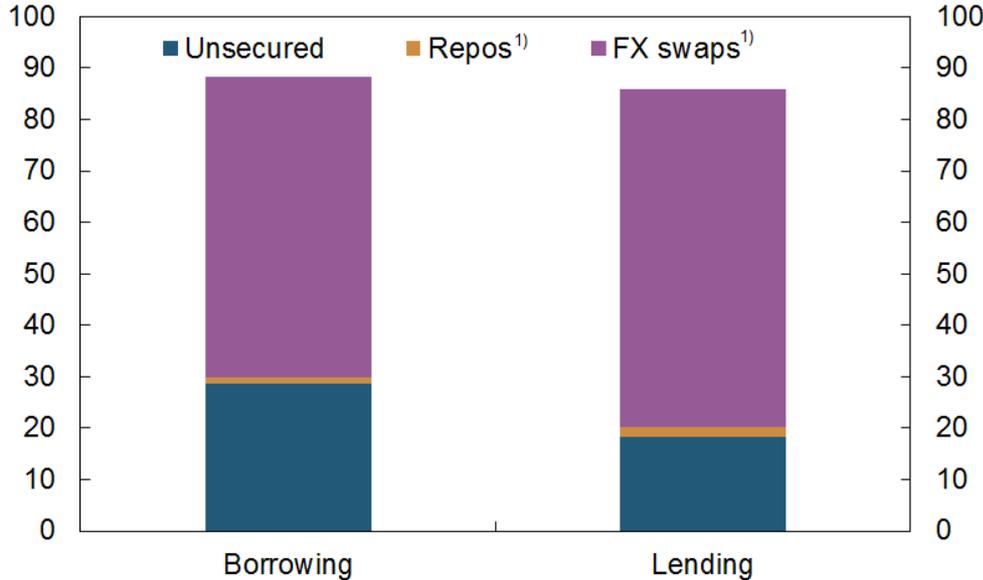
## 2.1. Money market

The term money market refers to several types of financial market in which participants can invest or borrow funds using financial instruments with maturities of up to one year. Participants use money markets primarily to manage their funding liquidity, i.e. the degree to which participants have the means to meet their obligations on time (see **Box: Liquidity**). Banks are important participants. The market for borrowing and lending between banks is called the interbank market and is a substantial part of the money market. Other participants, such as the government and other enterprises, also utilise money markets, primarily to issue notes and Treasury bills. Norges Bank is also a key participant in the money market.

The most important instruments in the money market are secured loans in the form of currency swaps, which are mostly used by banks, and unsecured loans in the form of Treasury bills and notes. There are also markets for unsecured interbank loans, with overnight loans as the most important, and repurchase agreements (repos).

Chart 2.1 is taken from Norges Bank’s money market survey and shows daily borrowing and lending by instrument in April 2015 (see *Money Market Survey* on the Norges Bank website). “Unsecured” only refers to unsecured loans and deposits, not notes.

Chart 2.1 Lending and borrowing by instrument.  
 Daily average. April 2015. In millions of NOK



1) Defined in Section 2.1.4.  
 Source: Norges Bank

2.1.1. Money market participants

Participants in the money market are mostly banks. Fluctuations in banks’ liquidity are mainly related to banks’ tasks with regard to payment services, lending and maturity transformation (see Section 3.2.1 *Banks’ tasks*). An example related to payment services is that of a bank customer who transfers an amount from his or her own account to the account of a recipient in another bank. The payer bank’s liquidity will then be reduced as its deposit in Norges Bank is reduced. Conversely, the liquidity of the bank receiving the transfer will increase as its deposit in Norges Bank is increased. Banks use the money market to manage such liquidity fluctuations. Interbank loans comprise not only unsecured loans, but also secured loans such as repurchase agreements (repos) and currency swaps.

Box: Liquidity

The term liquidity is used differently in different contexts.

The **liquidity of an asset** means the ease with which it can be converted into money for the purchase of goods, services and other assets. Cash and bank deposits are money and thus the most liquid form of liquidity, while fixed capital such as housing is an asset with limited liquidity.

**Funding liquidity** means the degree to which a person or business has sufficient funds available to pay for goods and services or to service debt as it falls due. In

practice, it is a question of the amount of cash and bank deposits, which for banks includes their deposits in Norges Bank, that is or can easily be made available. Funding liquidity is most often used to describe the possibility of obtaining funding at an acceptable price so that a business has sufficient funds to make payments and service debt.

**Market liquidity** means the degree to which it is possible to trade assets, such as securities, in the market without substantially influencing market prices. A market is considered liquid if it is possible to trade large volumes in a short period of time without causing substantial movements in market prices. Some markets are by their nature more liquid than others, but in most markets liquidity varies over time. During financial crises, liquidity in many markets can dry up.

**Central bank liquidity** means banks' deposits in the central bank (central bank reserves) and their cash holdings. Central bank liquidity plays a key role in the setting of short-term market rates and for the execution of payments in the economy.

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Insurance companies, finance companies, mortgage companies and local governments also trade in the money market when they need to borrow or invest funds for short periods. Insurance companies invest most of their funds in long-term securities, but they also make short-term investments in the money market in order to have the means to cover upcoming payments. In the private sector, money markets are primarily used by the largest companies, whose resources are large enough to utilise this market, at least as borrowers. Smaller participants can invest in the money market by for example purchasing investment fund units. The government is also a major participant and uses the money market to meet its short-term funding needs by issuing Treasury bills. As the government holds its liquidity in its account at Norges Bank, the government only participates in the money market as a borrower.

Norges Bank is also a key participant in the money market. It uses market operations to control the quantity of central bank reserves in the banking system. Norges Bank also offers standing deposit and lending facilities to banks as part of its liquidity management (see **Box: Norges Bank's liquidity management and overnight lending rate**).

### 2.1.2. Unsecured money market instruments

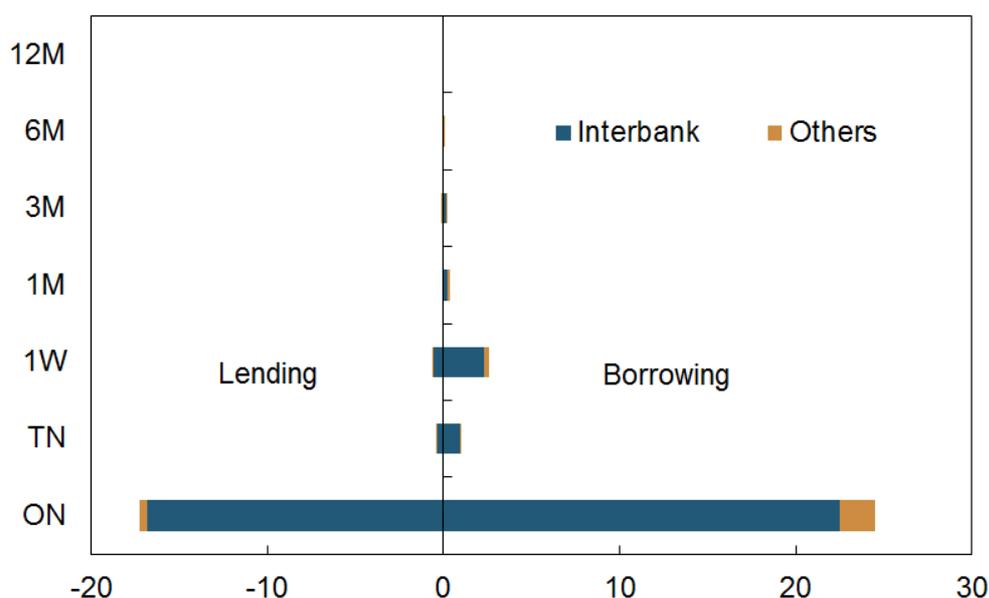
Unsecured money market instruments refer to unsecured interbank loans, Treasury bills and other short-term paper. Trades in unsecured interbank loans and deposits are concentrated around the shortest maturities, while Treasury bills and short-term paper can vary in maturity up to a maximum of one year.

#### 2.1.2.1. Interbank loans and deposits

Banks can borrow from and invest with each other in the unsecured interbank market. Most trades take place at very short maturities, particularly overnight (Chart 2.2).

If a bank has large net outgoing payments one day but large net incoming payments the next, it can cover its short-term liquidity shortfall by borrowing in the interbank market. The bank will normally cover its more permanent financing needs with longer-term funding. This use of the interbank market explains why trades are concentrated around the shortest maturities. The interbank market is primarily used for banks' daily liquidity management. Its main function is as a safety valve, allowing banks to cover unexpected or short-term liquidity shortfalls at short notice.

Chart 2.2 Unsecured lending and borrowing by maturity and counterparty.<sup>1</sup>  
 Daily average. April 2015. In billions of NOK



1) Maturity is from ON (overnight), TN (tomorrow next: from tomorrow to the next trading day), 1W (one week), 1M (one month) etc. up to 12M (12 months).  
 Source: Norges Bank

### Box: Norges Bank's liquidity management and overnight lending rate

The aim of liquidity policy is to keep the shortest money market rates close to the key policy rate. Norges Bank accomplishes this by setting the terms for banks' loans and deposits in the central bank and by controlling the size of banks' total deposits in Norges Bank (central bank reserves).

So-called corridor systems are very common internationally. In such a system, the central bank's lending and deposit rates form a corridor for the shortest money market rates in the interbank market. The key policy rate is normally in the middle of this corridor, and the central bank manages the reserves in the banking system (banks' deposits in the central bank) to keep them at zero (or slightly above zero). A bank that has received a net inflow from other banks over the course of the day and has a positive account balance in the central bank lends reserves to banks that have had a net outflow over the course of the day and thereby have a negative account balance in the central bank. By the end of the day, (most) banks have account balances at zero and claims on other banks in the interbank market. A corridor system incentivises banks to trade reserves with other banks and not with the central bank.

In a so-called floor system, the central bank seeks to maintain an oversupply of central bank reserves in the banking system. This system drives the shortest money market rates down to banks' marginal deposit rate at the central bank, which then forms a "floor" for the shortest rates. For more detail on liquidity management systems in general, *see* "Liquidity management system: Floor or corridor?" Norges Bank Staff Memo 4/2010, "Systemer for likviditetsstyring: Oppbygging og egenskaper" [Liquidity management systems: structure and characteristics], Norges Bank Staff Memo 5/2011 (in Norwegian only) and "Penger, sentralbankreserver og Norges Banks likviditetsstyringssystem" [Money, central bank reserves and Norges Bank's liquidity management system], Norges Bank Staff Memo 5/2016 (in Norwegian only).

Norway's liquidity management system is a cross between a floor and a corridor system. Norges Bank seeks to maintain reserves at a given level within a target range. Each bank has a sight deposit quota at Norges Bank. Deposits below the quota are remunerated at the sight deposit rate (which is equal to the key policy rate), while deposits in excess of the quota are remunerated at a lower rate, known as the reserve rate.

In Norway, as in many other countries, the government has an account at the central bank. Government outflows increase banks' deposits at the central bank. On Norges Bank's balance sheet, the government's deposits are reduced while banks' deposits increase. Correspondingly, government inflows reduce banks' deposits at Norges Bank. Thus, transactions over the government's account alter the quantity of reserves in the banking system and Norges Bank restores the balance using market operations, the most common of which are F-loans and F-deposits. F-loans are loans against collateral in fixed-rate securities with a given maturity. F-deposits are fixed-rate deposits with a given maturity. Such operations are necessary when government account transactions would otherwise have moved banks' deposits outside the target range.

Norwegian banks also borrow reserves from other banks overnight through the interbank market. A bank that has been a net recipient of reserves through the day and exceeds its quota will normally lend reserves to banks with negative account balances or deposits below the quota. The alternative is to deposit the reserves in excess of the quota at the lower reserve rate. Banks with net outflows of reserves through the day, and with negative account balances at the central bank, will want to borrow reserves from other banks. Otherwise, banks' negative account balances in the central bank will be made into overnight loans (called D loans) and charged at Norges Bank's overnight lending rate for banks, the D-loan rate.

As in a corridor system, banks thus have an incentive to redistribute reserves among themselves. The interest rate that banks pay each other overnight is referred to as the Norwegian Overnight Weighted Average (NOWA), which is normally close to the key policy rate (Chart 2.3). The NOWA rate is the first point on the "yield curve" and the very first part of the "transmission mechanism", i.e. how the central bank's key policy rate affects longer-term interest rates: short-term money market rates influence the interest rates facing households and enterprises, which in turn affect decisions concerning consumption, investment and saving.

### 2.1.3. Short-term paper and Treasury bills

Short-term paper refers to liquid debt securities with maturities of up to one year. The short-term paper market consists of a primary market where short-term paper is issued and a secondary market, where existing short-term paper can be resold. The government is the largest issuer in the short-term paper market, but banks, municipalities, municipal enterprises, mortgage companies and other private sector enterprises also obtain short-term funding by issuing short-term paper. Local governments are the second largest issuers of short-term paper in NOK after the central government. Norwegian banks' issuance of short-term paper in NOK is limited because their short-term NOK needs can largely be met at lower cost in the FX swap market (see Section 2.1.4 *Secured money market instruments*).

Short-term paper issued by the Norwegian government is referred to as Treasury bills, which are short-term government debt instruments. Treasury bills are issued as zero coupon securities with a maturity of up to one year. They are only issued in NOK and are listed on Oslo Børs. Norges Bank sells Treasury bills on behalf of the government in the primary market. Sales take place in auctions at Oslo Børs where all the allotted bidders in the auction pay the same price (Dutch auction). Only selected banks, so-called primary dealers, are authorised to participate directly in the auctions. In the secondary market, the Treasury bills are listed and traded at Oslo Børs. Secondary market trades in government paper are regulated by a primary dealer agreement between Norges Bank and the primary dealers. The primary dealers are obliged to quote binding bid and ask prices at Oslo Børs. In recent years, a growing number of electronic trading platforms have also come into use for trading government securities.

New Treasury bills are introduced on international money market (IMM) dates and mature on IMM dates in the same month a year later. Over the course of that year, the Treasury bill can be re-opened to increase the volume outstanding. The maturity date will nevertheless always be a year after the bill was initially sold in the market. IMM dates are commonly used maturity dates for standardised money market products. IMM dates are the third Wednesday of March, June, September and December.

### 2.1.4. Secured money market instruments

FX swaps are the most commonly used secured money market instruments in Norway. Although significantly smaller, the market for repurchase agreements (the repo market) seems to be growing.

#### 2.1.4.1. Repurchase agreements (repos)

In a repurchase agreement (repo), two parties agree to exchange securities for money for a given period. The agreement consists of two transactions with different settlement dates – one sale date and one repurchase date – which are agreed upon simultaneously. Upon entering into the agreement, one party relinquishes the securities in exchange for money (the sale). Once the agreement has reached maturity, the securities are returned to the initial seller, who simultaneously relinquishes a predetermined amount of money (the repurchase). The buyer pays an implicit rate determined by the difference between the sale and repurchase price of the security.

Since repurchase agreements are loans where the lender receives securities as collateral, lenders are exposed to very limited risk. If the buyer, or borrower, should default when the agreement matures, lenders have access to the securities that were posted as collateral. In principle, all securities that can be traded in the fixed income market can be used in repurchase agreements. The amount that can be borrowed, however, depends on the quality of the security and how easily it can be sold in the market. An important difference between a repurchase agreement and an ordinary loan with collateral in the form of securities is that in a repurchase agreement the lender is the legal owner of the security in the period to the loan's maturity. The lender can make use of the collateral in the period until the repurchase agreement matures.

Although relatively small, the Norwegian repo market seems to be growing. The largest banks are the primary participants. Most repurchase agreements are made with Norwegian Treasury bills and covered bonds as collateral. The maturities of such agreements are normally between one week and one month. Repurchase agreements are also made with foreign securities as collateral and so-called tri-party-repos, i.e. repurchase agreements in which the two parties entering an agreement allow a third party to manage the exchanges between them. Repurchase agreements with listed securities as collateral, such as Treasury bills and covered bonds, are registered on the stock exchange if one of the parties in the transaction is a member of the exchange. The trades themselves take place OTC.

#### 2.1.4.2. Foreign exchange (FX) swaps

In an FX swap, two parties agree to exchange one currency for another for a given period (see **Box: Derivatives**). By entering into an FX swap, a bank holding foreign currency and needing liquidity in NOK can swap the currency for NOK for a given period. An FX swap between two banks can also be regarded as a secured interbank loan. The FX swap market is different from the repo market in that the collateral received by the lender is in the form of another currency rather than in the form of securities. The parties to an FX swap exchange currency at the current FX market spot rate and agree to reverse the swap on an agreed date in the future at a rate agreed on today. This future rate is called the forward rate. The difference between the spot rate and the forward rate, known as the forward premium, expresses the interest rate differential between the two currencies during the life of the swap.

The FX swap market is the segment of the Norwegian money market with the highest turnover. It is an OTC market, and its participants are largely major banks that rely heavily on foreign credit. Smaller banks use the unsecured interbank market to a greater extent to manage short-term liquidity fluctuations.

#### Box: Derivatives

Derivatives are contracts that derive their value from an underlying asset. Derivatives can thus be used to reduce or increase exposure to an underlying asset and are therefore useful in risk management. The basic types of financial derivative are forward contracts and options.

A **forward contract** is an agreement to buy or sell an asset at a specified future time at a price agreed on today. The two parties to a forward contract have symmetrical

rights and obligations. No payments normally accrue upon entering into a forward contract. The forward price is the future delivery price, making the value of the contract equal to zero for both parties at the time the contract is entered into. Once the forward contract has been entered into, its value can be changed. The buyer of a forward contract will make a profit on the settlement date if the price of the underlying asset is higher than the contract price and will take a loss if it is lower. The selling party will have the opposite exposure. If a forward contract is used to hedge an underlying position for the risk of losses due to price changes, the value of the forward contract will move in the opposite direction from the value of the underlying position, resulting in neither loss nor profit.

A **future** is a standardised forward contract traded on the stock exchange.

A **Forward Rate Agreement (FRA)** is a forward contract with an agreed future rate of interest, for example the six-month interest rate in three months' time. FRAs are settled on the same day that the future interest rate period begins, often IMM dates, on the basis of the difference between the agreed interest rate and a selected reference rate.

A **swap** is a contract in which two parties exchange cash flows. The two most common types are interest rate swaps and FX swaps. Parties to interest rate swaps usually exchange a fixed interest rate for a floating exchange rate. For example, a bank can use interest rate swaps to exchange fixed rate interest payments on bonds for floating rate payments. Its counterparty in the swap pays the bank's fixed rate interest payments to its bondholders, while the bank pays the floating rate to the counterparty. In an FX swap, the parties agree to exchange specified amounts of two different currencies at the current rate (the spot rate) and exchange these amounts back at a pre-agreed rate (the forward rate) when the agreement expires. The difference between the spot rate and the forward rate, the so-called forward premium, expresses the interest rate differential between the two currencies over the life of the contract. FX swaps are used, for example, by banks to exchange bond funding in foreign currencies for NOK. There are also combined foreign exchange and interest rate swaps, referred to as "cross-currency swaps".

An **option** is a contract that gives one party the right, but not the obligation, to buy (call option) or sell (put option) an asset at an agreed price (the strike price) on or before an agreed future date. The other party is obligated to fulfil this transaction if the option is exercised. The buyer pays the party selling the option a remuneration, or premium. The premium expresses the option's market value when the contract is entered into, which reflects its market value today and the value of potential future gains. The value of the option will vary according to the value of the underlying asset. The option will be exercised if this is profitable for its owner. A call option is exercised when the value of the underlying asset is higher than the strike price, while the put option is exercised when the value of the underlying asset is lower than the strike price. In both instances, the option is said to be "in-the-money". By buying an option, the investor's potential loss on the investment in the underlying asset is limited to the option premium paid to the party selling the option, while fully preserving the potential for profit. A distinction is made between options that can be exercised at any

time during the life of the option (American options) and options that can only be exercised at maturity (European options).

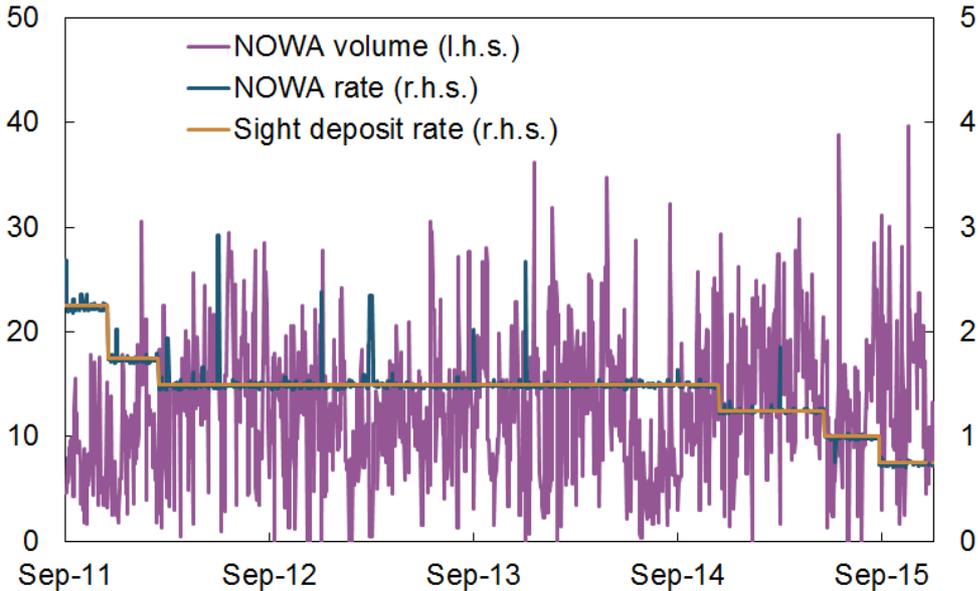
A **credit default swap (CDS)** is a financial contract to insure the issuer of a bond or a bond index against default. The seller of a CDS will compensate the buyer if the underlying bond defaults. The price of a CDS contract thus provides some indication of how the market assesses the likelihood of default.

### 2.1.5. Money market reference rates

A reference rate is an interest rate that is used as a starting point for the pricing of other financial instruments. Money market rates are frequently used as reference rates.

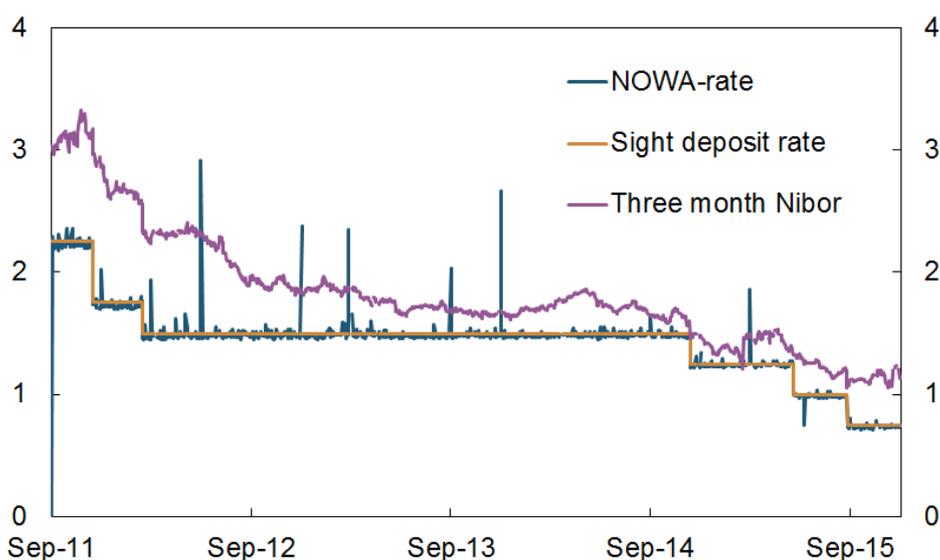
In 2011, in collaboration with Finance Norway, Norges Bank began gathering and registering data on unsecured interbank lending in the overnight market. Daily transaction volumes have averaged NOK 12.6bn (Chart 2.3). The weighted average of interest rates on these trades is called the NOWA rate (Norwegian Overnight Weighted Average). The NOWA rate is used as a reference rate by banks for certain financial and non-financial entities' deposits. It is published daily on the *Finance Norway website*. The NOWA rate is the first Norwegian money market rate to be listed on the basis of actual trades and has on average been half a basis point lower than the interest rate on banks' deposits in Norges Bank (sight deposit rate) since it was established (Chart 2.4).

Chart 2.3 NOWA rate and turnover volume.  
As a percentage and in billions of NOK



Source: Norges Bank

Chart 2.4 Sight deposit rate and short-term money market rates. Percent



Source: Norges Bank

The most important reference rate in Norway is the indicative interest rate known as Nibor (Norwegian Inter Bank Offered Rate). Nibor is indicative because it is not based on actual trades, but on a selection of banks' best estimates of what the interest rate would be if trades had been made. There are six banks that submit, or quote, Nibor. Each bank provides a daily quotation of the rate for maturities from one to six months. For more details, see "[Risk premiums in Nibor and other countries' interbank lending rates](#)", Norges Bank, *Staff Memo* 21/2012) and "[A Decomposition of Nibor](#)", Norges Bank, *Economic Commentaries* 3/2015. The Nibor rules, laid down by Finance Norway, state that: "The interest rates submitted by an individual panel bank shall reflect the interest rates the bank would charge on lending in NOK to a leading bank that is active in the Norwegian money and foreign exchange markets". Based on the interest rates submitted by the six banks, Nibor is calculated as the average of the four middle observations for each maturity (see the [Finance Norway](#) website).

Three-month and six-month Nibor are the most commonly used reference rates for other financial products. Very few actual unsecured trades between banks are made at these maturities. In the unsecured interbank market in Norway, most of the activity is at maturities of no more than a few days. The most important reference rates in other countries, such as Euribor for EUR and Libor for USD and GBP, are also indicative rates. Setting reference rates for unsecured loans therefore entails judgement on the part of the banks.

### 2.1.6. Interest rate derivatives market

Interest rate derivatives are widely used to hedge the risk of interest rate fluctuations. Banks are important participants in this market. One reason is that banks often pay a fixed interest rate on their bond debt, while interest rates on bank lending to households and enterprises are primarily floating rates, which may, for example, be linked to Nibor, which is also a floating interest rate. If the Nibor rate falls, there is a risk that interest income will be lower than interest expense. Banks can hedge for the

effects of such interest rate changes by entering into an interest rate swap with Nibor as the reference rate (see **Box: Derivatives** in Section 2.1.4). Under the terms of the swap, banks makes interest payments at the Nibor rate and receive interest payments at a fixed interest rate (the swap rate), thereby hedging for the risk of fluctuations in the Nibor rate.

Interest rate derivatives can also be used for speculation in the fixed income market. The fixed rate (swap rate) reflects market expectations of Nibor over the life of the swap. For example, a participant who expects Nibor to rise by more than the increase priced into the fixed rate can buy an interest rate swap in order to pay the fixed rate (swap rate) and receive payments at the Nibor rate. If the participant's expectations are realised, the trade will be profitable.

Forward rate agreements (FRAs) are entered into primarily to take positions based on the expected three-month Nibor rate on a future date. A buyer of an FRA contract with three-month Nibor as the reference rate commits to paying the fixed FRA rate in exchange for three-month Nibor on a given future date (often an IMM date). If three-month Nibor rises by more than the increase priced into the FRA rate, parties that have agreed to pay the FRA rate stand to profit in the same way as if they had entered into an interest rate swap.

#### 2.1.6.1. Participants in interest rate derivatives markets

Participants in interest rate derivative markets can be divided into two groups: market makers and end-users. Market makers are investment firms, including banks, offering to buy from or sell derivatives to end-users. Market makers make their profit from the difference between bid and ask prices. The difference between bid and ask prices reflects the risk taken on by market makers in setting binding prices.

End-users include financial undertakings, the public sector, private individuals and institutional investors. An undertaking can be both market maker and end-user. This is the case for many of the banks that, in addition to setting prices, use derivatives to manage their risk or to take positions based on their perception of interest rate developments.

The Norwegian government can use interest rate swaps as a part of government debt management, as it did between 2005 and 2014. By entering agreements to receive payments at a fixed interest rate and pay a floating interest rate, the government reduced the time to refixing (i.e. when new interest rate conditions can be fixed) of government debt. One of the reasons for using interest rate swaps is that reducing the time to refixing can result in lower interest costs.

#### 2.1.6.2. Trading venues and turnover

Interest rate derivatives can be traded in both the OTC markets and on a stock exchange, but in Norway the majority of trades are OTC. Derivative contracts traded in the OTC market can be tailored or standardised. Standardised contracts, which are often tied to IMM dates, generate the largest turnover.

The most recent triennial survey of derivative and FX market activity conducted by the Bank for International Settlements (BIS) shows that total turnover in OTC interest rate derivatives in the Norwegian market in terms of underlying nominal value in 2013 was USD 119bn. Forward rate agreement (FRA) and interest rate swap markets showed the highest level of activity, at USD 76bn and USD 43bn respectively. Turnover in the interest rate option market was USD 50m. For more information on the BIS survey, see the [Norges Bank website](#).

## 2.2. Bond market

Bonds are standardised loans with original maturities of more than a year. A bond holder is entitled to repayment of the amount paid for the bond (face value, or principal), as well as interest at a predetermined fixed rate (coupon rate). Coupon payments are normally paid annually or biannually. The principal is repaid at a predetermined time (the bond's maturity date).

The bond market is an organised market for issuing and trading bonds and can be divided into a primary and a secondary market. The primary market is a venue for participants needing long-term loans and investors seeking a vehicle for long-term saving. Bond issuers borrow money in the primary market by issuing bonds, which are bought by investors. Banks, mortgage companies, the government and non-financial undertakings are the largest issuers in the bond market. The largest investor categories include life insurance companies, pension funds, securities funds and banks. Bonds are marketable, and previously issued bonds can be resold between investors in the secondary market. The pricing of bonds that are regularly traded in the secondary market is an important source of information about the risk associated with the issuer (for more information see **Box: Bond yields and bond risk premiums**).

In Norway, standardised loans with maturities shorter than one year are called short-term paper or Treasury bills. The short-term paper market is discussed in greater detail in Section 2.1 *Money market*.

### Box: Bond yields and bond risk premiums

A bond yield is the compensation an investor demands to lend money to the issuer. In addition to expectations of future yields, the yield can contain risk premiums to compensate investors for various types of risk. The risk premium will usually be divided into maturity, credit and liquidity risk premiums. The size of the risk premiums reflects the level of uncertainty and how much compensation investors will demand to take on such uncertainty. (For more information on risk premiums in the Norwegian bond market, see also "[Renteforventninger og betydningen av løpetidspremier](#)" [Yield expectations and the importance of maturity premiums], Norges Bank, *Penger og Kreditt* 1/2003 (in Norwegian only) and "[Risikopremier i det norske rentemarkedet](#)" [Risk premiums in the Norwegian bond market], Norges Bank, *Penger og Kreditt* 3/2005 (in Norwegian only).)

A maturity premium compensates the investor for the risk of unfavourable developments in interest rates while he or she holds the bond. For example, an investor who has purchased a two-year fixed-rate bond would be exposed to price

risk/interest rate risk if the bond has to be sold in a year's time. A maturity premium can also arise because investors tie up liquidity over long periods when they invest in fixed-income securities with long maturities. To compensate for this, investors demand a positive liquidity premium to invest in fixed income instruments with longer maturities. A rising yield curve does not therefore necessarily reflect market expectations of higher short-term yields in the future. There are also other theories seeking to explain maturity premiums in the bond market. If investors have clear preferences for certain maturities, maturity premiums can vary in the different maturity segments.

A credit/default premium compensates the investor for losses on a bond if the issuer fails to make the agreed interest or principal payments.

A liquidity premium compensates the investor for the risk that selling a bond prior to maturity without reducing the price may prove to be more difficult than expected.

Since uncertainty concerning future developments normally tracks the rise in bond maturities, bonds with longer residual maturities normally have higher maturity, credit and liquidity premiums than corresponding bonds with shorter maturities.

Government bond yields and money market rates are widely used as reference rates for other bonds. In the Norwegian market, the most commonly used reference rate is the three-month money market rate Nibor. (For more information on reference rates, see "*Om langsiktige referanserenter i det norske obligasjonsmarkedet*" [On long-term reference rates in the Norwegian bond market], Norges Bank, *Penger og kreditt* 3/2004 (in Norwegian only).) If the reference rate is a risk-free rate, the risk premium will be the investor's compensation for choosing a high-risk investment rather than a risk-free alternative.

A regularly traded bond provides an ongoing pricing of the risk associated with the bond, and bond yields are therefore an important indicator of risk and required rates of return in the market.

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## 2.2.1. Key concepts in the bond market

There are many different types of bond with varying maturity, yield and priority in the event of bankruptcy. This section provides a short review of some key concepts in the classification of bonds.

### 2.2.1.1. Maturity

Bonds have maturities of at least one year, often up to 20-30 years. The term to maturity is decided by the lender based on the demand for financing. In determining a bond's maturity, the issuer will also take account of the investor's desired maturity. Bonds with redemption rights contain clauses that provide either the issuer or the investor with the right to require the bond to be redeemed before the maturity date. An issuer with the right to redeem the bond can choose to repurchase the bond from the

investor at an agreed price. The redemption right for the bondholder provides a corresponding right to sell the bond back to the issuer at an agreed price.

### 2.2.1.2. Interest rate

Bonds that regularly pay interest on their face value are called coupon bonds. Bonds that do not pay interest over the life of the bond are called zero-coupon bonds. When issued, the price of a zero-coupon bond is lower than the face value of the bond if the level of interest rates in the economy is positive, while the bondholder receives the bond's face value at maturity. Zero-coupon bonds are common internationally but less so in Norway. The most common bonds in Norway are a type of coupon bond called bullet bonds. Bullet bonds pay regular interest on fixed dates in the period to maturity and repay the entire principal at maturity.

The coupon rate that is paid during the life of a bond, can be either fixed or floating. Floating rate bonds, referred to as floating rate notes, pay a (short-term) reference rate plus a fixed risk premium (see **Box: Bond yields and bond risk premiums**). Coupon rates on such notes will vary in line with the level of interest rates in the economy. A fixed rate bond pays a fixed nominal rate throughout its term. For such bonds, the nominal rate at the time of issue will reflect issuer and bondholder expectations of the general level of interest rates and their compensation for the risk associated with the specific bond. Floating rate notes are more common than fixed rate bonds in Norway. Some bonds feature coupons that can be refixed over the life of the bond according to specified rules.

### 2.2.1.3. Priority

A bond represents a liability item on the issuer's balance sheet. In the event of bankruptcy, different bonds have different priority for repayment. A bond's priority influences the degree of compensation investors will demand to invest in the bond.

Secured bonds are bonds backed by collateral in, or preferred claims to, specified asset items on the issuer's balance sheet. In Norway, for example, covered bonds have a preferred claim on a defined selection of high-quality assets. Covered bonds are used extensively in the banking system to finance housing mortgages (See **Box: Secured funding** in Section 2.2.2). Preferred claims or collateral in the form of specific assets reduce the risk that investors will not be repaid.

Unsecured bonds are called senior bonds. These are not backed by collateral in the form of specific assets, but represent a general claim on the issuer.

Bonds with lower priority than senior bonds can be described as *regulatory capital*. Regulatory capital will, after equity capital, absorb losses first if the borrower goes bankrupt. Equity capital has the lowest priority, below all bond debt.

Convertible bonds allow or require bondholders to convert bonds into shares in the same company at an agreed price. The criteria for when conversion can take place vary for different bonds. In recent years, contingent convertible bonds (CoCos) have been widely discussed. These are bonds issued by banks that are contractually written

down or converted into equity if the issuer's capital levels fall below a predetermined level. With these kinds of bonds, bondholders risk incurring losses before equity capital is fully depleted.

## 2.2.2. Norwegian bond issuers

The Norwegian bond market consists of bonds issued under Norwegian legislation. At the end of 2015, the volume of bonds outstanding was NOK 1728bn. Bonds are often large and are not suitable as funding for small entities. Issuers in the bond market are generally the same as in the money market. The largest issuers in the Norwegian bond market are the government, the banking sector and non-financial undertakings (see Table 2.1). Norwegian local governments also obtain funding to some degree by issuing bonds in the Norwegian market.

**Table 2.1: Issuer categories in the Norwegian bond market**

Volumes outstanding at year-end, in billions of NOK

	2013	2014	2015
Banks and mortgage companies	816	776	771
Central government	289	344	338
Local government	61	75	83
Norwegian non-financial undertakings	227	257	269
Other countries	227	258	251
Other	17	19	16
<b>TOTAL</b>	<b>1 638</b>	<b>1 728</b>	<b>1 728</b>

Source: Statistics Norway

### 2.2.2.1. The central government

The central government is the largest single issuer in the Norwegian bond market. The bonds it issues are called government bonds, and at the end of 2015 the volume of Norwegian government bonds outstanding was slightly below NOK 340bn. In addition, the government also had NOK 86bn in Treasury bills outstanding, which are described in greater detail in Section 2.1 *Money market*. Government bonds are bullet bonds, i.e. with a fixed coupon rate paid annually and issued in NOK.

By comparison with other countries, the Norwegian government bond market is small. This is because the Norwegian government's borrowing requirements are limited due to high petroleum revenues. Governments normally borrow money to cover budget deficits and to strengthen their foreign exchange reserves. The Norwegian government has a positive net foreign asset position, but still needs a liquidity reserve to meet daily payments. The government also borrows to fund lending and provide capital injections for state banks and other government lending schemes. The government's borrowing requirements have increased in recent years because of increased lending by both the Norwegian State Housing Bank and the Norwegian Public Service Pension Fund residential mortgage programme and because the government took over the Norwegian export financing scheme in 2011 (see the *Eksporfinans website*). This has led to an increase in the volume of government bonds outstanding.

Government bonds are claims on the government and the credit risk associated with these bonds is considered to be very low. Government bonds are also typically liquid, i.e. they can easily be sold without substantial price reductions. Government bonds therefore offer lower yields than corporate bonds. In many countries, government bond yields play an important role in the economy as reference rates for the valuation of other bonds and financial instruments, although they are seldom used as reference rates in Norway (see **Box: Bond yields and bond risk premiums** in Section 2.2). In Norway, government borrowing seeks to distribute bonds across different maturities to provide reference rates for government bonds with maturities up to ten years, thereby contributing to the efficiency of the financial market.

#### 2.2.2.2. Local governments

Norwegian municipalities and counties are a smaller issuer category in the Norwegian bond market, and the volume of bonds outstanding from this sector accounted for 5% of the market at end-2015. The municipalities also borrow substantially through Kommunalbanken, which primarily obtains funding in bond markets abroad.

#### 2.2.2.3. Banks and mortgage companies

The banking sector is comprised of banks and bank-owned mortgage companies and is the largest issuer category in the Norwegian bond market. The volume of bonds outstanding from this sector was NOK 771bn at end-2015, or approximately 50% of the total volume outstanding in the market. A distinction is usually made between bonds that are secured on banks' assets and those that are not. Bonds that are not secured can be further classified based on their prioritisation (subordination) in the event the bank must be wound up or in any other way becomes subject to crisis management measures implemented by the authorities. Norwegian banks and mortgage companies also raise substantial funding in foreign bond markets (see **Box: Norwegian banks' and mortgage companies' bond funding abroad**).

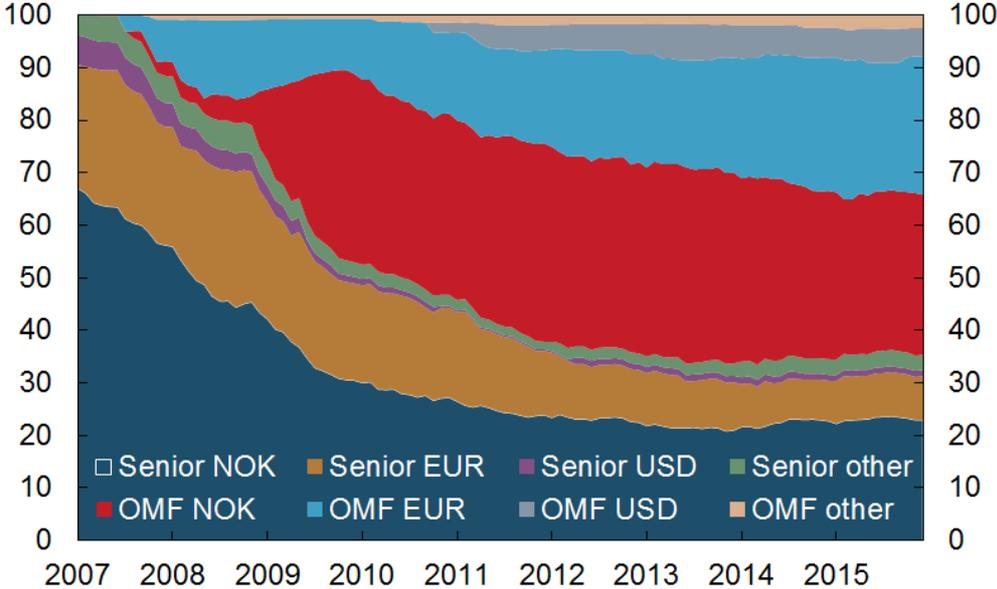
#### Box: Norwegian banks' and mortgage companies' bond funding abroad

Norwegian banks and mortgage companies obtain a substantial share of their bond funding in foreign currency. At end-2015, approximately 45% of bond funding in Norway was issued in a foreign currency (Chart 2.5). Most of the bonds are issued in EUR, but the banks also issue bonds in other currencies, including USD, SEK, CHF and GBP. Mortgage companies in particular sell large volumes of covered bonds in foreign markets (see **Box: Secured funding**).

Some of the foreign currency funding obtained by Norwegian banks is used to finance assets in the same currency. The remainder is converted and primarily used to finance lending in NOK. To conduct this conversion, banks utilise derivatives called foreign exchange (FX) swaps and interest rate swaps, (see **Box: Derivatives** in Section 2.1). Banks use FX swaps to exchange FX funding for NOK today, while agreeing to reverse the transaction at an agreed time in the future. This provides banks with the NOK they require and ensures that the FX will be returned in time to pay back the bondholder at maturity. Banks use interest rate swaps to exchange the interest payments on fixed-rate bonds for floating interest rate payments. Floating interest

rates on funding reduces banks' risk, as most loans offered by banks carry floating interest rates.

Chart 2.5 Norwegian banks' and covered bond mortgage companies' bond debt. By currency and type of bond.



Sources: Stamdata and Bloomberg

Such FX and interest rate swaps can either last for the life of the bond or banks can roll a series of shorter swaps. Covered bond mortgage companies utilise combined interest rate and currency swaps, called cross-currency swaps, which last for the life of the bond and are thus fully secured until maturity.

For a more detailed review of the banking system's bond funding abroad, see "*Norwegian Banks' foreign currency funding of NOK assets*", Norges Bank Staff Memo 2/2014.

The bond market provides long-term funding for banks and mortgage companies with maturities that more closely match the maturities of their loans to households and enterprises. In a global context, the Norwegian banking system has a comparatively high share of bond funding.

Banks have established specialised mortgage companies that have taken on some of their residential and commercial mortgages. These mortgage companies issue covered bonds backed by these mortgages (read more in **Box: Secured funding**). At end-2015, the volume outstanding in the market for covered bonds was NOK 456bn, or slightly more than 25% of the Norwegian bond market as a whole.<sup>1</sup> Most banks jointly own

<sup>1</sup> If covered bonds issued by KLP Kommunekreditt, which issues Norwegian covered bonds backed by government-guaranteed loans, are included, the total volume of covered bonds outstanding at end-2015 was NOK 472bn.

mortgage companies with other banks, while larger banks own their own mortgage companies. Issuing covered bonds via jointly-owned mortgage companies means that smaller banks also have access to a larger funding market. Most covered bonds in the Norwegian market are issued at a floating rate, as most residential mortgages funded by the covered bonds are floating rate loans.

During the financial crisis, when it was more difficult to issue bonds, banks could convert their own covered bonds into more liquid Treasury bills through the swap arrangement with the central government. This contributed to a marked increase in volume outstanding in the period between 2009 and 2010. The swap arrangement was discontinued in 2014.

### Box: Secured funding

Some issuers offer guaranteed bonds. These bonds are considered particularly safe because the guarantor must pay the debt should the issuer default. The safest guaranteed bonds are backed by the government. Other bonds can include provisions whereby bondholders have security interests in the assets of the issuer or priority over holders of other bonds from the same issuer in the event of bankruptcy.

**Covered bonds (OMFs):** OMFs are the Norwegian version of bonds referred to internationally as covered bonds. A covered bond provides an investor with a preferred claim on a defined pool of high-quality assets on an issuer's balance sheet. Norwegian covered bonds are subject to regulations with strict requirements as to who can issue such bonds and the quality of the underlying collateral. Only mortgage companies with special authorisation can issue covered bonds, and these companies are primarily owned and controlled by the banks. Approved collateral includes residential mortgages with a maximum loan-to-value (LTV) ratio of 75%, loans for commercial real estate and holiday homes that are within 60% of the property's value, loans to or guaranteed by certain governments and authorities, and certain derivatives. The cover pool for Norwegian covered bonds mostly comprises residential mortgage loans. Under the so-called balance sheet requirement, the value of the cover pool must always exceed the value of the covered bonds outstanding. The individual mortgage company is responsible for ensuring that its cover pool always meets the requirements. Mortgage companies commonly over-comply with the balance sheet requirement by posting more collateral than the value of outstanding covered bonds. This is called overcollateralisation and provides investors with an additional buffer against a reduction in the value of the cover pool, for example in the event of a fall in house prices. Covered bonds have for many years played an important role in residential mortgage funding in a number of European countries, including Sweden, Denmark and Germany. Covered bonds (OMFs) were introduced in Norway in 2007. For a further discussion of Norwegian covered bond regulations and the covered bond market in Norway, see "[\*Norwegian covered bonds – a rapidly growing market\*](#)", Norges Bank, *Economic Bulletin* 1/2010.

**Securitised bonds (Asset-Backed Securities (ABSs)):** Securitisation means that the issuer sells certain assets to a legally separate special purpose vehicle (SPV), which

funds the purchase by issuing ABSs in the market (see “Verdipapirisering” [Securitisation], Norges Bank *Penger og Kreditt* 3/1994, in Norwegian only).

Unlike covered bonds, ABSs are normally not subject to regulations defining the kind of assets that are eligible as collateral. The types of asset included in the cover pool will vary and are specified in the contract. In contrast to issuers of Norwegian covered bonds, ABS issuers are normally not required to maintain the value of the cover pool. The credit risk of the cover pool is therefore fully transferred to the investors. There are also no capital requirements for SPVs. ABSs are divided up based on quality and maturity into so-called tranches with different risk profiles. The tranches with the highest risk, but also the highest interest rates, must absorb losses first. Investors can adjust their risk profiles by the bond tranches they select. Securitisation is widespread in mortgage financing in countries such as the US and the UK, while covered bonds are more prevalent in most European countries. In Norway, the use of securitised bonds has been very limited and issuing them has been prohibited since 2015.

Before covered bonds were introduced in Norway in 2007, senior bonds were banks' most important source of long-term wholesale funding. The volume outstanding of senior bonds has fallen since 2007, in pace with the emergence of covered bonds in mortgage financing. Senior bonds are, however, still an important source of funding for lending that does not qualify for the issue of covered bonds. Senior bonds are primarily bullet bonds with floating interest rates.

Banks also issue subordinated bonds and hybrid capital. Banks can use these instruments to meet some of their statutory capital requirements. Read more about this in Section 2.2.1 *Key concepts in the bond market* and Appendix 2: *Regulating banks' capital*.

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#### 2.2.2.4. Non-financial undertakings

For non-financial undertakings, bonds are an alternative to bank loans. Most Norwegian enterprises are too small to issue bonds, and nearly all credit to enterprises is channelled via banks. In recent years, however, an increasing number of non-financial undertakings have obtained funding in the Norwegian bond market, and there has been a substantial increase in the volume of bonds outstanding, to approximately NOK 400bn at end-2015. This increase has to a great extent occurred over the past few years. Norwegian regulations relating to the issuance of bonds are more concise and standardised than they are in many other countries, and this has probably facilitated access to the market for a greater number of small enterprises.

Enterprises can have various motives for obtaining funding in the bond market. In some instances, an enterprise can secure more favourable funding conditions in the market than through a bank, while in other cases the bond market provides funding opportunities for enterprises that are not able to obtain bank loans.

While the Norwegian bond market used to be used primarily by enterprises in the power sector, sectors such as oil, gas and shipping now account for substantial shares of the volume of bonds outstanding. Today, a substantial number of bonds in the

Norwegian bond market are issued by enterprises with high credit risk, known as high-yield bonds, also called junk bonds. At end-2015, high-yield bonds accounted for just under 60% of the volume of bonds outstanding issued by non-financial undertakings. The market for high-yield bonds has grown rapidly over the past ten years, and high-risk enterprises include a number of foreign issuers. Since some enterprises' revenues are in foreign currency, a large share of these bonds is also denominated in currencies other than NOK, particularly USD.

In the corporate bond market, fixed rate bonds are more common than bonds issued by banks. Fixed coupon payments provide enterprises with more predictability. Asset-backed bonds are relatively common among non-financial undertakings, particularly in the real estate, oil, gas and shipping sectors, where buildings, ships, oil rigs or other fixed assets serve as collateral.

### 2.2.3. Bond investors

The largest investor categories in the Norwegian bond market are life insurance companies, pension funds, banks and securities funds (see Table 2.2). Foreign investors are the dominant category in the Treasury bill market. Compared with Treasury bill markets in other countries, the ownership share held by foreign investors in Norway is high.

**Table 2.2: Investors in the Norwegian bond market**  
Holdings at year-end, in billions of NOK.

	2013	2014	2015
Banks and mortgage companies	412	438	397
Securities funds	156	228	241
Life insurance companies and pension funds	383	364	350
Non-life insurance companies	57	59	72
Central government	162	89	92
Other countries	389	470	490
Other	78	80	85
<b>TOTAL</b>	<b>1 638</b>	<b>1 728</b>	<b>1 728</b>

Source: Statistics Norway

Life insurance companies and pension funds have long-term obligations and have traditionally invested in bonds with long maturities and low credit risk. These participants therefore constitute a large investor category in the government bond, covered bond and municipal bond markets, although they also purchase bonds issued by non-financial undertakings with low credit risk. In many cases, bonds are held to maturity. In recent years, the government bond and covered bond holdings of life insurance companies and pension funds have fallen. This may be related to these investors' nominal required rate of return, which has been higher than the current low yields on government bonds and covered bonds. (Read more in Section 3.5: *Insurance companies* and Section 3.6 *Pension funds*.)

Banks also hold marketable government bonds, covered bonds and municipal bonds to a great extent as a buffer against liquidity problems, so that they can sell some of these

liquid holdings in the market in the event of a liquidity shortfall. Banks' holdings of government bonds and covered bonds have increased in recent years, reflecting new regulatory requirements for the composition and size of banks' liquidity portfolios. Both government bonds and covered bonds are among the securities that have been approved as liquid assets under the Liquidity Coverage Ratio (LCR) requirement. (Read more in Section 3.2.6 *Liquidity regulation*.)

Securities funds manage savings on behalf of their customers. The kind of securities the individual fund invests in depends on the kind of savings product they sell to their customers. Some pension funds only invest in government bonds, while others buy high-yield bonds. Securities funds are the largest investor category in the bank bond market and also buy covered bonds and municipal bonds. (Read more in Section 3.7 *Securities funds*.)

## 2.2.4. Primary bond market

The market for issuing bonds is called the primary market. It is a marketplace where participants with long-term borrowing needs can meet those seeking long-term investment. While government bonds are issued by auction, other bonds are issued by means of what is known as a book-building process or through private placements. Issuers can increase the volume outstanding of a bond issue a number of times in the primary market. Such increases are called tap issues or re-openings.

### 2.2.4.1. Auctions

Government bonds are issued by Dutch auction on Oslo Børs. In Dutch auctions, bidders submit bids for the quantity they want to invest (volume) and the price they are willing to offer. A high price means a low yield for the government. The bids are ranked by price, from the highest to the lowest. Norges Bank determines the total volume to be allocated. All the successful bidders in an auction pay the price quoted by the lowest bidder. Auctioning government bonds ensures low borrowing costs for the government and equal access for all those wishing to participate. While in a Dutch auction all the bidders pay the same price, in an American auction bidders pay the price they submitted.

Government bond auctions were previously open to anyone. Since 2006, only selected banks, called primary dealers, are authorised to participate directly in the auctions. The government has entered an agreement with the primary dealers giving them the exclusive right and duty to participate in government bond auctions. They are, however, not obligated to deliver a specific bid volume per auction. The primary dealers accept bids on behalf of customers wishing to invest in the Norwegian government. Alternatively, primary dealers can buy the securities themselves and then resell them to interested investors in the secondary market.

Norges Bank has received a mandate from the Ministry of Finance for the management of Norway's government debt. Auction dates and estimated borrowing volumes are regularly announced by Norges Bank in order to reduce uncertainty among investors, promote transparency in the market and thereby contribute to lower borrowing costs for the government.

### 2.2.4.2. Book-building process

While government bonds are issued through auctions, other large bonds are issued through what is referred to as a book-building process. Book building begins with an issuer in need of funding. This issuer contacts one or more underwriters. Issuers normally indicate the amount of funding they need and the price they wish to pay. The underwriter assists the issuer in preparing the bond issue. The underwriter contacts potential investors and “builds a book” in which investors indicate the amount they want to buy and the price they are willing to pay. A single bond can involve multiple investors. The issuer can adjust the volume and price of the bond depending on demand in the market. Bonds are commonly oversubscribed, but when they are undersubscribed, the underwriter may be obliged to buy the difference between what the issuer wishes to sell and the other investors wish to buy. The underwriter can also offer derivatives to issuers and investors so that they can alter the fixed rate or convert to another currency. The entire process is normally conducted over a short space of time and the underwriter is paid by the issuer for these services. Issuers often advertise bond issuances in advance. This is especially common if the issuer is not known to the investors.

### 2.2.4.3. Private placements

Smaller bonds can be issued through what are referred to as private placements, where the bonds are sold to a few investors without advertising via an underwriter. In many cases, there is only one investor who buys the entire placement and who may have initiated the transaction. In such cases, the issuer will often adapt the bond’s size, maturity and other terms to suit the investor. An issuer may prefer a private placement to market funding in a turbulent market or if the issuer wants flexibility in the choice of volumes and maturities.

### 2.2.5. Secondary bond market

Some investors buy bonds to hold to maturity, while others will be interested in the possibility of reselling the bonds to another investor before they mature. The market where investors purchase bonds (and securities in general) from other investors is called the secondary market.

There are different forms of bond trading. Listed bonds in Norway are available on the Oslo Børs electronic system for direct trading between investors. This form of trading is not widely used. A more common form is over-the-counter (OTC) trading, where buyers and sellers contact one another. A bond broker often acts as intermediary for these trades and helps investors find counterparties for the transaction. Brokers can themselves also act as counterparty until they find another investor, a process referred to as market-making. Buyer and seller both submit ownership transfer information to the *Norwegian Central Securities Depository (VPS)*, which checks the information for accuracy. Trades are normally settled two days after they have been reported to VPS (read more in Section 4.3 *Securities settlement system*).

Bonds that are expected to be widely traded in the secondary market are often listed on the stock exchange. Bonds listed on the exchange can also be traded electronically on the exchange’s electronic trading platform. Some investors require the bonds they

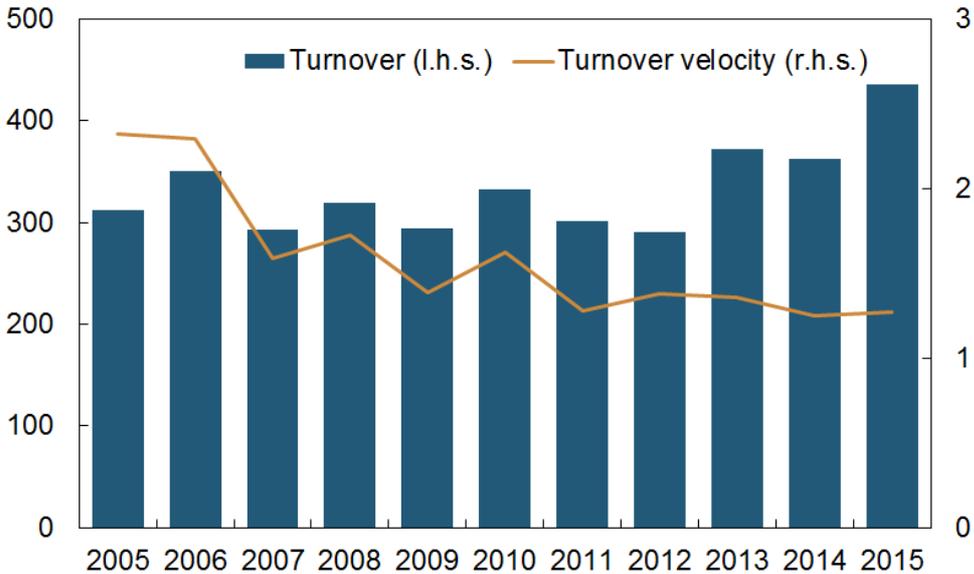
invest in to be listed on the exchange. Listing provides issuers with access to a wider investor base. It can also improve the liquidity of the securities, leading to lower liquidity premiums for issuers (read more on liquidity premiums in **Box: Bond yields and bond risk premiums** in Section 2.2). Bonds can also be registered in alternative markets, such as Oslo ABM (Alternative Bond Market), which is subject to less extensive reporting requirements.

2.2.5.1. Secondary government bond market

All Norwegian government bonds are listed on Oslo Børs and can be traded on the stock exchange. The primary dealers are obligated to quote firm bid and ask prices for a minimum volume of all the government bonds outstanding on Oslo Børs.<sup>2</sup> Primary dealers thus act as government bond market makers. This improves liquidity in the government bond market and ensures that updated information on effective government bond yields is available at all times. Liquidity and reliable information are important for government bond yields to function as reference rates and can also reduce the government’s borrowing costs. Only a small share of government bond trades take place electronically on the exchange, while most are agreed upon directly between the trading parties. Primary dealers also promote investment in government bonds domestically and abroad. In order for primary dealers to quote ask prices at any given time, they can borrow securities from the government as necessary. The government has its own stock of all its securities for this purpose. The government can lend government bonds to primary dealers on request for up to a week at a time.

On an international scale, turnover of listed Norwegian government bonds is low. The turnover rate has fallen markedly over the past 15 years (Chart 2.6). The turnover rate is frequently used as an indicator of liquidity in the secondary market. It provides an indication of trading activity in relation to the volume outstanding in a given period. A high numerical value for the turnover rate suggests a more active secondary market, which is one indicator of a liquid market.

Chart 2.6 Turnover in billions of NOK and turnover velocity of government bonds on Oslo Børs



Source: Oslo Stock Exchange

Trades between parties that are not registered on Oslo Børs are not captured in these statistics. In recent years, a number of electronic trading platforms for government bonds have emerged, such as MTS, Eurex Bonds, Tradeweb and Bondvision. Since a large share of Norwegian government bond investors are foreign nationals, and not members of the stock exchange, there could be considerable turnover volumes that are not included in Oslo Børs' official statistics.

#### 2.2.5.2. Secondary market for other bonds

For other bonds as well, most trading takes place in the secondary market via bond brokers. Brokers act as market makers for government bonds as well as other securities. In contrast to the government bond market, there are no requirements to quote firm prices for corporate bonds. Market makers quote indicative prices, i.e. prices that give an indication of the price they might be willing to buy or sell the bonds for. Customers must make contact to obtain precise price quotes and execute trades.

Both Norwegian covered bonds and other bonds can be listed on Oslo Børs, but the vast majority of trades take place OTC. In 2014, Oslo Børs introduced a reference list for Norwegian covered bonds that meet certain requirements for size and investor base diversity. For the bonds on this list, indicative prices are now quoted continuously through the day. The reference list is intended to improve the liquidity of the securities and to promote them to investors.

#### 2.2.6. Other bond market participants

Credit rating agencies assess the credit quality of issuers and their bonds and issues credit ratings on a rating scale. Credit ratings can be regarded as an assessment of expected losses. Market pricing of risk associated with issuers and bonds is therefore closely linked to the credit ratings they achieve.

A single bond issue often involves a large number of investors. A trustee is usually appointed to act on behalf of all the bond investors and promote their interests vis-à-vis the issuer. In Nordic bond markets, the Nordic Trustee company acts as trustee. The presence of a trustee is important in that it provides assurance to bond investors that their rights are being safeguarded.

### 2.3. Foreign exchange

Currency is the generic term for a country's monetary unit. The Norwegian krone (NOK) is Norway's currency, while pound sterling (GBP) is the UK's currency. The FX market is the market for the purchase and sale of currencies. An exchange rate is the price of one currency in terms of another and is decided in the FX market. A very small share of the activity in the FX market involves exchanging cash or using traveller's cheques. In practice, most currency exchange takes place when deposits in

one national currency in a banking system (for example NOK in a Norwegian bank) are transferred and deposited in a banking system in another currency (for example Swedish krona (SEK) in a Swedish bank). The way currency trades are settled is explained in Section 2.3.3 *Trading structure and turnover in the FX market*. There are certain risks associated with settlement of currency trades, which can for example be related to large time differences between national settlement systems that are involved in the trades. This is discussed in Section 4.2.4 *CLS currency settlement system*. A list of standard currency codes is available (see **Box: Currency codes (ISO 4217)**).

### Box: Currency codes (ISO 4217)

ISO 4217 is an international standard for currency codes established by the International Organization for Standardization (ISO). The codes were introduced in 1978. The standard is based on three letters and has made it possible to standardise data processing for different currencies as special symbols such as \$ (US dollar), € (euro) and £ (pound sterling) have been rendered superfluous. The first two letters are based on the ISO 3166-1 alpha-2 country codes and designate the country. These codes are the same as those used for websites. The last letter designates the currency type. For Norwegian kroner, the code is NOK, NO for Norway and K for kroner. In the same way, the code for the US dollar is USD and the code for the pound sterling is GBP. An important exception is the currency code for the euro, which is EUR.

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#### 2.3.1. FX market

The FX market is the world's largest market in terms of turnover. It is open almost every day, 24 hours a day. It is not one centralised market, but a worldwide collection of trading venues. For NOK, most trades take place abroad, in for example London, New York, Copenhagen and Stockholm. The FX market is one of the markets that are subject to fewest regulations and requirements imposed by the authorities.

The exchange rate expresses the terms of trade between two different currencies, often called a currency cross or a currency pair. The rate is given as the price of one unit of a currency, referred to as the base currency, in terms of another, referred to as the quote currency. For the euro, the European Central Bank (ECB) recommends using EUR as the base currency, i.e. expressing the value of one euro in foreign currency.

An exchange rate is determined by supply and demand in the FX market. Supply and demand for currency are determined by transactions in connection with international trade in goods and services, interest and other payments between countries, and international capital transactions such as lending and investment. Speculative capital transactions account for a substantial share of the transactions in the FX market. Traditional models seeking to explain exchange rate developments over the somewhat longer term are often based on developments in macroeconomic variables, such as interest rates, inflation and output. Over the short term, exchange rates are affected by a number of technical market conditions.

## 2.3.2. FX market instruments

### 2.3.2.1. Spot trades

The most common FX market transactions are spot trades, which are the purchase or sale of currency for immediate delivery. For most currency pairs, spot trading means that settlement will take place two business days after the trade has been entered into, although some currency pairs also settle the day after the day of the trade.

### 2.3.2.2. Forward trades (outright forwards)

It is also possible to enter into agreements to settle at a later date. Such contracts are called outright forward contracts. The exchange rate used in an outright forward contract is called the forward exchange rate, which is the spot rate adjusted for the interest rate differential between the two currencies during the relevant maturity. This adjustment is either called the forward premium or forward discount, depending on whether the interest rate differential is positive or negative. The designation of forward trades as “outright” indicates that, unlike swap agreements, they will not be reversed at a later date.

### 2.3.2.3. FX derivatives

The most commonly used derivatives in the FX market are FX swaps (see paragraph above) and FX options (see **Box: Derivatives** in Section 2.1).

FX swaps are widely used by banks to manage liquidity in both NOK and foreign currency. Banks agree to exchange one currency for another for a short or long period. The process is reversed when the forward contract is settled. Turnover in the FX swap market is highest for contracts with maturities of up to one year. As FX swaps carry no exchange rate risk for banks, they are useful for parties wishing to hedge for exchange rate movements.

FX options are often used to hedge for large undesirable exchange rate changes, but are also used to take speculative positions in the FX market. FX options are primarily traded OTC (see **Box: Turnover in securities: Exchange-traded and OTC** at the beginning of this section).

## 2.3.3. Trading structure and turnover in the FX market

Banks have traditionally had an important market maker role in the FX market, by quoting firm bid and ask prices for trades. Previously, the FX market was to a large extent based on telephone communication between banks. Voice traders were important participants in the market and contributed to a well-functioning market by communicating prices between market makers via open landlines. Today, a substantial share of FX trading takes place on electronic trading platforms. In recent years, other non-bank participants, i.e. large financial market participants such as hedge funds and other high frequency traders (HFT), have also begun to act as market makers in the FX market. These participants can trade on behalf of large international banks via special counterparty codes and using bank credit lines. Banks charge fees for providing lines of credit. Such participants will often base their FX trades on so-called algorithms.

An algorithm is a mathematical model used to make investment decisions in financial markets. Algorithms can, for example, be programmed to divide up large transactions into many small trades in order to limit exchange rate effects. They can also be used to identify exchange rate trends or they can be programmed to buy or sell foreign exchange if financial key figures differ from market expectations. Electronic Broking Services (EBS) was the first platform to facilitate algorithmic trading in the spot market, and by 2013 algorithmic trading accounted for approximately 2/3 of turnover on the EBS platform. Algorithms can change prices in fractions of a second. Electronic trading venues such as Thomson Reuters and EBS have decided that prices quoted by market makers cannot be removed until a certain amount of time has passed, even if no trades are made at that price. This is referred to as the minimum quote life.

### 2.3.3.1. Electronic FX trading

Electronic FX trading has gained ground since the end of the 1980s, when Reuters offered an electronic system where banks could ask for prices (exchange rates) for various currency pairs. Systems were eventually launched where banks could submit how much they were willing to buy or sell at a given price. Today, that company's name is Thomson Reuters and it has traditionally been an important trading platform for trades in currency pairs such as GBP/USD, EUR/GBP, British Commonwealth currencies (AUD/USD, NZD/USD and USD/CAD), Nordic currencies (EUR/NOK, EUR/SEK and EUR/DKK) and several emerging economies' currencies. To compete with Reuters, a number of major international banks jointly established EBS in 1990. Today, the most widely traded currencies on EBS are EUR/USD, USD/JPY, EUR/JPY, USD/CHF and EUR/CHF. The market is primarily divided between Thomson Reuters and EBS, but a large number of different electronic FX trading platforms have since been established. These are multibank platforms, where multiple banks make prices, or single bank platforms operated by a single bank. Bloomberg also offers its customers the opportunity to trade FX electronically via the FXGO platform.

In order to facilitate standardisation and increase efficiency in the exchange of confirmations, payment orders and account information between financial institutions, SWIFT (the Society for Worldwide Interbank Financial Telecommunications) was established in 1973 by 239 banks from 15 different countries. In 2014, more than 10 800 financial institutions in over 200 countries used the system and more than 5.6bn messages were sent via SWIFT. The SWIFT main office is in Brussels.

### 2.3.3.2. Turnover in NOK

As the FX market is not a centralised market venue, acquiring a complete overview of all its activities is difficult. The BIS has conducted triennial surveys of global FX market activity since 1989 (see the [BIS website](#).)

The BIS survey is extensive, and close to 1300 financial institutions from 52 countries participated in the 2013 survey. The survey showed that the average daily turnover in the Norwegian FX market was NOK 124bn in April 2013 (Table 2.3) (see the [Norges Bank website](#).) Slightly less than 13% of turnover was in the spot market, while more than 85% was in the forward market. The remainder was in FX options and currency swaps. FX swaps accounted for nearly all turnover in the forward market. Turnover in

the FX option and currency swap markets was limited compared to the FX swap market. Turnover in currency swaps has, however, picked up since June 2007, when Norwegian mortgage companies were authorised to issue covered bonds.

**Table 2.3 Average daily turnover in Norway's FX market in April**

In billions of NOK and percent

	1998	2001	2004	2007	2010	2013
Spot	22.5 (33.6%)	31.1 (26.4%)	18.9 (18.9%)	20.8 (10.8%)	13.6 (10.4%)	15.9 (12.8%)
Forwards	44.1 (65.8%)	85.8 (72.8%)	80.7 (80.7%)	170.7 (88.7%)	114.5 (87.2%)	106.7 (85.8%)
- of which, outright forwards	1.2 (1.8%)	3.8 (3.2%)	3.2 (3.2%)	14.5 (7.5%)	10.8 (8.2%)	3.2 (2.6%)
- of which, FX swaps	42.9 (64.0%)	82.0 (69.6%)	77.5 (77.5%)	156.2 (81.2%)	103.7 (79.0%)	103.5 (83.2%)
Currency swaps (basis swaps)	-	0.2 (0.1%)	0.1 (0.1%)	0.3 (0.2%)	2.4 (1.8%)	0.9 (0.8%)
FX options	0.4 (0.6%)	0.9 (0.7%)	0.3 (0.3%)	0.7 (0.3%)	0.8 (0.6%)	0.7 (0.6%)
Total	67.0 (100%)	117.9 (100%)	100.0 (100%)	192.5 (100%)	131.4 (100%)	124.3 (100%)

Sources: Norges Bank, BIS

In the NOK spot market, turnover is highest in EUR, while in the forward market, turnover is highest in USD. If a Norwegian customer wants to buy USD with NOK, the customer's bank will first use NOK to buy EUR and at the same time sell EUR for USD. The transaction is conducted in this manner because these markets are more liquid than the market for USD purchased with NOK. Globally, spot turnover is greatest in USD and EUR against other currencies. In the forward market, USD is the dominant benchmark currency.

### 2.3.3.3. Reference exchange rates

Oslo Børs has listed exchange rates in Norway since the stock exchange opened in 1819 and was responsible for official exchange rate listings in Norway until 1 September 2001, when Norges Bank took over. Exchange rate listing is now normally undertaken daily at 2.15 pm in cooperation with the European Central Bank (ECB) and a number of other central banks. The rates are not binding for Norges Bank and are only meant to provide a snapshot of the FX market. So far, the reference exchange rates have been published at around 2.30 pm. The ECB has, however, decided to push back the publication time to around 4 pm, starting on 1 July 2016. The background for this is the ECB's view that the rates are for informational purposes only and should not be used for transaction purposes (see [ECB press release](#) of 7 December 2015).

Exchange rates fluctuate considerably in the course of a day, and official exchange rate listings at fixed times are needed in order to measure the value of FX positions. The Norwegian Tax Administration, for example, refers to Norges Bank's exchange rates to assess foreign currency items in tax returns. A commonly used official

benchmark exchange rate is the WM/Reuters Fix, which is fixed daily at 4 pm GMT. These rates are fixed in cooperation with State Street, a US bank, and Thomson Reuters and are widely used by international banks and managers in portfolio valuation. The WM/Reuters Fix has received considerable attention in recent years because several banks are said to have exchanged information about customer orders that were to be executed at the time of the fix. This gave banks the opportunity to take on large positions just before the fix, and a number of large international banks have since received substantial fines for abusing their positions. To make it more difficult to manipulate the benchmark, the fixing window, i.e. the period in which price developments are used to calculate the fix rate, has been widened to 2½ minutes before and after the time of publication. For most currency pairs, turnover data from the Thomson Reuters Matching trading platform are used to calculate the WM/Reuters fixes.

#### 2.3.4. FX for travel and holidays

Norwegian tourists today largely use international debit or credit cards such as VISA, Mastercard, Diners or American Express to pay for goods and services when they are abroad. However, there will still be a need for cash in local currency to pay various expenses. In recent years, Norwegian banks have scaled back FX purchase and sale facilities at their branches, and instead redirected customers to ATMs that dispense the most common currencies. Much of the turnover in FX for travel and holidays in Norway today takes place at exchange bureaus in the largest cities and at airports and train stations.

## 2.4. Equities

Equities represent ownership shares of companies. Equity markets are markets for trading equities. Equity markets distribute capital and spread risk among investors and companies/projects.

#### 2.4.1. Corporate structure and funding

An entrepreneur starting a business must use some of their own funds that take the form of equity capital. For both startups and existing companies, equity capital is a prerequisite for obtaining loans from banks and/or markets. Equity capital and any loans, referred to as debt or debt capital, are used to fund the purchase of machinery, goods and other equipment a company needs for its daily operations.

Return on equity capital takes the form of capital appreciation and/or dividend distribution. In the event of bankruptcy, debt capital is given priority over equity capital. As a result, equity capital financing involves higher risk than debt capital financing from the investor perspective. Greater risk implies that equity capital should yield higher returns than debt capital over time, so that the expected return is higher. A high relative level of equity capital, measured by the equity capital ratio, improves a company's ability to survive periods of negative earnings and facilitates raising new debt capital. Companies operating in a sector where earnings are volatile normally have higher equity capital ratios than those operating in sectors where earnings are more stable.

Starting and operating a company involves substantial risk, and may thus require a high level of equity capital. An entrepreneur may want or need to raise equity capital from, and therefore share the risk with, others. This can be accomplished by issuing equities, or ownership shares, in the company. The most common corporate structure is the limited liability company, where shareholders' responsibilities are limited to the amount of their contribution to the company's equity capital. Shareholders are otherwise not liable for the company's obligations.

Norwegian limited liability companies can either be public (ASA) or private (AS) and are regulated by the Norwegian *Public Limited Liability Company Act* and Limited Liability Company Act, respectively. This legislation includes provisions relating to accounting, dividend distributions and share capital write-downs, which are intended to protect a company's creditors. Requirements are more stringent for ASAs, and include requirements for higher minimum share capital and gender-balanced boards. Listed limited liability companies must be ASAs.

#### 2.4.2. Equity market

When holding shares in a company as a financial investment, shareholders are often interested in the ability to easily buy and sell such shares. Therefore, shares in a limited liability company are often traded on a stock exchange or other regulated trading venue. Most limited liability companies are nevertheless small and unlisted, with few shareholders and infrequently traded shares.

The equity market provides a way of transforming illiquid investments in fixed assets, such as specialised production equipment, into more liquid holdings for investors. Although in most cases it may be possible to sell a share (a security), the price may not be high enough to make selling desirable. The potential problem related to executing transactions of a desired size without affecting prices is referred to as market liquidity risk (see **Box: Liquidity** in Section 2.1).

Equity market investors conduct a form of continuous monitoring of companies' operations, indirectly via the price of new issues (primary market) or via the ongoing pricing in the secondary market (trading on the stock exchange). For investors to be willing to buy shares, subscription/market prices must be attractive enough for expected earnings to satisfy buyers' required rate of return when adjusted for the risk associated with the investment. Companies/projects with low profitability or poor management are "punished" by lower prices, which correspond with lower expected returns. With diversified ownership via the exchange, profitability assessments of projects and management are conducted by a number of investors. For assessments to be as accurate as possible, companies are required to submit reliable information. Stock exchanges and rule makers play an important role in ensuring that appropriate regulatory frameworks are in place. This includes the requirement that all relevant information about listed companies is made available to market participants in such a way that all participants receive the information at the same time (see Appendix 1: *Regulation of financial markets and trading venues*).

It can be costly to make a company/project known to investors in the equity market. Direct access to capital from the equity market is therefore not possible for many small companies/projects. An alternative source of equity capital has therefore emerged; crowdfunding. Crowdfunding is the funding of projects through raising financial contributions from a large number of people, often via the Internet. There are no formal reporting requirements and agreements on return on invested capital can vary.

Access to reliable information is important for accurate pricing in capital markets so that savings are channelled to the most profitable projects. An active equity market allows investors to diversify their investments across companies/sectors and thus reduce the risk associated with individual companies. At the same time, risk is distributed in such a way that the highest risk will be borne by the investors with the highest capacity and appetite for risk. In a well-functioning equity market, it is also easier for companies to specialise, and risk can thereby be reduced by diversifying investments.

An efficient equity market also requires a secure system for registering the ownership of securities in dematerialised (i.e. electronic) form, known as a central securities depository. (Read more in **Box: Central securities depositories** in Section 4.3.)

### 2.4.3. Size of the Norwegian equity market

At end-2015, there were 238 public limited liability companies (ASAs) and 264 323 limited liability companies (ASs) in Norway. The number of ASAs has fallen by 42.5% since 2009 and the number of ASs has increased by 25%.

At end-2015, the market value of listed equities registered with the Norwegian central securities depository (VPS) was NOK 1827bn, while the market value of unlisted equities registered with the VPS was NOK 432bn (source: Statistics Norway). Most Norwegian limited liability companies are not VPS-registered. At end-2015, 1038 limited liability companies were VPS-registered.

Oslo Børs ASA operates venues for trading equities (and equity certificates), fixed income products (bonds, short-term paper and Treasury bills) and derivatives. There are three venues for trading equities at Oslo Børs: Oslo Børs, Oslo Axess and Merkur Market. Large, long-established companies with wide shareholder bases are listed on Oslo Børs. Oslo Axess has somewhat less stringent listing requirements than Oslo Børs and comprises a large number of young companies. Merkur Market was established in 2016 and is aimed at small and medium-sized companies as well as large companies that do not aim to be fully listed on regulated exchanges. The admission process for Merkur Market has been designed to be quicker than for Oslo Børs and Oslo Axess, and its admission requirements are also lower. At end-2015, 174 equities were listed on Oslo Børs with a total market value of NOK 1827bn, while 38 equities were listed on Oslo Axess with a total market value of NOK 13bn.

In addition to Oslo Børs ASA, there are two other companies licensed as regulated exchanges in Norway; Nasdaq OMX Oslo ASA and Fish Pool ASA. On Nasdaq OMX

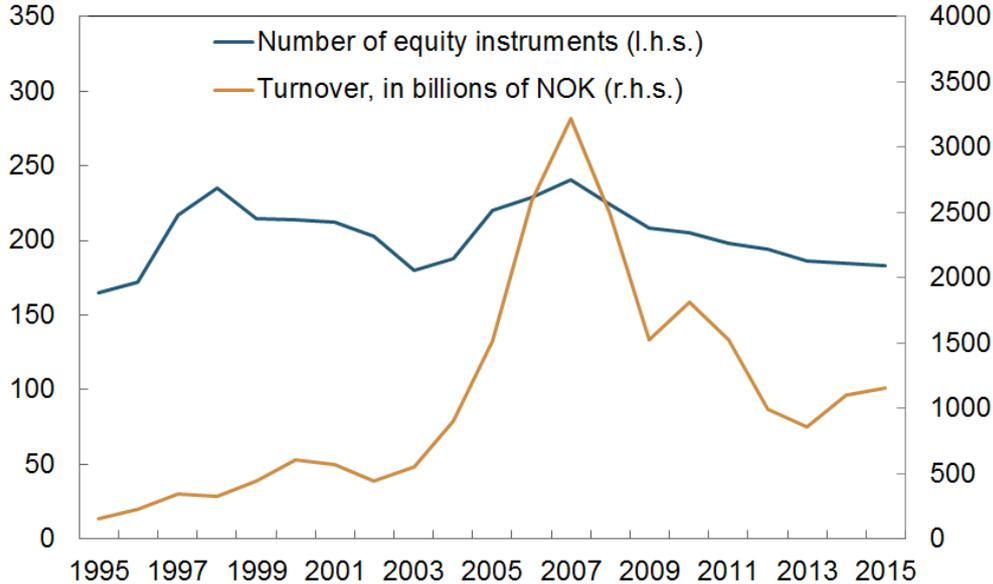
Oslo ASA, with the trade name Nasdaq OMX Commodities Europe, securities traded include Nordic power derivatives. Fish Pool ASA trades in salmon derivatives.

2.4.3.1. Other equity instruments

Equity certificates are equity instruments issued by savings banks (see **Box: Commercial and savings banks** in Section 3.2). There are clear similarities between equity certificates and equities and both are taxed in the same manner. The primary difference is that equity certificates do not confer full ownership rights to a bank's assets and that the composition of savings banks' governing bodies is subject to specific requirements. At end-2015, 37 savings banks had issued equity certificates, 19 of which were listed on Oslo Børs. The total market value of listed equity certificates was NOK 23.6bn. Oslo Børs has established an index for equity certificates (Oslo Stock Exchange Equity Certificate Index - OSEEX), which includes all of the 19 listed equity certificates.

Equities and equity certificates are both equity instruments. Chart 2.7 shows developments in equity instrument turnover on Oslo Børs and in the number of listed equity instruments over the past 20 years.

Chart 2.7 Annual turnover and number of equity instruments<sup>1)</sup> listed on Oslo Børs<sup>2)</sup>. Number of equity instruments at year-end. 1995–2015

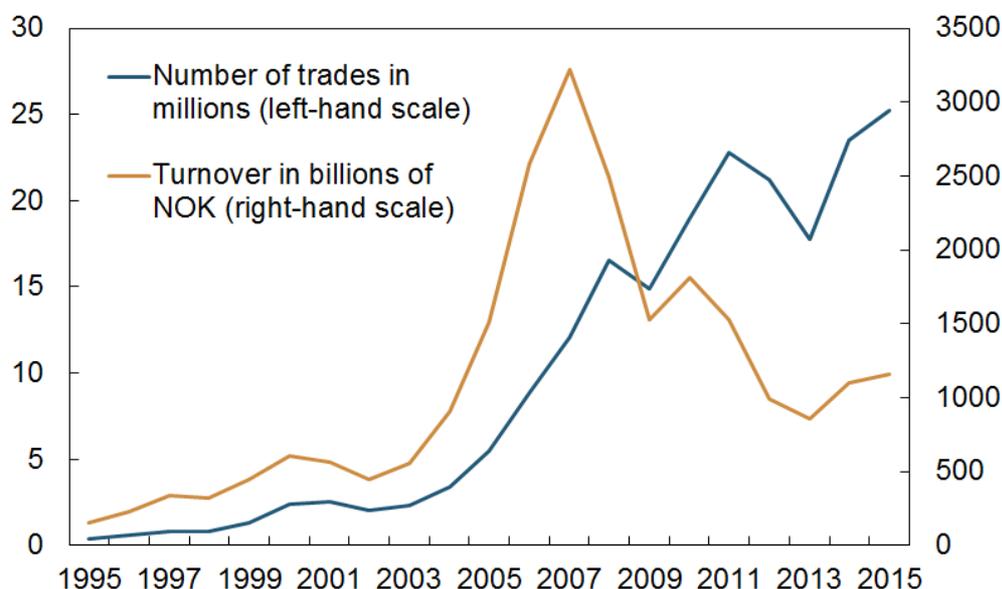


1) Equity instruments = shares and equity certificates.  
2) Does not include turnover and equity instruments on Oslo Axess.  
Source: Oslo Stock Exchange

The turnover rate is influenced by price developments for equity instruments (Chart 2.8). The higher the price level, the higher the turnover rate, all else being equal. When online trading of equities became possible with the introduction of a new electronic trading system on Oslo Børs in 1999, transaction costs were reduced substantially, especially for small investors. The annual number of trades and the turnover rate increased sharply until the onset of the international financial crisis in 2008 (Chart 2.8). The number of trades has also remained fairly high since the crisis.

Turnover has nonetheless declined as a result of increased competition for trading in Norwegian equities from alternative market venues and foreign stock exchanges.

Chart 2.8 Annual turnover and annual number of trades in equity instruments<sup>1)</sup> on Oslo Børs<sup>2)</sup>, 1995–2015



1) Equity instruments = shares and equity certificates.  
2) Does not include turnover and number of trades on Oslo Axess.  
Source: Oslo Stock Exchange

#### 2.4.4. Issuers

Chart 2.7 shows developments in the number of equities and equity certificates listed on Oslo Børs. The number of new companies on Oslo Børs varies with the business cycle. It is easier to raise capital in the market, and to list a company on a stock exchange, when the economic outlook is favourable. Companies aiming to be listed on the stock exchange must meet listing requirements in terms of size, company history and spread of share ownership. A large number of owners increases the likelihood that the company's shares will be regularly traded on the exchange. The most common reason why a company is no longer listed on Oslo Børs is that it is taken over by another company. Companies that go bankrupt will also be delisted. In some cases, majority shareholders want to remove a company from the stock exchange; delisting of shares for this reason is subject to special rules that aim to protect the interests of minority shareholders.

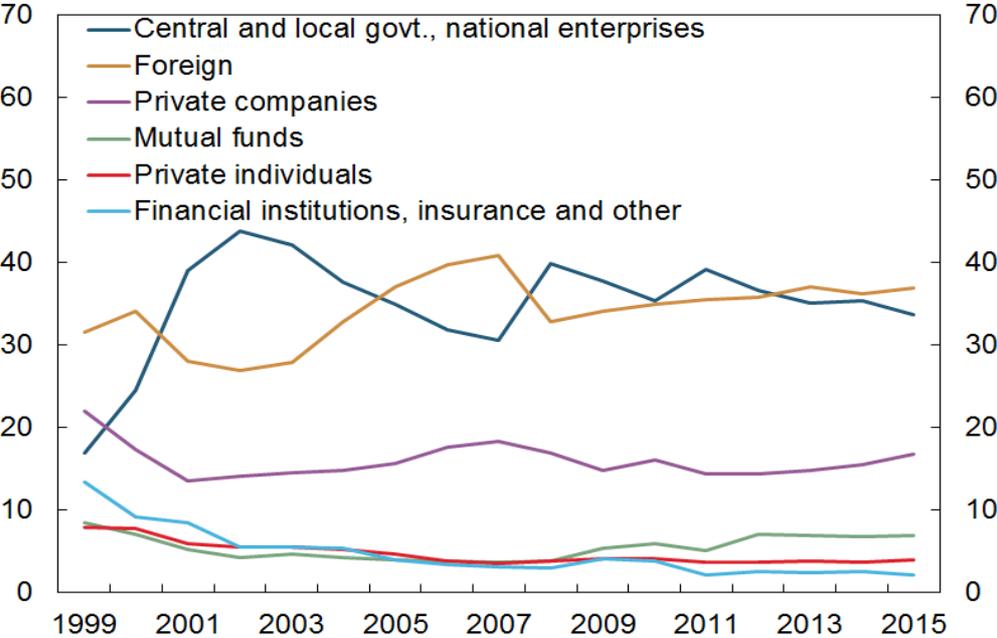
The sector composition of companies listed on Oslo Børs is markedly different from that of other countries. The Oslo Børs energy sector index (primarily oil and offshore companies) has a particularly large number of companies. At end-2015, energy companies accounted for 29% of the market value of Oslo Børs.

#### 2.4.5. Investors

All equities and equity certificates traded on Oslo Børs are registered with the Norwegian central securities depository (VPS). Some unlisted equities are also registered with VPS, although turnover in unlisted equities is lower. Developments in

the shareholder structure for companies listed on venues at Oslo Børs since 1997 are shown in Chart 2.9.

Chart 2.9 Shareholder structure for companies listed on Oslo Børs at year-end, 1999–2015



Source: Norwegian central securities depository (VPS)

The two largest categories of shareholders on Oslo Børs are foreign nationals and the Norwegian government, both with ownership interests of more than a third of the total market. The third largest owner category is other companies. Less than 4% of equity instruments on Oslo Børs are held by Norwegian private individuals, down by half since 1999. The partial privatisation and listing of both Statoil in December 2000 and Telenor in June 2001 led to a considerable rise in the government’s ownership interest between 1999 and 2001. Changes in the government’s ownership interest since 2001 have been influenced by Statoil and Telenor sell-offs and the relative performance of shares in companies that are partly government-owned compared with general share price developments on Oslo Børs.

2.4.6. Equity indices on Oslo Børs

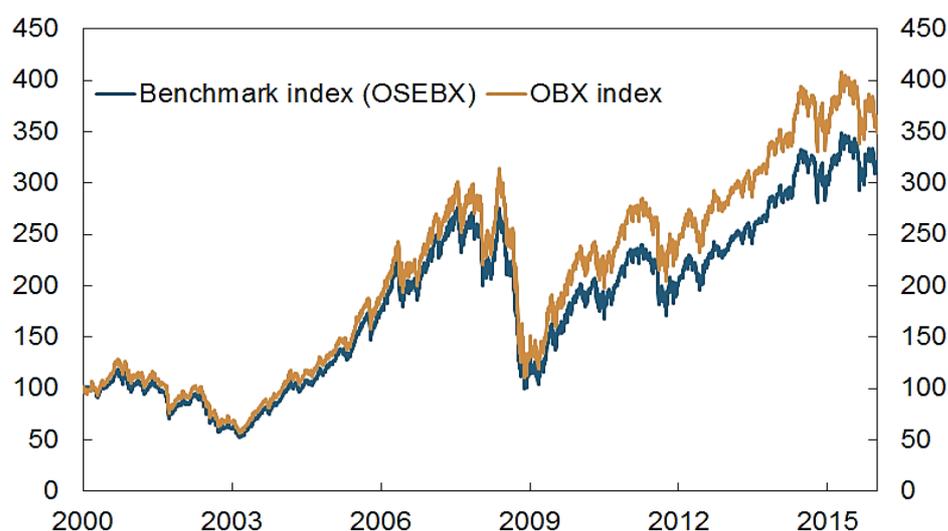
Equity indices are computed to measure the value of the total equity market and of the different sectors of the equity market. The most widely used type of equity index is called a total return index. Changes in both share prices and dividends received are used to compute the index. The weights of various equities in the index are changed daily based on price developments. Equity indices simplify the comparison of returns in the equity market with those from alternative investments such as bonds and bank deposits.

All equity indices on Oslo Børs are total return indices. The Oslo Børs Benchmark Index (OSEBX) is an index containing a representative selection of all the shares

listed on Oslo Børs. The selection is based on share turnover and intended to achieve a spread across sectors. The OSEBX is revised semi-annually with changes implemented on 1 December and 1 June. In autumn 2015, 58 equities were included in the OSEBX. The OSEBX equity weights are free-float adjusted, i.e. equities that are not expected to be traded, such as the government's holdings and the strategic holdings of shareholders with controlling influence, are not assigned weights.

The Oslo Børs OBX index comprises the 25 most traded equities on Oslo Børs. The composition of equities in the index is revised semi-annually. One aim of the OBX index is that it should consist of marketable equities that appropriately reflect the equity market on Oslo Børs. The OBX index serves as an underlying index for trading in listed derivatives (options and futures) on Oslo Børs (see **Box: Derivatives** in Section 2.1). For various derivatives trading strategies, it is important to be able to buy and sell the various OBX index components (the underlying securities). Chart 2.10

Chart 2.10 Main Norwegian stock market indices, 2000–2015. 31 December 1999 = 100



Source: Thomson Reuters Eikon and Bloomberg

shows total return in the OSEBX and the OBX index. The chart shows that since 2001, the 25 most traded equities have shown somewhat higher returns than a more broadly composed index.

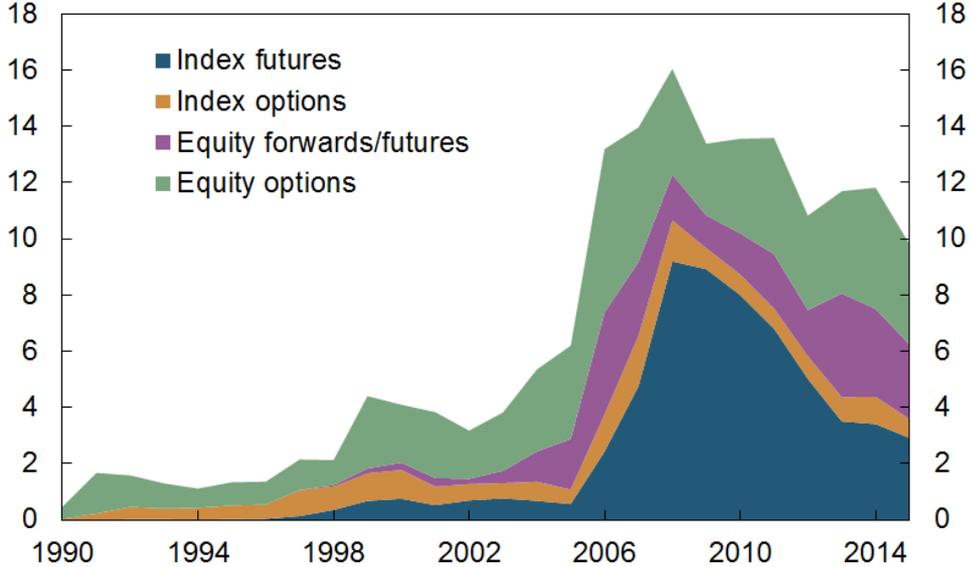
#### 2.4.7. Equity-related derivatives

The characteristics of different types of derivative are explained in **Box: Derivatives**, in Section 2.1. Exchange-traded derivatives are standardised with regard to quantity, quality of the underlying instrument and terms of delivery. On Oslo Børs, options and futures on the OBX index, and options, futures and forwards for 20 of the most liquid equities are traded. Listed derivatives are settled via a clearing house, which acts as a central counterparty (CCP) for both buyer and seller (see Section 4.3 *Securities settlement (VPO)*). There are eight market makers, i.e. agents that offer bid and ask prices, in the most liquid derivatives contracts, and fewer in the less liquid contracts.

Two widely used key figures for activity in the derivatives market are the number of traded contracts and the total value of these contracts. The annual number of

standardised derivatives contracts on Oslo Børs rose substantially in the period 2002-2008, but has since decreased somewhat (Chart 2.11) as a result of the fall in the number of index derivatives. As shown by Chart 2.11, the distribution of the different types of derivative has varied somewhat over time.

Chart 2.11 Annual number of trades in standardised equity derivatives contracts on Oslo Børs. In millions of trades. 1990–2015.



Source: Oslo Stock Exchange

Oslo Børs also offers trading in non-standardised derivatives, called TM derivatives or OTC derivatives (TM=Tailor Made, OTC=Over-The-Counter). Parties themselves agree upon underlying instruments, exercise price, expiry date and the handling of corporate events. Trading in OTC derivatives takes place to a great extent outside Oslo Børs.

## 3. Financial undertakings

Financial undertakings function as intermediaries between economic agents and play important roles in performing the financial system's three main functions. They enable businesses and private individuals to borrow money and invest savings. The role of financial undertakings in money and capital markets is discussed in *Section 2 Financial markets*. In addition, they execute payments (see *Section 4*) and assess, redistribute and price risk. The access of private individuals and businesses to cash is also based on having an account with a bank. The Act on Financial Undertakings and Financial Groups regulates the entities that may be established as financial undertakings (see **Box: Act on Financial Undertakings and Financial Groups**).

### Box: Act on Financial Undertakings and Financial Groups

The new Act on Financial Undertakings and Financial Groups entered into force on 1 January 2016 and is primarily a systematisation and continuation of earlier legislation. The purpose of the act is to promote financial stability, and to ensure that financial undertakings operate in an appropriate and sound manner. The act lays down requirements for the establishment, operation and wind-up of financial undertakings. Under the act, the following kinds of entities are considered financial undertakings:

- banks
- mortgage companies
- finance companies
- insurance companies
- pension undertakings
- holding companies of financial groups
- undertakings authorised to operate as payment institutions or electronic money institutions, unless otherwise prescribed by provisions of or pursuant to the Act on Financial Undertakings and Financial Groups.

Investment firms, management companies for securities funds, state banks, public funds and Norges Bank are not considered financial undertakings. Nevertheless, some of these entities will be discussed in this section.

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Banks constitute the largest and most important category of financial undertaking. They have the exclusive right to accept deposits and account for the largest share of lending. Banks are significant participants in the payment system since deposits are used as means of payment alongside cash and lines of credit. Private individuals and businesses hold accounts in banks in order to receive or pay wages and pay bills. Banks also lend to private individuals and businesses that, for example, intend to purchase a home or invest in new machinery. Mortgage companies, which have taken over a large share of residential mortgage financing since their establishment in 2007, may also lend money, but may not accept deposits. Insurance company activities can be divided into life insurance, non-life insurance and credit insurance. Together with pension funds, they channel savings and manage risk. Several different types of financial undertaking may often belong to a single financial group.

Table 3.1 provides an overview of various types of financial undertaking in Norway by size.

**Table 3.1 Types of financial institution**  
At 31 December 2015

	Number	Total assets (in percent of GDP)
Banks	124	128
Branches of foreign banks	10	21
Mortgage companies	32	64
Finance companies	48	5
State lending institutions	3	10
Life insurance companies	13	40
Non-life insurance companies	60	5

Sources: Statistics Norway and Norges Bank

### 3.1. Financial groups

Several different types of financial undertaking may belong to a single financial group (Table 3.2). Financial groups may include banks, mortgage companies, insurance companies and finance companies. Over time, there has been a trend towards increased consolidation of financial undertakings, both in Norway and internationally.

**Table 3.2 Structure of the Norwegian financial system**  
As a percentage of total assets.<sup>1</sup> At 31 December 2015

	Credit institutions	Securities funds	Non-life insurance	Life insurance	Total group
DNB	35	24	1	22	<b>31</b>
SpareBank 1 / Collaborating savings banks	15	5	6	3	<b>12</b>
Nordea	10	11	0	7	<b>10</b>
KLP	0.5	17	2	36	<b>7</b>
Storebrand	1	11	1	21	<b>4</b>
The Eika Alliance	5	1	2	0	<b>4</b>
Gjensidige	0.5	0	24	2	<b>1</b>
Total financial groups/ alliances	66	69	36	91	<b>39</b>
Other companies	34	31	64	9	<b>31</b>
Total	100	100	100	100	<b>100</b>
Of which foreign branches	13		29	0.3	<b>10</b>
Of which foreign-owned subsidiaries	12		1	9	<b>10</b>

1) For credit institutions belonging to a banking group, total assets for the banking group are used. Total assets for the other groups are based on total assets of the various segments and will differ from the groups' own consolidated financial reporting. The total market includes Norwegian banks' operations in other countries and foreign institutions' branches in Norway.

Source: Finanstilsynet

Financial groups seek to offer customers a complete range of products and services, exploiting economies of scale in IT and marketing. What is known as “cross-selling”, where group companies market and sell one another’s products and services, can boost earnings. Alliances of savings banks have had the same effect. A number of alliances operate non-banking activities on behalf of member banks. The individual savings banks are usually too small to form their own financial groups to engage in insurance activities, investment management and the like. A jointly owned financial group, such as SpareBank 1 Gruppen, can offer these services.

Table 3.3 provides an overview of the eight largest financial groups in Norway by main activity. Of these, six are bank-dominated, while the remainder are insurance-dominated. All groups have activities in Norway.

**Table 3.3: Largest banking groups with activities in Norway**  
**By market capitalisation. At 18 January 2016**

Nordea	Bank-dominated
Danske Bank	Bank-dominated
Handelsbanken	Bank-dominated
Swedbank	Bank-dominated
SEB	Bank-dominated
DNB	Bank-dominated
Gjensidige	Insurance-dominated
Tryg	Insurance-dominated

Source: Finanstilsynet

DNB, Storebrand, SpareBank 1 Gruppen, KLP and Gjensidige are the largest Norwegian-owned financial groups that offer most kinds of financial services. DNB and SpareBank 1 Gruppen are bank-dominated, while the other three are insurance dominated.

## 3.2. Banks

Banks offer a number of products and services to economic agents. Banks provide short-term and long-term loans. They differ from other types of financial undertaking because they have the exclusive right to create and accept deposits from “an undefined range of depositors”. Deposits are the simplest and most common form of savings, as well as the most important means of payment.

Banks offer a number of deposit products, which can vary according to the interest rate and on how often or how quickly deposits may be withdrawn. Among the types of account offered by banks are ordinary current accounts, high-interest accounts and youth home savings scheme (BSU) accounts. Deposits can be withdrawn as cash at bank branches, from ATMs and in shops, or used directly to make payments using debit cards or via an online banking service. As the technology has evolved, the use of online banking has become more widespread, resulting in fewer bank branches and ATMs in Norway. (See *Section 4 Financial infrastructure* for a detailed discussion of banks’ role in the payment system.)

Banks offer several types of loan, such as residential mortgage loans, commercial loans and consumer loans, including car loans. Loans can vary by interest type (fixed or floating), length of fixed-rate periods, currency and form of repayment (amortising or serial loan). Interest-only loans have also become more common, often in the form of home equity lines of credit up to a maximum amount. This amount may be a certain percentage of the dwelling's value, and the borrower pays interest only on the amount drawn at any given time. Furthermore, banks can exchange foreign currency and provide financial advice.

Norwegian banks are classified as either savings banks or commercial banks (see **Box: Commercial and savings banks**), but the significance of this distinction has diminished over time. The main difference is related to ownership structure and not to customer services. (See also **Box: Evolution of the Norwegian banking sector over the past 50 years.**)

### Box: Commercial and savings banks

Norwegian banks are classified as either commercial banks or savings banks. A commercial bank may only be established as a private limited liability company (or public limited liability company). On the other hand, a savings bank may not be established as a limited liability company. Savings banks have traditionally been organised as mutually owned foundations, where equity has primarily comprised previous years' retained profits. Savings banks are expected to support local communities, even if no legal obligation exists, both by offering reliable banking services and by using portions of earnings to support local activities.

In 1987, savings banks were allowed to obtain equity in the market by issuing primary capital certificates, which in 2009 were renamed equity certificates. Equity certificates have many similarities with shares, including identical tax treatment. The difference primarily concerns that fact that holders of equity certificates do not have ownership rights to all of the company's net assets and that there are special rules for the composition of a savings bank's governing bodies. In 2015, 35 savings banks had issued equity certificates.

In 2002, savings banks were allowed to be converted to limited liability companies. Prior to its merger with DnB, Gjensidige NOR Sparebank ASA was the first savings bank to be converted to a limited liability savings bank. DNB is currently a limited liability savings bank. Following the establishment of DNB, Sparebanken Bien and SpareBank 1 SR-Bank have been converted to limited liability savings banks. Upon conversion to limited liability savings banks, separate foundations were established that are intended to own the equity (except for primary capital certificates) from the original savings bank. At end-2015, DNB's savings bank foundation owned just below 10% of the shares in DNB.

For a complete overview of the different types of bank in Norway, see [\*Finanstilsynet's license registry\*](#) (Norwegian only).

## Box: Evolution of the Norwegian banking sector over the past 50 years

From around 600 savings banks in 1960, the number has fallen to slightly over 100 today. *The Norwegian Savings Banks Association* describes this process in detail (Norwegian only). While commercial banks increasingly became nationwide institutions, regional savings banks emerged. With changes in settlement patterns and industry structure, larger entities in the savings bank sector became necessary in order to constitute a real alternative to commercial banks. Following the banking crisis around 1990, just over 70% of savings banks' total assets were concentrated in the ten largest savings banks.

Alliances in the savings bank sector developed through the 1990s. SpareBank 1 Gruppen was established in 1996, while Eika Gruppen (Terra Gruppen between 2000 and 2013) was established in 1997. The idea behind forming alliances was to establish joint product companies for non-bank activities, at the same time as actual banking activities continued at the individual institutions.

In 1985, foreign banks were allowed to engage in banking activities in Norway. The late 1980s and the 1990s were marked by mergers between Norwegian banks and by foreign acquisitions. The foreign acquisitions substantially reduced the market share of Norwegian commercial banks. There are currently 22 Norwegian commercial banks, including subsidiaries of foreign banks.

Today's largest Norwegian financial group was formed through a series of mergers. In 1990, the country's two largest banks, Bergen Bank and Den norske Creditbank, merged to form Den norske Bank (DnB). DnB and Postbanken merged in 1999, and Gjensidige NOR and Den norske Bank merged to form DnB NOR in 2003. Read more about the evolution of the banking sector in Norway in "*Norges Bank's financial sector role in the period 1945–2013, with a particular focus on financial stability*", Norges Bank Staff Memo No. 9/2016.

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### 3.2.1. Banks' tasks

#### 3.2.1.1. Providing opportunities to save and borrow

Banks play an important role as a link between prospective savers and prospective borrowers. The amount an individual wishes to save does not normally correspond to a borrower's need for funds. A bank functions as an intermediary between a large number of savers and borrowers by offering flexible deposit and loan products.

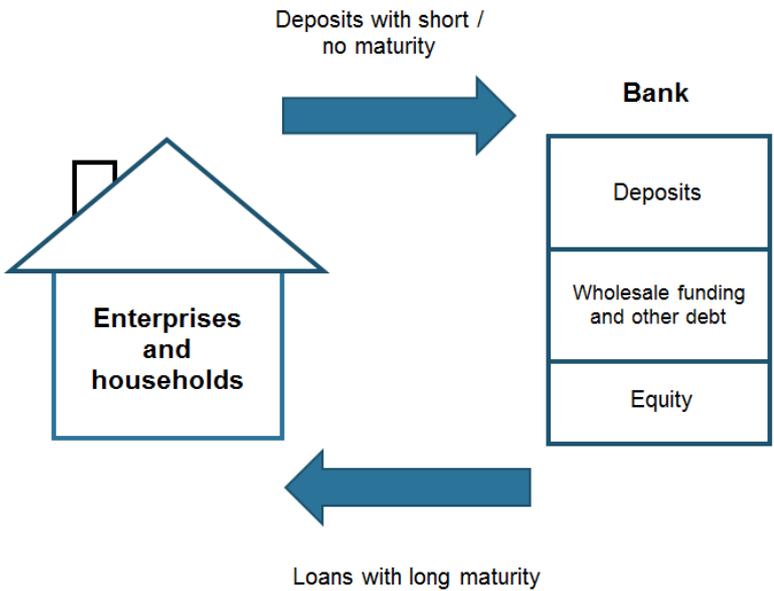
Banks can achieve economies of scale, for example with regard to gathering and processing information, credit rating and follow-up of borrowers and formulating loan agreements. Banks may also obtain access to privileged information on existing and potential customers. This may be information necessary for establishing a contract, such as personal identity number, income and degree of capacity for work, but which customers are not willing to provide to "just any" provider of goods or services. Owing to the cost of obtaining information, most private individuals and small and medium-sized businesses will save with and borrow from banks, and not directly in credit markets.

### 3.2.1.2. Maturity transformation

A borrower may have a substantial immediate need for capital, for buying a home or purchasing production equipment, for example. However, the income intended for repaying the loan is spread over several years. In such cases, borrowers need a loan with a long maturity. On the other hand, savers may prefer to have immediate access to their funds.

Banks offer borrowers loans with long maturities while promising savers immediate access to their savings. The transformation of deposits with short maturities into loans with long maturities is called maturity transformation (Chart 3.1). The primary reason banks are able to do this is that the overall stock of deposits has proved to be fairly stable. Statistical calculations enable banks to forecast how much they must normally expect to have available to pay depositors. Banks hold deposits with the central bank and have access to the central bank borrowing facilities, which helps them to manage fluctuations in customer deposits. Nevertheless, a situation may nonetheless arise when a bank's future is in doubt, prompting a large number of depositors to withdraw their funds at the same time. This is known as a "bank run". To prevent such an occurrence, deposit guarantee schemes have been introduced. Deposit insurance is intended to protect the funds of small savers, even if the bank experiences problems. The guarantee scheme in Norway currently covers deposits of up to NOK 2m (see also *Section 3.2.7. Deposit insurance in Norway*).

Chart 3.1 Maturity transformation



In addition to maturity transformation of customer deposits, banks perform maturity transformation by borrowing in the market at shorter maturities than their loans. Loans with short maturity normally have a lower interest rate than loans with long maturity. Banks will therefore earn more when they choose funding with short rather than long maturity. Banks can modify the maturity structure of their wholesale funding to better match funding to the maturity of their loans. This reduces maturity transformation, but also reduces refinancing risk (see **Box: Risks in Norway's financial system** in Section 1).

Financial markets also contribute to maturity transformation (see *Section 2.2. Bond market* and *Section 2.4. Equities*).

### 3.2.1.3. Assessing risk

In a well-functioning credit market, banks' assessments of individual investment projects and of borrowers and pledged collateral will help to channel savings to sufficiently profitable investment projects. This means, among other things, that the price for or interest rate on a loan rises when the assumed risk associated with the loan increases. If the borrower pledges collateral, the lender's risk of losses is reduced. In this case, the interest rate on the loan will be lower.

Banks and their covered bond mortgage companies have long experience in assessing borrower risk. They often know their customers and use this information and credit risk expertise to quantify and price the risk associated with each loan. Banks also reduce the risk associated with lending by making a large number of small loans to different customers (diversification). Banks and the risks they assume are then monitored by owners, the banks' lenders and supervisory authorities. This reduces the likelihood that they will assume risks greater than their risk bearing capacity.

### 3.2.1.4. Creating money

Money is defined as a generally accepted means of payment (See **Box: What is money?** and **Box: Definitions of money** for a more detailed and precise description of money).

Banks create money when they issue a new loan to a customer. A new loan increases the customer's deposit account by a corresponding amount. Customer deposits are money. The customer may then choose to use the deposit to pay for a car. The deposit is transferred to the car dealer, which may either have an account with the same bank or with another bank. In the former case, the deposit will remain in the same bank. In the latter case, the deposit will be transferred to another bank, but remain in the banking system. For the banking system as a whole, new loans will always give rise to deposits, often referred to as deposit money. When the customer repays a loan, the customer's deposits will be reduced by the same amount and money "disappears". The same will take place if banks issue bonds that are purchased by individuals and businesses, and if individuals or businesses purchase foreign currency. When a customer exchanges kroner for foreign currency, the krone deposit will be withdrawn from a Norwegian bank and thus "disappear" from the Norwegian money supply and the customer receives a foreign currency deposit that is not included in measures of the money supply. Tax payments to the central government (but not to local government) also reduce the money supply. Tax payments to the central government end up in the government's deposits with Norges Bank, which are not included in the money supply. Cash withdrawals by individuals and businesses reduce deposits, but not the money supply.

Bank lending depends on opportunities for making profitable loans. This will depend among other things on the level of key policy interest rate and funding costs, capital and liquidity requirements and the ability of businesses and households to repay loans. Loan volumes will then determine the volume of bank deposits created in the banking

system. This in turn will determine the level of central bank reserves the bank deems necessary to hold to meet withdrawals of deposits and make payments to other banks or satisfy the authorities' liquidity requirements (see also **Box: Liquidity** in Section 2). Higher demand for central bank reserves increases the interest rate in the money/interbank market.

*“Money in the modern economy: an introduction” in the Bank of England Quarterly Bulletin 2014 Q1* provides a more detailed account of how banks create money.

### 3.2.1.5. Provision of payment services

Banks are key participants in the payment system. All payments in NOK are ultimately settled between banks in Norges Bank's settlement system (NBO) (see *Section 4 Financial infrastructure*). Only banks may hold an account in Norges Bank (with some exceptions).

#### Box: What is money?

Money is defined as a generally accepted means of payment. This means that money may be used as payment for purchasing goods and services, for purchasing financial assets such as equities and bonds and for repaying loans. Money also has a function as a measurement of the value of a good and as a store of value. Banknotes and coins and bank deposits (deposit money) are defined as money (see the [Norges Bank website](#) (*Norwegian only*)).

Norwegian banknotes and coin are issued by Norges Bank, and the holder of this cash has a corresponding claim on Norges Bank. Cash is legal tender in Norway for any amount and is thus a generally accepted means of payment. Bank deposits are also generally accepted, but are not legal tender. Since cash and bank deposits are measured in the same unit, in Norway in kroner and øre, an amount in the form of bank deposits may be converted to the same amount in cash and conversely. This is important if bank deposits are to be generally accepted as a means of payment. Finanstilsynet ensures that issuers of bank deposits – banks – are solid and are able to meet the demands of the public. Norges Bank's task is to promote an efficient payment system and in that connection oversee the entire financial system and is able to take the actions that are normally expected of a central bank. In addition, the Norwegian Banks' Guarantee Fund guarantees customers' bank deposits of up to NOK 2m per depositor per Norwegian bank (see *Section 3.2.7 Deposit insurance in Norway*). Account holders, i.e. owners, gain access to their bank deposits using such payment instruments as bank cards, online banking solutions, giros or over-the-counter cash withdrawals at a bank.

The authorities cannot directly set the total volume of bank deposits. The volume of bank deposits depends, among other things, on the volume of bank lending (see *Section 3.2.1 Banks' tasks*). Since bank lending is influenced by monetary policy, including the interest rate on bank deposits with Norges Bank (the key policy rate), Norges Bank is able to influence the volume of lending and thus the volume of bank deposits.

## Box: Definitions of money

The money supply is divided into:

*Monetary base (M0).* The total of banks' and the money-holding sector's holdings of Norwegian banknotes and coins in circulation and banks' deposits with Norges Bank – central bank reserves or central bank money. The money-holding sector comprises households, non-financial enterprises, local government administration and financial undertakings other than banks and state lending institutions. Foreign sectors are not included.

*Narrow money (M1).* The money-holding sector's holdings of Norwegian banknotes and coin and the sector's deposits in transaction accounts in Norges Bank and commercial savings banks (in NOK and foreign currency). Bank deposits in transaction accounts include deposits (in NOK or foreign currency) that can be immediately converted to banknotes and coin or from which direct payments may be made without incurring costs other than ordinary transaction or establishment fees.

*Broad money (M2).* The money-holding sector's holdings of Norwegian banknotes and coin, unrestricted bank deposits, certificates of deposit and units in money market funds. M2 is also referred to as the public's liquidity.

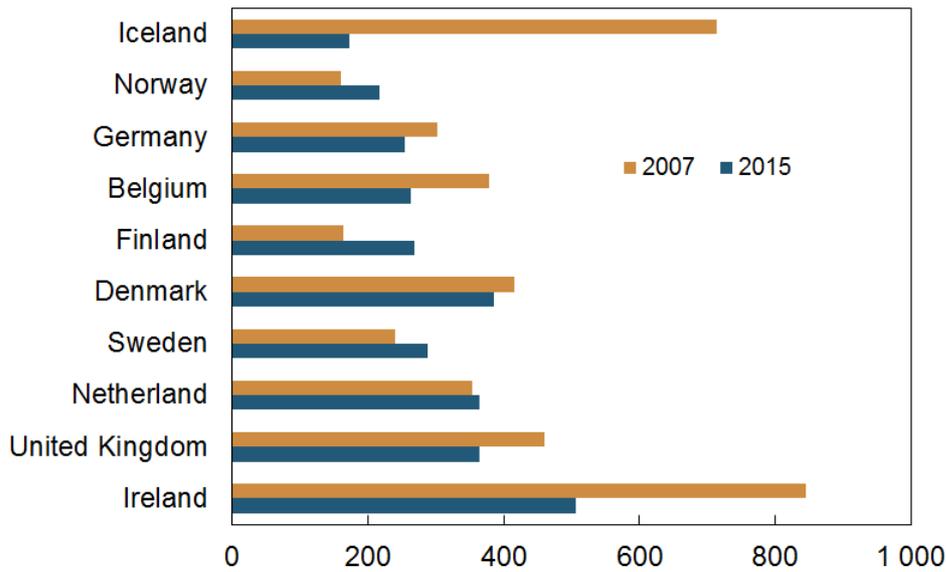
*“Om pengemengden”* [On the money supply, in Norwegian only], *Norges Bank Staff Memo 14/2013* discusses the money aggregates in detail and examines the relationship between them and developments in credit. *“The declining deposit to loan ratio - What can the banks do?”* *Norges Bank Staff Memo 28/2012* is a detailed discussion of developments in bank deposits. Statistics Norway publishes statistics on both credit and monetary aggregates.

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### 3.2.3. Structure of Norway's banking sector

Compared with other European countries, Norway's banking sector is not particularly large relative to total GDP (Chart 3.2). Norwegian banks' total assets are approximately two times GDP. By comparison, the Swedish banking sector is four times GDP. Many countries have a large banking sector because their banks also

Chart 3.2 Banks' total assets as a share of GDP.  
Percent. 2007 and 2015



Sources: ECB, Central Bank of Iceland and Norges Bank

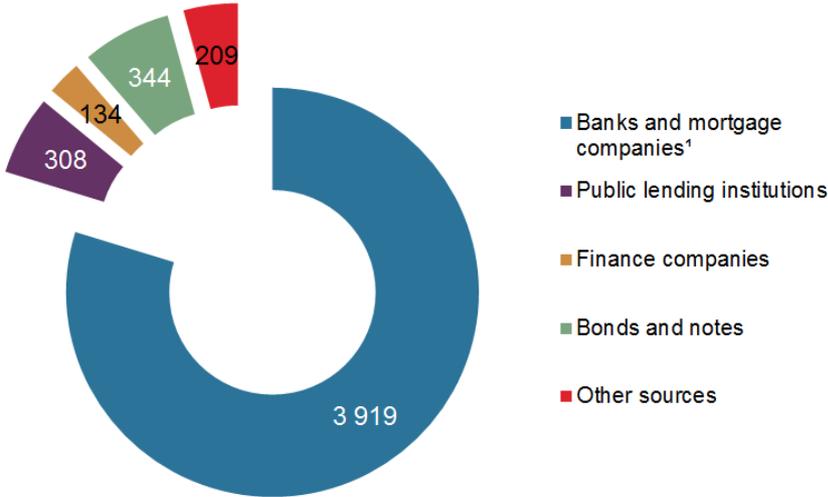
operate internationally.

The Norwegian banking sector primarily lends to domestic customers. A number of European countries have substantially reduced the size of their banking sector since the financial crisis in 2008, but developments in Norway have been fairly stable.

Banks and their mortgage companies account for over 80% of total domestic credit to Norwegian households and enterprises (Chart 3.3). This is a far higher share of total credit than in the US, for example, where the bond market plays a more important role. Norwegian households borrow almost exclusively from banks or their mortgage companies. Over the past two years, enterprises have borrowed more in the bond market, both in Norway and abroad, but the share of bonds remains much lower than the share they borrow from banks. Enterprises, especially in the oil sector, also borrow from foreign banks.

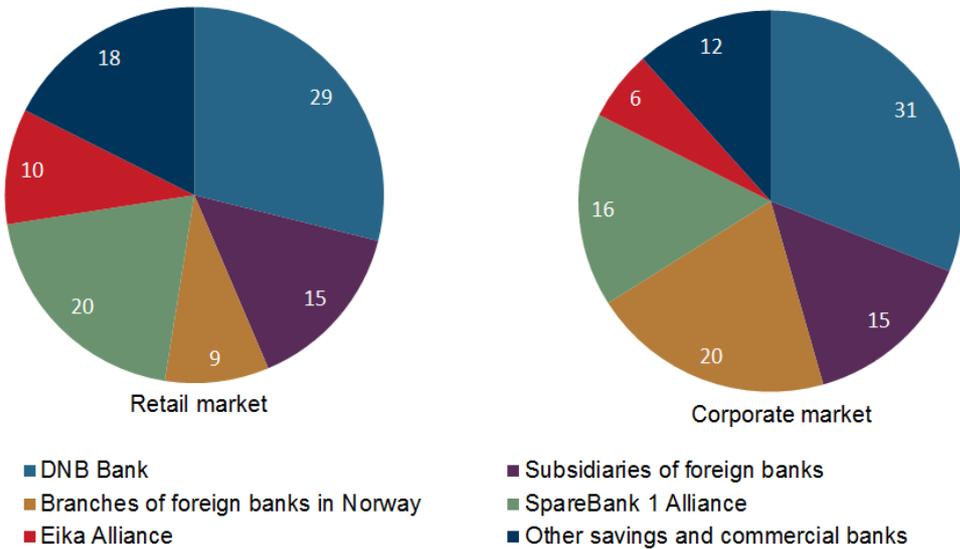
The Norwegian banking sector is characterised by the presence of a large number of banks, but a relatively high degree of concentration. The largest bank, DNB, has a lending market share of around 30% in both the retail and commercial market (Chart 3.4). By comparison, the banking sector in Denmark and Sweden is characterised by the presence of several large banks, with three and four, respectively, with high market shares.

Chart 3.3 Gross domestic lending to the private sector by credit source in billions of NOK. At 31 December 2015



1) All banks and covered bond mortgage companies including Eksportfinans.  
Source: Statistics Norway

Chart 3.4 Lending market shares in the Norwegian banking sector. As a percentage of total loans in the market. Includes covered bond mortgage companies. At 31 December 2015



Source: Norges Bank

Over the past 20 years, foreign subsidiaries and branches have increased their market shares in the Norwegian banking market. The large Scandinavian banking groups in particular are active in Norway, but the market share of the subsidiary of the Spanish Santander Consumer Bank is also large. Foreign banks' market share is highest in the commercial market, with around a third of lending, broken down approximately equally between subsidiaries and branches. The category of foreign-owned subsidiaries is dominated by Nordea's Norwegian subsidiary, which is the second

largest bank in Norway. Danske Bank and Handelsbanken are the largest foreign-owned branches (see Table 3.4 for an overview of the largest banks in Norway).

**Table 3.4 Largest banking groups in Norway**

Banking group:	Part of:	Head office/main area:
DNB Bank	DNB ASA	Oslo / entire country
Nordea Bank Norge ASA	Subsidiary of a Swedish bank	Oslo / entire country
Danske Bank NUF	Branch of a Danish bank	Trondheim / entire country
Handelsbanken NUF	Branch of a Swedish bank	Oslo / entire country
SpareBank 1 SR-bank	SpareBank 1 Gruppen	Stavanger / Rogaland, Hordaland, Agder
Sparebanken Vest	Independent savings bank	Bergen / Western Norway
SpareBank 1 SMN	SpareBank 1 Gruppen	Trondheim / Trøndelag, Northwestern Norway
SEB AS NIF	Branch of a Swedish bank	Oslo / investment bank
Santander Consumer Bank	Subsidiary of a Spanish bank	Oslo / Car and consumer loans
Sparebanken Sør	Independent savings bank	Kristiansand / Agder, Telemark
SpareBank 1 Nord-Norge	SpareBank 1 Gruppen	Tromsø / Troms, Nordland, Finnmark
Sparebanken Hedmark	SpareBank 1 Gruppen	Hedmark / Oppland / Akershus
Sparebanken Møre	Independent savings bank	Møre og Romsdal
Skandiabanken Group	Independent commercial bank	Entire country

Sources: Banking groups' reports and Norges Bank

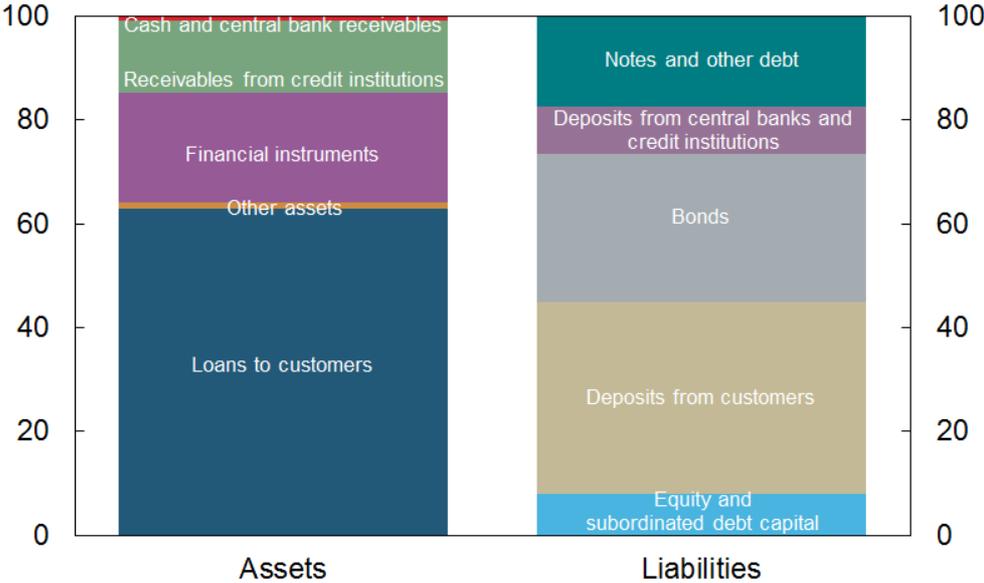
Today's savings bank sector is characterised by a large number of savings banks. Most are very small, but they have joined extensive alliances. The SpareBank 1 Alliance comprises 16 banks, most of which are large in their regions, while the Eika Alliance comprises close to 80 smaller savings banks. Slightly fewer than 20 savings banks remain outside of formalised alliances even though some have joint holdings in covered bond mortgage companies and insurance companies.

### 3.2.4. Banks' assets and funding

Loans account for the majority of Norwegian banks' assets (Chart 3.5). The largest single loan items are residential mortgages and commercial real estate loans (Chart 3.6 and Chart 3.7), and lending to these sectors has increased further in recent years. Loans are primarily in NOK. Other assets include securities in addition to deposits in credit institutions and central banks. An important reason for banks to hold assets of this type is that they need assets that can be sold quickly if depositors increase their withdrawals or the bank cannot roll over its wholesale funding. Substantial portions of the other assets are in foreign currencies such as the US dollar and euro.

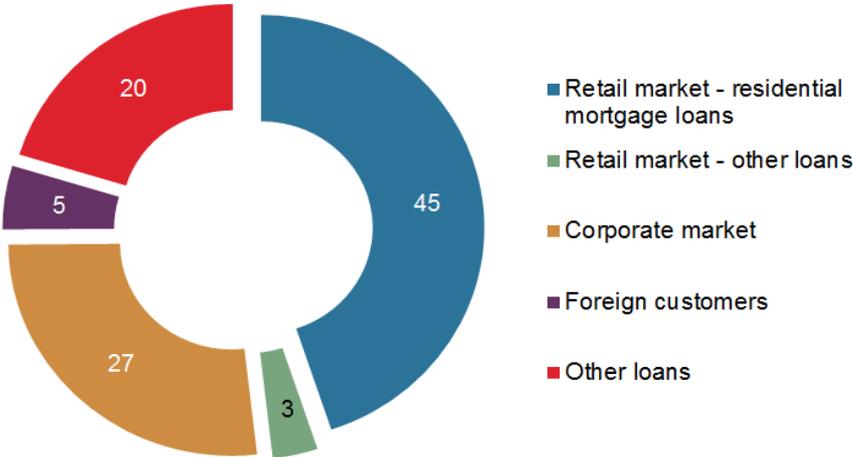
Norwegian banks fund most of their activities with deposits and bonds (Chart 3.5). Customer deposits account for a third, while long-term wholesale funding accounts for around 30%. These two funding sources are as a rule assumed to be stable. Banks with stable funding are better positioned to deal with periods of turbulence. The smaller savings banks are funded to a greater degree by customer deposits than the large banks, while foreign subsidiaries and branches are largely funded by the parent of the foreign banking group. The largest bank, DNB, also relies to some extent on short-term wholesale funding in the form of commercial paper.

Chart 3.5 Assets and funding. Norwegian-owned banks and covered bond mortgage companies.<sup>1</sup> Percent. At 31 Desember 2015



1) Total of all banks and covered bond mortgage companies excluding subsidiaries and branches of foreign banks in Norway.  
 Source: Norges Bank

Chart 3.6 Lending breakdown.  
Banks and covered bond mortgage companies in Norway. Percent.  
At 31 December 2015



Source: Norges Bank

Over half of banks' wholesale funding is raised in foreign currency (Chart 3.8 and discussion in **Box: Norwegian banks' and mortgage companies' bond funding abroad** in Section 2.2.2.) The smaller savings banks are funded to a greater extent in NOK than the large banks (see "*Norwegian banks' foreign currency funding of NOK assets*", *Norges Bank Staff Memo 2/2014* for a more detailed review of Norwegian banks' foreign currency funding).

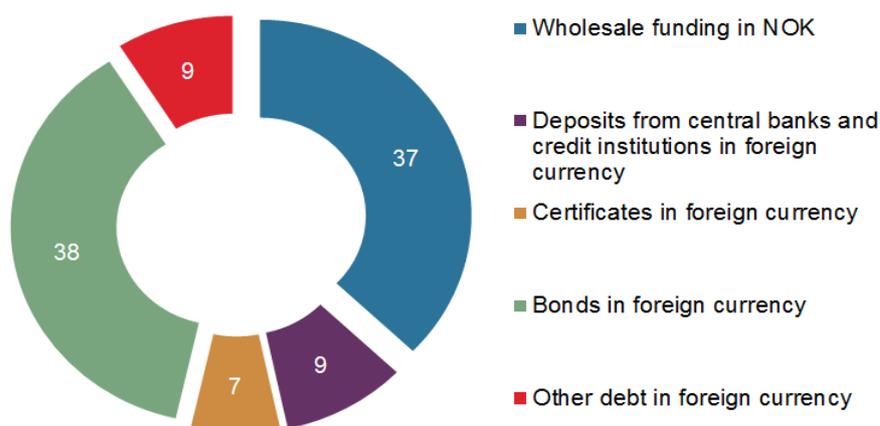
Chart 3.7 Lending to the corporate sector.  
Banks and covered bond mortgage companies in Norway. Percent.  
At 31 December 2015



1) Other industries comprises "Extraction of natural resources", "Oil services", "Other transport activities" and "Power supply etc". Loans to foreign customers are not included.

Source: Norges Bank

Chart 3.8 Wholesale funding<sup>1</sup> by currency.  
Norwegian-owned banks and mortgage companies.<sup>2</sup> Percent.  
At 31 December 2015



1) Total liabilities less customer deposits and equity.

2) All banks and covered bond mortgage companies excluding branches of subsidiaries of foreign banks in Norway.

Source: Norges Bank

In addition to deposits and borrowing (debt capital), banks also rely on equity funding. In the event of bank losses, equity capital is the first to absorb losses. Equity funding is discussed in more detail in (*Section 3.2.5 Capital adequacy regulation*).

More statistics are available at [Statistics Norway's website](#).

### 3.2.5. Regulating banks – why and how?

Given their considerable social importance, banks are subject to extensive regulation. Deposits are an important savings vehicle and means of payment for most people. Other tasks of the banking sector, such as maturity transformation, distribution of risk and assessing and monitoring borrowers are also important for a well-functioning financial system and for the overall economy.

The aim of banking regulation is a stable and efficient financial system. Regulation is intended to reduce the probability of future financial crises and ensure that banks are able to perform their tasks and do so as efficiently as possible. Regulations may entail costs in the form of lower production of financial services. If regulation provides gains that are higher than the costs associated with regulation, it is a benefit to society as a whole. (See "[Why regulate banks?](#)" *Norges Bank Staff Memo 16/2013* for a detailed discussion of why banks are regulated.)

Especially owing to maturity transformation (see *Section 3.2.1 Banks' tasks*), banking is vulnerable in principle to large withdrawals of deposits and a loss of wholesale funding. In such a case, a bank may quickly find itself in a situation that threatens its existence. In addition, banks are closely interlinked. Problems at one bank can easily spread to others, creating domino effects that can imperil the entire financial system.

Deposit insurance is intended to reduce the risk of large withdrawals of deposits by shielding retail customer deposits if a bank fails. Consumer protection is an element of deposit insurance schemes. Retail customers are not ordinarily able to adequately assess a bank's risk level and thus determine, for example, whether their deposits are correctly priced.

Instability may entail reduced confidence in the banking system, problems in the payment system, credit shortages and hence impair banks' lending capacity. The first regulations were aimed at promoting adequate and stable access to banking services. The safety net that was put in place (deposit insurance and central bank borrowing facilities) may have created a kind of stability that has encouraged risk-taking and moral-hazard driven behaviour. This in turn has resulted in additional rounds of regulation, primarily to curb risk-taking.

Owing to increased globalisation of the banking sector, problems in banks easily spread across borders. For that reason, the past 30 years have seen growing coordination of banking regulation internationally (see *Appendix 2: Bank capital regulation*). Moreover, the EU single market in financial services has led to a common set of rules for banks in Europe.

*Finanstilsynet* supervises banks and other financial undertakings to ensure regulatory compliance. If a bank or other financial undertaking is in breach of current regulations, *Finanstilsynet* is mandated to take action to ensure compliance. In the event of non-compliance, the undertaking is as a first step directed to present plans for returning to compliance. These plans must be approved by *Finanstilsynet*. *Finanstilsynet* may also impose restrictions on dividend payments to shareholders and interest payments on certain instruments and as a last resort revoke the undertaking's licence, among other actions. If a bank is on the verge of failing or the authorities decide to close it, separate crisis resolution rules will apply (see *Section 3.2.8 Crisis management of banks*).

Historically, banking crises have had considerable influence on the design of banking regulation (see "*Bank regulation and bank crisis*" *Norges Bank Working Paper 18/2009*). In the aftermath of banking crises, regulation is tightened and minimum capital requirements are raised. When some time has elapsed after the crisis, capital levels have tended to fall. This tendency is also observed in developments in Norway over the past 25 years.

For a thorough review of the Norwegian banking crisis at the end of the 1980s and beginning of the 1990s, see "*The Norwegian banking crisis*" *Norges Bank Occasional Papers 33/2004* and "*Norges Bank's financial sector role in the period 1945–2013, with a particular focus on financial stability*", *Norges Bank Staff Memo No. 9/2016*. *Norges Bank Occasional Papers 48/2015 (Norwegian only)*. *Bedre rustet mot finanskriser – Finanskriseutvalgets utredning* [Better positioned against financial crises – Report of the Financial Crisis Commission] *NOU 2011:1 (in Norwegian, with English summary)*, provides a thorough review of the global financial crisis in 2008–2009.

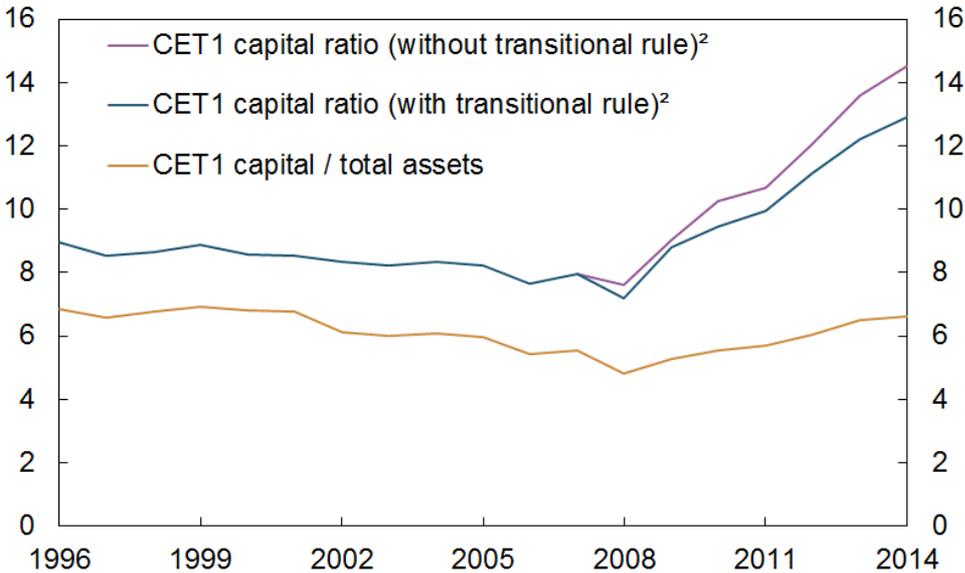
### 3.2.6. Capital adequacy regulation

The aim of capital adequacy regulation is to ensure that financial undertakings hold sufficient loss-absorbing capital relative to the risk they assume. This capital, which primarily comprises equity and other loss-absorbing capital, is to be sufficient to absorb fairly large unexpected losses.

Following the banking crisis in the years 1988–1993, the parliamentary commission appointed to investigate the crisis (the Smith Commission) noted that the minimum capital requirement was too low prior to the crisis and that banks were undercapitalised. Banks’ capital requirements were subsequently increased. Somewhat stricter capital requirements in Norway than those prevailing internationally were a source of strength for the Norwegian banking sector during the global financial crisis in 2008–2009. The crisis highlighted the need for stricter banking regulation in many areas, and banks’ capital requirements were raised (see *Appendix 2: Bank capital regulation*).

Since the trough in 2008, Norwegian banks’ Common Equity Tier 1 (CET1) capital ratios have increased to a fairly considerable degree. CET1 capital as a percentage of total assets has also increased, but far less (see Chart 3.9).

Chart 3.9 Common Equity Tier 1 (CET1) capital ratios and CET1 capital in percent of total assets.<sup>1</sup> Percent. 1996–2014



1) Consolidated figures are used for banks that are banking groups. Parent bank numbers are used for the other banks.

2) See Appendix 2: Bank capital regulation for explanation of the transitional rule.

Source: The Financial Supervisory Authority of Norway

Norway will be covered by EU capital adequacy legislation, which is based on the Basel III framework and which entered into force in the EU from January 2014 (see Finanstilsynet’s consultation document [Gjennomføring av CRD IV i norsk regelverk \[Implementation of CRD IV in Norwegian regulations\] \(Norwegian only\)](#) for more information on the structure of EU capital adequacy legislation). Norway began

phasing in the Basel III principles in 2013, thereby choosing a faster implementation than the EU timetable. For a more detailed presentation of the capital requirements in Norwegian regulations see *Appendix 2: Bank capital regulation*.

### 3.2.7. Liquidity regulation

In Norway, the global financial crisis of 2008–2009 was primarily a liquidity crisis, which uncovered a need for better management of banks' liquidity and funding structure (see **Box: Liquidity** in *Section 2.1.1.* for an introduction to the concept of liquidity). Banks can reduce liquidity risk by holding deposits distributed among a large number of small depositors, having long maturities on wholesale funding and holding sufficient liquid assets (liquidity buffers) in the form of readily saleable securities or central bank reserves. By holding liquidity buffers, banks will be better positioned to deal with periods of market turmoil. Banks may use the buffers as collateral for new loans or sell them as a way to avoid additional borrowing.

Liquidity rules direct banks to hold a certain stock of liquid assets. Under the Liquidity Coverage Ratio (LCR) requirement, banks must hold sufficient high quality liquid assets to survive a 30-day period of stress in funding markets. For a more detailed description of the liquidity regulation, see Norges Bank's *Financial Stability Report 2014*.

The LCR requirement was finalised in the EU in 2015 and implementation in the EU began in October 2015. The new requirement is in the process of being introduced in the EEA. In December 2015, the Ministry of Finance approved new Norwegian liquidity requirements harmonised with the new EU liquidity regulations. (See *Press release from the Ministry of Finance, 25 November 2015 (Norwegian only)*).

The Net Stable Funding Ratio (NSFR) requirement proposed by the Basel Committee requires that banks fund illiquid assets with stable funding. The requirement is intended to make banks' funding structure more robust. Loans to customers and encumbered assets are examples of illiquid assets. Stable funding includes Tier 1 capital, bonds with long residual maturity and several types of customer deposit. For a detailed description, see *Press release from the Basel Committee, 31 October 2014*.

### 3.2.8. Deposit insurance in Norway

Deposit guarantee schemes became enshrined in law for savings banks in 1924 and for commercial banks in 1961. This legislation also applies to subsidiaries of foreign banks. Deposit insurance rules are intended to protect small and uninformed depositors, eliminating the need for them to monitor the bank's economic situation and reducing the risk that they will withdraw their funds in a panicked response to rumours that the bank is in trouble. Under Norwegian law, an individual customer's deposits in a bank are guaranteed in an amount of up to NOK 2m, including accrued interest (see the *Financial Institutions Act*). This limit applies even if the customer has more than one account with the same bank. If the customer has deposits in more than one bank, the limit applies to each bank.

In Norway, the *Norwegian Banks' Guarantee Fund* is responsible for the deposit guarantee. Banks are charged an annual fee to the fund. The fund shall pay out deposit

insurance as soon as possible and by no later than one week after (i) Finanstilsynet has concluded that the institution is incapable of repaying deposits or (ii) the bank has been placed under public administration.

Branches of foreign banks in Norway are, in principle, not covered by the Norwegian guarantee scheme. Deposits held by Norwegian customers in these banks will be insured by the deposit guarantee schemes in these banks' home states. However, branches may apply for membership of the Norwegian deposit guarantee scheme (also called "topping up"). In this case, the Norwegian fund guarantees deposits of up to NOK 2m less the amount guaranteed by the home state scheme.

From 2011, the amount insured by deposit guarantee schemes in the EU has been harmonised to EUR 100 000. Norwegian authorities have worked to retain the higher limit in Norway. (*See the [Ministry of Finance's web page on the Norwegian deposit guarantee scheme](#) (Norwegian only)*).

### 3.2.9. Crisis management of banks

When a large and important bank has been in danger of failing, the authorities in most countries have intervened to ensure the bank's continued operation. They feared serious consequences for the financial system if the bank failed. Rescue operations have been in the form of loans on favourable terms and loan guarantees or providing the bank with additional capital. The result has nearly always been that the bank's creditors have avoided having to realise losses ("bailout"). For that reason, an expectation has arisen among creditors that the authorities will bail them out also in the event of future problems at the bank (moral hazard). The bank's creditors have enjoyed a form of implicit guarantee for their loans, with the possible result that they perform less thorough risk assessments of the bank's activities than they otherwise would. The bank has been able to increase the risk it takes without having to pay its lenders for the higher risk-taking. This increases lending as well as the risk in the banking system.

Following the global financial crisis in 2008, new international rules have been introduced for resolving banking crises.

In January 2015, the *Bank Recovery and Resolution Directive (BRRD)* entered into force in the EU. The aim of the directive is to enable the authorities to manage banks in trouble so that banks' critical functions can continue, but without providing banks with public funds.

An important element of the directive is the "bail-in" tool. In a bail-in, the authorities convert portions of the bank's liabilities to equity or write down the value of liabilities without closing the bank. If creditors, also those of systemically important banks, face a real risk of losses, they will more thoroughly assess banks' risks and set the interest rate on their loans to banks more in accordance with the bank's risks. Bank funding will become more expensive, and banks will wish to take less risk. There will be less lending and the risk in the entire financial system will be lower (see "*Kriseløsning av banker ved hjelp av bail-in – momenter ved innføring i Norge*" [Bank resolution with the aid of the bail-in tool – factors associated with introduction in Norway], Norges Bank *Staff Memo 12/2014* (Norwegian only) for a review of the bail-in tool). In

addition to the use of bail-ins, the BRRD contains provisions relating to depositor preference, use of bridge institutions (temporary public ownership of a failing bank prior to restructuring and sale), the establishment of national resolution authorities and resolution funds, and the drawing up of living wills (contingency plans and plans for the orderly resolution of banks). The BRRD will be transposed into Norwegian law.

Deputy Governor Jon Nicolaisen discussed fundamental issues relating to bank resolution in his speech [\*Should banks be bailed out? from 2015.\*](#)

### 3.3. Mortgage companies

Mortgage companies originate long-term mortgages for households and enterprises. Mortgage companies differ from banks in that they cannot accept deposits or perform payment services. Mortgage companies mainly finance their activities by issuing bonds. Covered bond mortgage companies, which finance residential and commercial mortgages by issuing covered bonds, account for a large share of mortgage companies in Norway (see *Box: Collateralised loans* in Section 2.2).

#### 3.3.1. Covered bond mortgage companies

There are 23 covered bond mortgage companies in Norway. New rules were introduced in Norway in June 2007 allowing authorised mortgage companies to issue Norwegian covered bonds. A covered bond is a bond that gives investors a preferential claim on a specified pool of the issuer's assets, known as the cover pool.

Under Norwegian law, Norwegian covered bonds must be issued by a covered bond mortgage company. Most Norwegian covered bond mortgage companies are established, owned and controlled by banks. The majority of Norwegian banks are joint owners of such companies with other banks, but some large and medium-sized banks have established their own mortgage companies. A few banks do not have any links with companies issuing covered bonds. Norwegian covered bond mortgage companies are subject to requirements to ensure timely payment of interest and principal and are required to set limits on interest rate and exchange rate risk. Finanstilsynet is responsible for supervising Norwegian covered bond companies' liquidity management and their limits on exchange rate and interest rate risk.

A large number of mortgage loans in Norway are financed by Norwegian covered bond companies. These are either mortgages funded directly by the mortgage company or mortgages provided by banks and transferred to the covered bond mortgage company, which issues covered bonds backed by the mortgages. Banks normally extend short-term credit to the covered bond mortgage companies when the mortgages are transferred. The covered bond mortgage companies obtain liquidity to repay the credit either by selling covered bonds or by providing the bank with covered bonds of the same value as the mortgages it has transferred. When the mortgages are replaced by covered bonds or the proceeds from the sale, the bank's balance sheet is changed. The bank can, for example, use these funds to repay debt. The possibility of issuing covered bonds expands banking groups' sources of financing and provides

more stable options. Through jointly owned mortgage companies, smaller banks are also able to obtain funding in international capital markets. (The article “[Norwegian covered bonds – a rapidly growing market](#)», in Norges Bank *Economic Bulletin* 2010 (Vol. 81, 4–19) provides a detailed review of Norwegian covered bonds and covered bond companies.)

### 3.3.2. Other mortgage companies

There are also other mortgage companies that are not authorised to issue covered bonds. The number of these companies is limited in Norway and, with the exception of Kommunalbanken and Eksportfinans, they are relatively small.

#### 3.3.2.1. Kommunalbanken

Kommunalbanken provides credit to the Norwegian local government sector. Ninety-eight percent of Norway’s municipalities are customers of Kommunalbanken.

It is not practical for all Norwegian municipalities to borrow directly in capital markets. Kommunalbanken can offer favourable borrowing terms for municipalities by providing credit to the Norwegian local government sector as a whole. Kommunalbanken finances its lending to the local government sector by issuing bonds and notes in international capital markets. Kommunalbanken’s main product is long-term amortised loans, with the same interest rate offered to all the bank’s customers. Kommunalbanken is an AAA-rated limited company wholly owned by the government. It has been designated by the Ministry of Finance as systemically important and is therefore subject to additional capital requirements.

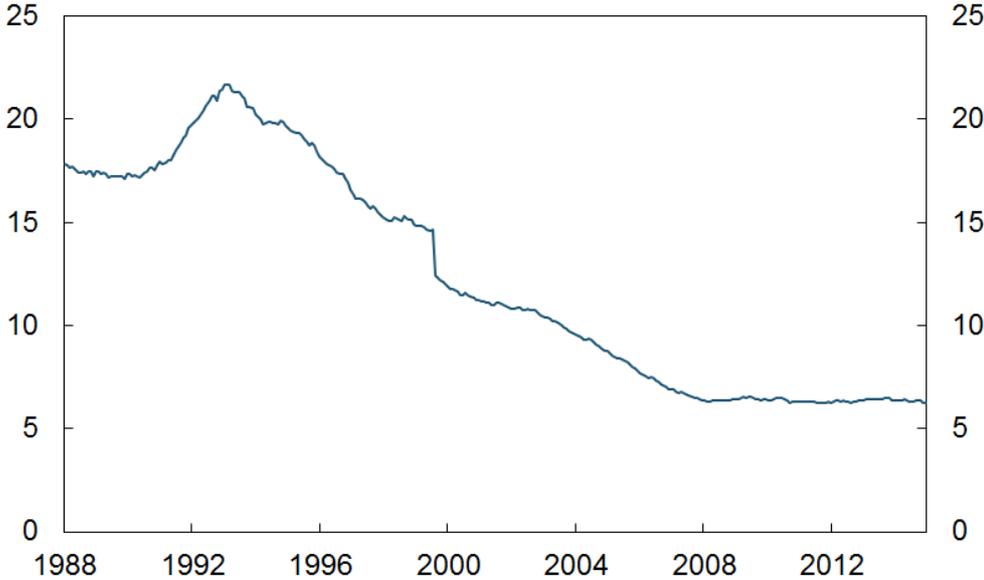
#### 3.3.2.2. Eksportfinans ASA

Until 2011, Eksportfinans provided long-term loans for the Norwegian export sector via the subsidised export financing scheme. The company is owned by a consortium of banks operating in Norway (85%) and the Norwegian government (15%). Eksportfinans financed its lending by bond and note issues in international capital markets. In 2012, the Norwegian government assumed responsibility for new lending by establishing a new government entity, Eksportkreditt Norge AS (see Section 3.4, *Government lending institutions*). Eksportfinans has therefore discontinued new lending and the existing loan portfolio will be gradually phased out as the loans reach maturity.

### 3.5. Government lending schemes

The purpose of government lending institutions is to finance politically prioritised activities such as providing equal opportunities in education or fostering innovation in the business sector. Government lending schemes are less common than they used to be. At the end of the 1980s, government lending schemes accounted for 18% of total credit in Norway (C2), whereas these schemes now account for about 6% (Chart 3.10).

Chart 3.10 Credit from state lending institutions.  
As a percentage of domestic credit (C2). January 1988–December 2015



Source: Statistics Norway

Household loans via these lending schemes have decreased in particular. Today, the largest government lending institutions are the Norwegian State Housing Bank, the Norwegian State Educational Loan Fund, Innovation Norway and the Norwegian Export Credit Guarantee Agency (GIEK) (see **Box: Government lending institutions**).

#### Box: Government lending institutions

##### *The Housing Bank*

The Norwegian State Housing Bank was founded in 1946 as a bank for housing construction. Following World War II, housing was in short supply and the Housing Bank was established to contribute to Norway’s reconstruction. Today, the Housing Bank is under the Ministry of Local Government and Modernisation and is responsible for implementing government housing policy. It provides housing allowances, housing grants, start-up loans and basic loans (see the *Housing Bank website*). Borrowers are primarily municipalities, private sector firms, housing cooperatives and wage-earners. The Bank’s lending portfolio amounts to about NOK 135bn.

##### *The Educational Loan Fund*

The Norwegian State Educational Loan Fund was established in 1947 to manage government support for education. The Educational Loan Fund is a government agency under the Ministry of Education and Research with the objective of promoting equal opportunities for all in education regardless of geographical location, age, gender, functional ability or socioeconomic status, primarily by providing grants and favourable loans. The scheme is intended to increase the level of education in the labour force. The Educational Loan Fund has over 1 million customers and financial support for students totalled NOK 26bn in 2015. The Fund's lending portfolio amounted to about NOK 155bn (see [\*the Norwegian State Educational Loan Fund's website\*](#)).

#### *Innovation Norway*

The objective of Innovation Norway is to foster profitable business sector developments in Norway. Innovation Norway is owned by the Ministry of Trade, Industry and Fisheries (51%) and local government authorities (49%) and was established in 2004 as the result of a merger between the Norwegian Industrial and Regional Development Fund (SND), the Norwegian Tourist Board, the Norwegian Trade Council and the Government Consultative Office for Inventors. Innovation Norway's mission is to foster Norwegian companies' competitiveness and promote long-term growth through business sector development. Innovation Norway provides advisory services, grants and loans, promotes Norwegian businesses and tourism abroad and is represented in more than 30 countries. Its lending portfolio amounted to about NOK 17bn at end-2015 (see [\*Innovation Norway's website\*](#)).

#### *Norwegian Export Credit Guarantee Agency*

The Norwegian Export Credit Guarantee Agency (GIEK) is a public enterprise under the Ministry of Trade, Industry and Fisheries and issues guarantees on behalf of the government to promote Norwegian exports in accordance with the [\*OECD Export Credits Arrangement\*](#). GIEK's objective is to be a supplement to the commercial banking market, with financial results that will break even over time. GIEK and Export Credit Norway work in close collaboration. GIEK guarantees credit extended by Export Credit Norway to foreign buyers for purchases of Norwegian export goods and services. GIEK has around NOK 100bn in outstanding guarantee liabilities (see [\*Norwegian Export Credit Guarantee Agency's website\*](#)).

#### *Export Credit Norway*

Export Credit Norway is a public limited company and not a financial undertaking, but is included here since its main purpose is to provide financing. Export Credit Norway manages the export financing scheme on behalf of the government and under the auspices of the Ministry of Trade, Industry and Fisheries. The export financing scheme is regulated by the Export Credit Act and the regulation relating to the export financing scheme. The purpose of the company is to provide credit in order to promote Norwegian exports. Norwegian and foreign companies can apply for credit from Export Credit Norway for the purchase of goods and services from Norwegian exporters. Borrowers come from all over the world.

All Export Credit loans are recorded on the government's balance sheet and are guaranteed either by government export guarantee institutions like GIEK and/or

financial undertakings with a good credit rating. The government is responsible for Export Credit Norway's obligations related to its lending activities. The company has been in operation since 1 July 2012, when it took over the function previously held by Eksportfinans ASA, with a current lending portfolio of NOK 77bn (see [Export Credit Norway's website](#)).

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## 3.6. Insurance companies

Insurance is an arrangement that guarantees compensation for financial loss as a result of arbitrary, unforeseen events. The basic idea behind all insurance is that a large number of people are exposed to the same type of risk of financial loss. As such a loss will not occur at the same time for everyone, it is an advantage to join a risk-sharing arrangement, via an insurance company, in order to distribute risk among its members. A necessary condition for such an arrangement to function is that there are a sufficient number of people who want to insure themselves against this risk. A loss incurred by an insured party may be covered, and compensated for, by the insurance company. The individual member, or policyholder, makes a regular, recurring payment, known as a premium, to the insurance company. The insurance company uses these premiums to build up reserves that can be drawn down in the event of losses. The return on the reserves is an important source of income for insurance companies.

A basic principle in insurance is that the insurance premium should be commensurate with the risk taken by the insurance company. This could in principle indicate a pricing of the insurance premium at the individual level. However, this could easily be perceived as unfair and may be difficult to implement in practice. Applicants who are able to hold back information about their risks are more likely to subscribe to an insurance policy and the premium will be lower than implied by the level of risk assumed by the insurance company. A higher take-up rate of high-risk applicants is called adverse selection. Since income from premiums is supposed to cover expected expenditure, the company will have to increase its premiums. Low-risk applicants may then be reluctant to take out insurance, which in turn increases the ratio of high-risk applicants. In a worst-case scenario, the company may have to withdraw the insurance product.

### 3.6.1. Types of insurance

Insurance can be classified in several ways. If the classification is based on the type of risk covered by the policyholder's insurance contract, insurance can be divided into life and non-life insurance. Non-life insurance comprises property-casualty insurance and other insurance. Insurance can also be classified by the insured object (life, property or asset insurance). Examples of life insurance are pension, health and accident insurance. Property-casualty insurance includes fire, auto and theft insurance. Examples of insurance that can serve to protect assets, are liability insurance and credit insurance.

A distinction is also commonly made between cases where the insurance company is the original issuer of the insurance contract (primary insurance) and cases where some

of the liability has been taken over by another company (reinsurance). Even insurance companies need to insure themselves against major unforeseen events or a large number of claims and reduce risk by purchasing reinsurance for this purpose.

Life insurance products can be divided into two main groups: pension insurance and insurance that normally provides a one-time payment in the event of disability or death. Pension insurance provides payments over a number of years in the event of disability, death or achieving pension age (see **Box: The pension system in Norway**).

### Box: The pension system in Norway

The pension system in Norway comprises three parts:

- State pensions under the National Insurance Scheme, with universal coverage.
- Employer-financed pensions, often called occupational pensions, supplement the state pension and are agreements between a company and its employees to provide pension benefits beyond the state pension (collective pension agreements). Companies can purchase pension benefits from a life insurance company or organise pensions through their own pension funds.
- Individual pension schemes.

A central feature of collective pension agreements in Norway in recent years is the transition from defined benefit to defined contribution occupational pension schemes (see “*Finansmarkedsmeldingen 2015*”, [*Financial Markets Report 2015*] (in Norwegian only), Ministry of Finance). The difference between the two schemes is related to their predetermined basis: the employee’s benefits beginning at pension age or the company’s contributions to the pension scheme.

In a defined benefit pension scheme, payments at pension age are specified beforehand and are often 66% of the employee’s final earnings. With this scheme, pension payments are predictable for the employee. The company pays an annual premium into the pension scheme. The size of the premium depends on factors such as the employee’s years of service, age, wage level and the return achieved by the life insurance company. As a result, the size of the company’s premium payments varies from year to year.

A defined benefit pension scheme provides a guaranteed future rate of return on contributions from the insurance company or the pension fund. The guaranteed rate of return will determine the size of the premium payments needed to provide the predetermined future pension. The guaranteed rate of return, referred to the minimum guaranteed rate, cannot be higher than the maximum rate set by the authorities. The low interest rate level of the past few years has made it more difficult for insurance companies and pension funds to fulfil the return guarantee.

In a defined contribution pension scheme, the company’s contribution to the pension scheme is set at a percentage of the employee’s salary. In contrast to the defined benefit pension scheme, the level of a defined contribution pension at pension age is not fixed, but will depend on the size of the contributions (pension capital), the return on this capital and the length of the withdrawal period chosen by the employee. The

costs of the scheme, i.e. the premiums to be paid, are predictable for the company. The employee bears all the risk related to returns on pension capital.

Occupational pensions have been mandatory in Norway since 2006. It became a statutory duty for private sector companies to establish an occupational pension scheme (primarily in companies with more than one employee). Employers must make contributions of at least 2% of employee earnings between 1 G and 12 G in a defined contribution pension scheme (G is the social security base amount, which was NOK 90 068 in 2015). Contributions are capped at 5% of earnings between 1 G and 6 G and at 8% of a member's earnings between 6 G and 12 G.

Pension capital is still highest in the defined benefit pension schemes, but premiums for the defined contribution schemes operated by Norwegian insurance companies are now higher than for the defined benefit schemes.

An employee who leaves a company that has a defined benefit pension scheme receives a paid-up policy. Paid-up policies are pension entitlements accrued through private sector employment. An employee will also receive a paid-up policy if the company chooses to discontinue the defined benefit scheme in favour of a defined contribution scheme or if the company closes down.

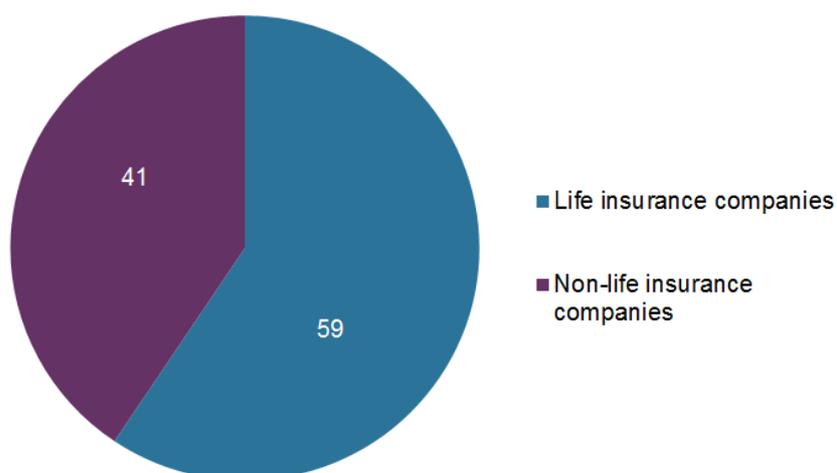
Pensions are a tax-favoured form of saving in Norway. Premiums are tax-free up to a certain limit, while pension benefits are taxed in line with other income.

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Life insurance companies and pension funds are often bracketed together when the life insurance market is discussed, because pension insurance is a very important part of life insurance companies' activities and most pension savings are held by life insurance companies. This is the case for the statistics used in this section. However, life insurance companies and pension funds are subject to different legislation, and pension funds are therefore discussed in Section 3.6 *Pension funds*.

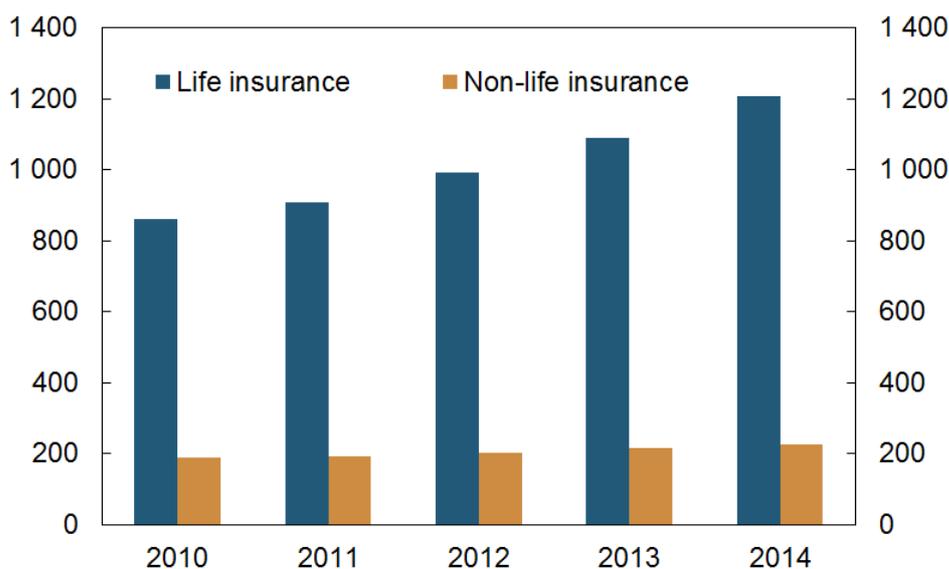
Life insurance accounts for the largest share of the insurance market in Norway, representing about 60% of the income from premiums (Chart 3.11). For pension insurance, the insurance premium includes a substantial saving element, and the insurance company manages these funds until the time comes for benefits to be paid out. As a result, insurance premiums and total assets for life insurance companies are high compared with non-life insurance companies (Chart 3.12).

Chart 3.11 Insurance companies in Norway.  
Market shares based on premium income. Percent. 2014



Source: Statistics Norway

Chart 3.12 Total assets of insurance companies.  
In billions of NOK. 2010–2014

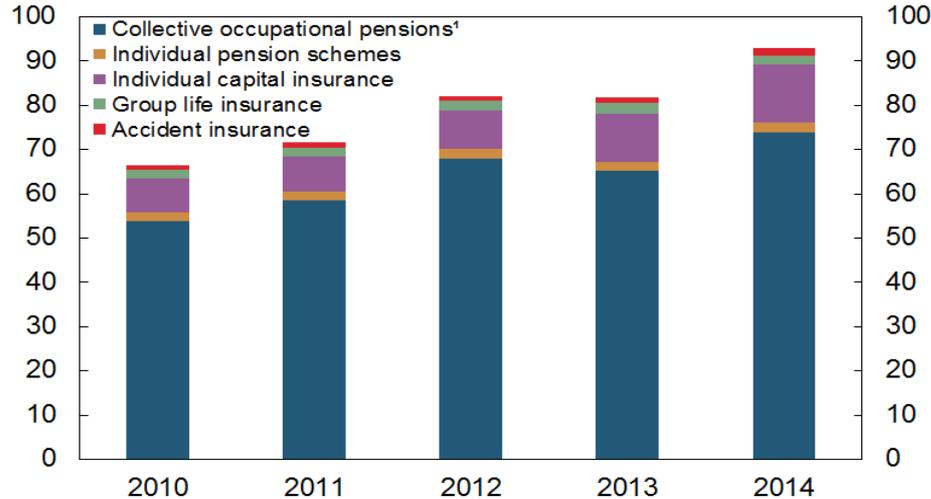


Source: Statistics Norway

Most premium income at life insurance companies is derived from pension insurance (Chart 3.13). Pension insurance comprises collective occupational pensions and individual pension schemes. Pension insurance provides fixed payments over an agreed period of time. Individual capital insurance provides a one-time payment in the event of death or disability.

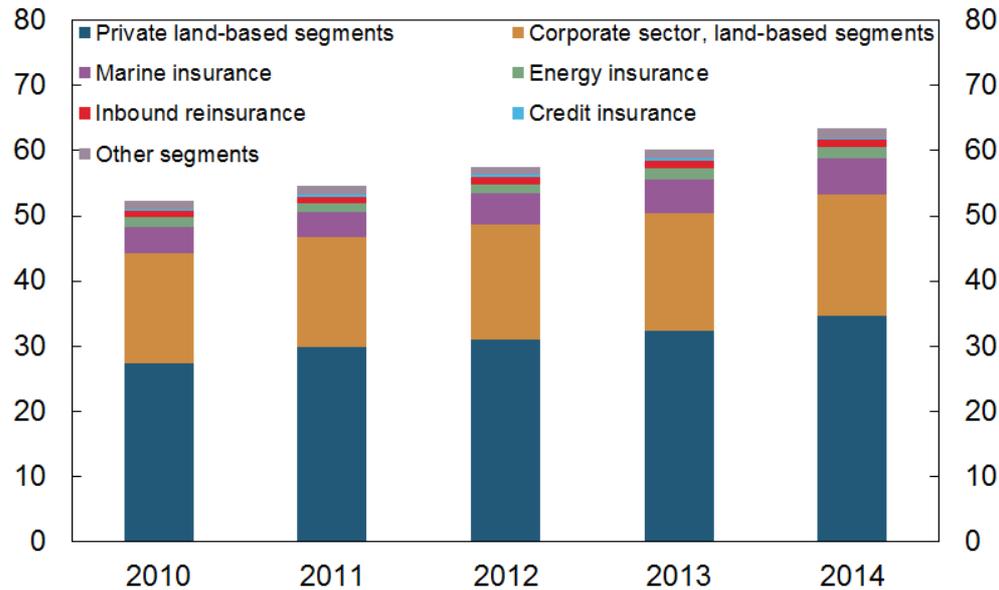
Private land-based insurance policies and land-based insurance for the corporate sector are the main groups contributing to non-life premium volumes (Chart 3.14). Auto insurance is the largest segment.

Chart 3.13 Life insurance companies' premium income by segment.  
In billions of NOK. 2010–2014



1) Includes pension schemes under the Company Pensions Act, the Defined Contribution Pensions Act and the Occupational Pensions Act. Data unavailable for company pension schemes in the period 2010–2013.  
Source: Statistics Norway

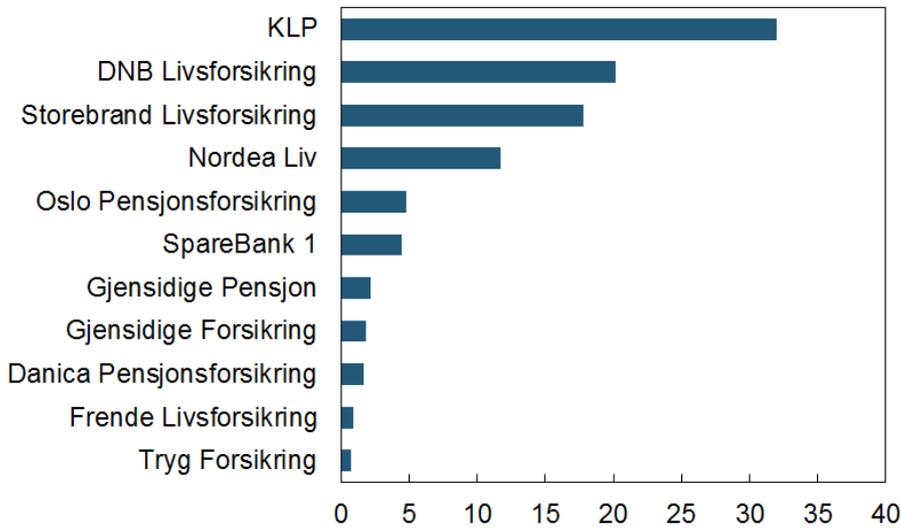
Chart 3.14 Non-life insurance companies' premium income by segment.  
In billions of NOK. 2010 - 2014



Source: Statistics Norway

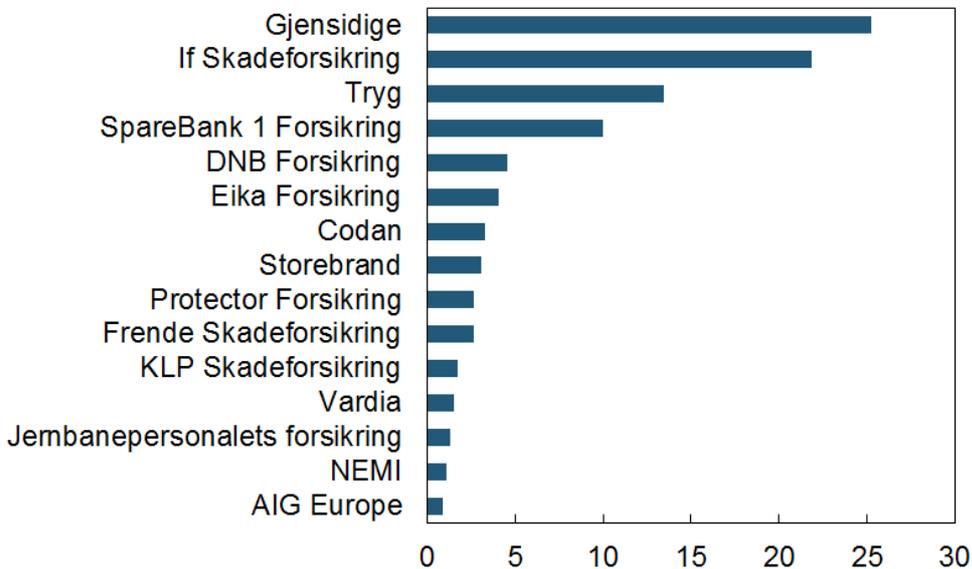
In 2015 Q4, there were 19 life insurance companies and 88 non-life insurance companies in Norway (see [Statistics Norway's website](#)). In 2013, foreign insurance companies had a market share of about 12% in the life insurance market and 43% in the non-life market (see *OECD Insurance Statistics 2014*). Ranked by income from premiums, KLP, DNB Livsforsikring, Storebrand Livsforsikring and Nordea Liv are the largest life insurance companies (Chart 3.15). Gjensidige, If Skadeforsikring, Tryg and SpareBank 1 Forsikring are the largest companies in the non-life market (Chart 3.16).

Chart 3.15 Life insurance market shares by premium income.  
Percent. 2015 Q4<sup>1</sup>



1) Provisional data for 2015 Q4.  
Source: Finance Norway

Chart 3.16 Non-life insurance market shares by premium income.  
Percent. 2015 Q4



Source: Finance Norway

Life insurance companies' main assets are Norwegian and foreign bonds, commercial paper, equities and property. Liabilities chiefly comprise customer claims. Claims are calculated as the present value of future payments to policyholders by the insurance company. These are referred to as technical provisions. Insurance companies do not borrow.

As insurance is often in the form of long-term contracts where confidence in the integrity of the agreement is important, insurance companies are subject to specific regulation (see **Box: Regulation of insurance companies**).

### Box: Regulation of insurance companies

Pension providers (life insurers and pension funds) manage substantial assets on behalf of policyholders. Policyholders' savings are managed for a long period before pension benefits are paid. For long-term saving to function, policyholders must have confidence in pension providers. The main objective of government regulation is to ensure that pension providers have sufficient funds to meet their future obligations (see "[Pensjonsinnretningenes tilpasning til Solvens II](#)" [[Pension providers' adaptation to Solvency II](#)] (in Norwegian only), Norges Bank *Penger og Kreditt* 1/2012).

The Solvency II Directive is a revised set of EU rules governing insurance companies. Solvency II was adopted by the EU Commission in 2009 and came into effect on 1 January 2016, although long transition periods are planned. Solvency II does not apply to pension funds.

Solvency II takes account of risks on both the asset and the liability side of the balance sheet. The new regime is different from the existing framework in several areas. Under Solvency II, both assets and liabilities are calculated at market value. Under the previous framework, the value of insurance liabilities is calculated using a fixed rate. Under Solvency II, the market value of liabilities will be calculated by discounting future liability cash flows using risk-free market rates.

A low interest rate environment is particularly challenging for life insurance companies under Solvency II. With low interest rates, the current value of insurance liabilities is increasing. At the same time, life insurance companies are finding it increasingly difficult to achieve sufficient returns to meet the minimum return guarantee on contracts that include such a guarantee.

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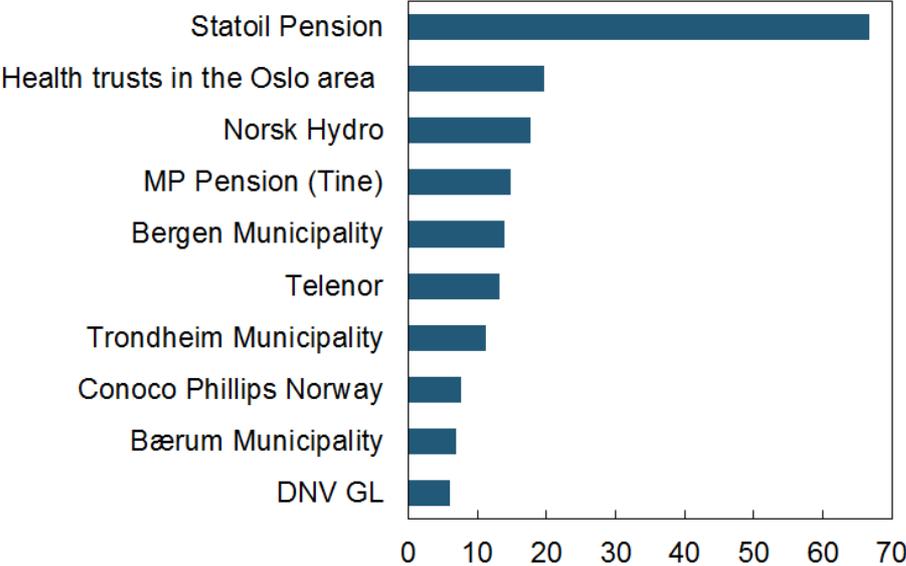
## 3.7. Pension funds

As mentioned in Section 3.5 *Insurance companies*, a portion of pension savings in Norway is held in pension funds. A pension fund is an autonomous institution established by a private or public (municipal) enterprise offering one or more collective occupational pension schemes. There were 87 private and public sector pension funds in Norway at the end of 2015. The largest of these are shown in Chart 3.17. Pension funds in Norway hold total assets of about NOK 300bn, primarily consisting of bonds, equities and real estate (Chart 3.18).

The two largest pension funds, Statens pensjonskasse (SPK, the Norwegian Public Service Pension Fund) and Kommunal Landspensjonskasse (KLP), are not included in these figures. SPK administers occupational pension schemes for employees in the public sector and state-owned companies. SPK also administers the pension scheme for some groups in the local government sector and the private sector. Stortinget

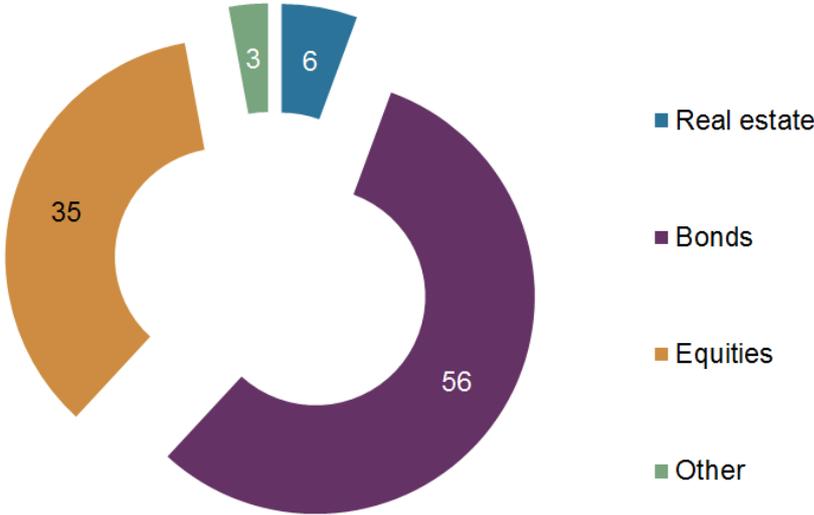
(Norwegian parliament) determines the framework and lays down regulations for SPK pursuant to the Act relating to SPK. SPK members pay a pension contribution of 2% of their salary. Employer contributions are only paid by enterprises with independent revenues. The portion of annual pension payments that is not covered by contributions is financed by government subsidies. SPK is therefore not a fully funded, but a pay-as-you-go pension scheme. Accrued pension entitlements in SPK amounted to NOK 492bn at the end of 2015. SPK offers housing loans to its members. SPK housing loans totalled NOK 75bn at the end of 2015.

Chart 3.17 The largest private and public (municipal) pension funds. Total assets in billions of NOK. At 31 December 2015



Source: Finanstilsynet

Chart 3.18 Pension funds' assets. Selection of 48 pension funds. As a percentage of total assets. At 31 December 2015



Source: Finanstilsynet

KLP provides pension, financial and insurance services for local authorities, health trusts and public sector enterprises and offers defined-contribution occupational pensions for private sector firms. KLP is organised as a mutual insurance company. This means that when a pension scheme is established, KLP customers invest capital and thus become the company's owners. KLP's main product is occupational pensions for municipal employees. KLP pension schemes are fully funded. At the end of 2015, public sector pension scheme assets accounted for NOK 412bn of the KLP group's total assets of NOK 543bn. These savings, from premiums paid in by employers and economically active members, are primarily invested in equities, real estate, bonds and lending.

### 3.8. Mutual funds

A securities fund or mutual fund is a collective investment scheme whereby a large number of unitholders pool their investments in securities markets. A securities fund is a legal entity owned by the unitholders and its assets are administered and managed by a securities fund management company authorised by Finanstilsynet (Financial Supervisory Authority of Norway). There are a number of advantages in investing via a collective investment fund rather than as an individual investor investing in individual equities or bonds.

First, securities funds can benefit from economies of scale, which lowers costs. This may be offset to some extent by management fees. Second, it is easier to spread risk across a large number of securities. This is known as diversification. Third, professional investment managers may be able to offer better returns and risk management.

Diversification means spreading risk by allocating investments among several securities, such as equities. Since the individual securities rarely move exactly in tandem, total risk in a diversified portfolio will be lower than if the investment were allocated to only one security.

Companies managing securities funds can be owned by banks, insurance companies or others (Chart 3.19, which shows the largest fund managers). Each management company usually offers a large number of funds with differing investment profiles.

Chart 3.19 Market shares of mutual fund management companies.  
Percent. At 31 December 2015



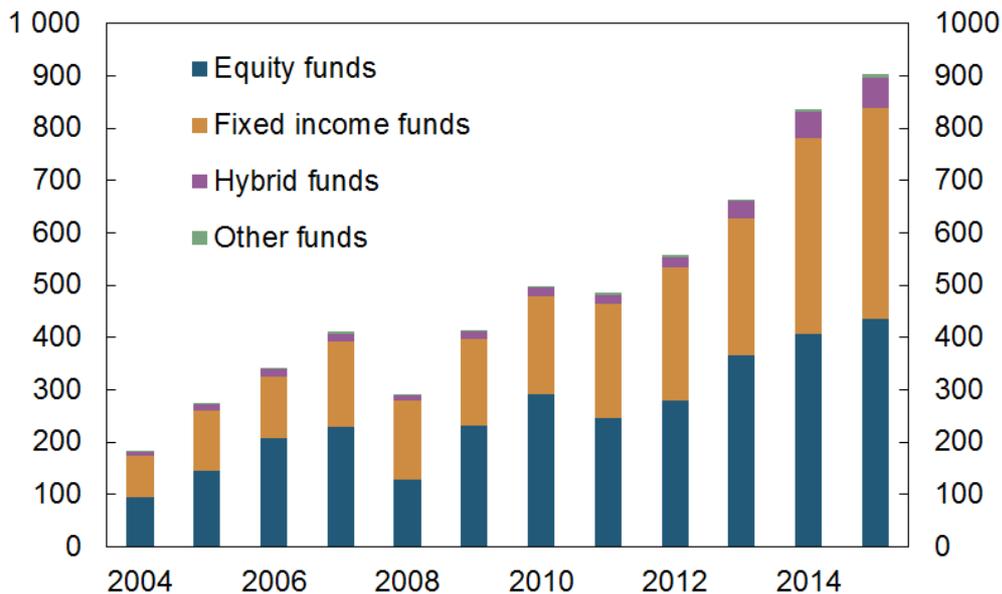
Source: Norwegian Fund and Asset Management Association

### 3.8.1. Types of fund based on underlying asset

Assets under management by securities funds in Norway totalled NOK 904bn at the end of 2015. These funds can be classified by investment instrument (Chart 3.20):

- Equity funds account for close to half of total assets under management by securities funds.
- Fixed income funds also account for a substantial share and invest in fixed income instruments. Although the majority of fixed income funds are bond funds, they also include money market funds and “other fixed income funds”.
- Balanced funds invest in both equities and fixed income securities. Other funds include Alternative Investment Funds (AIF), which differ from the other funds in that asset management operates under relatively loose constraints (see below). In other countries, these funds are referred to as hedge funds and they invest substantial sums of capital. In Norway, they are also known as specialised funds, with a modest level of investment.

Chart 3.20 Assets under management by mutual funds by type of fund.  
In billions of NOK. At year-end

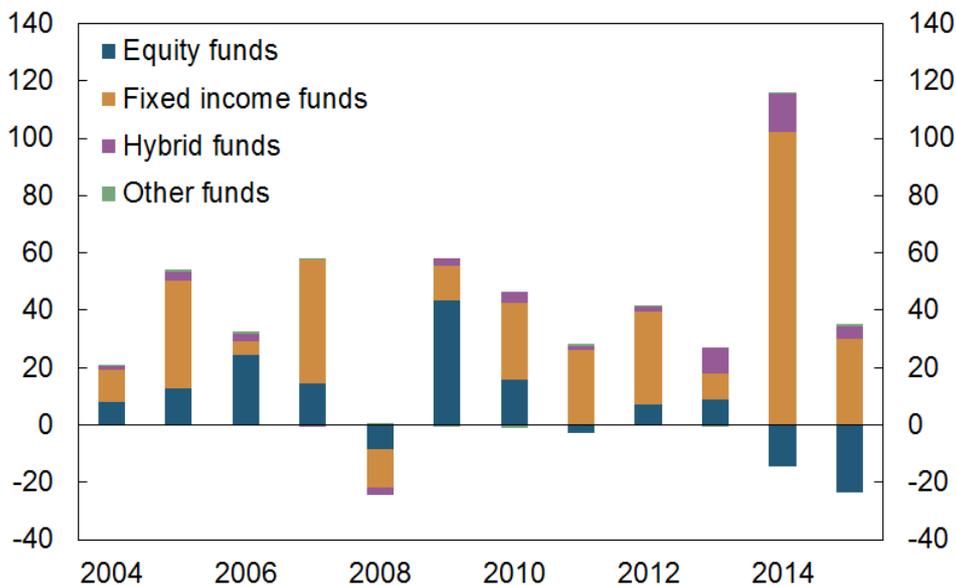


Source: Norwegian Fund and Asset Management Association

Total capital in securities funds grew by 8% in 2015, or NOK 69bn, of which NOK 12bn was net subscription, primarily in fixed income funds. Equity funds registered net redemption (Chart 3.21).

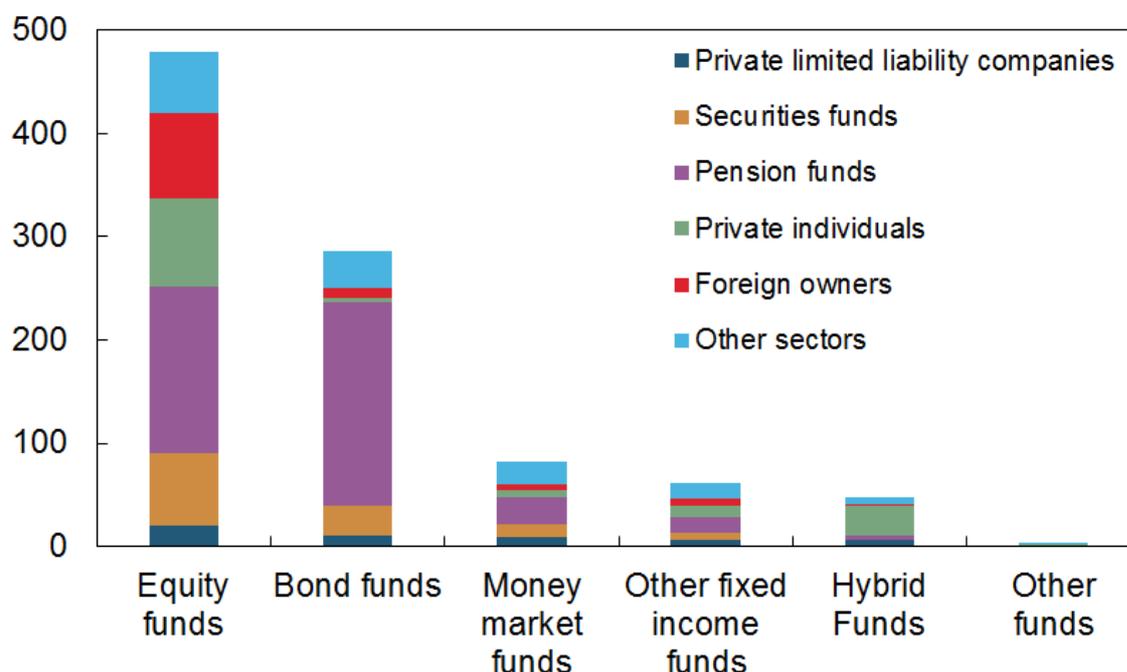
Norwegian securities funds are primarily owned by life insurance companies and pension funds (Chart 3.22). Private individuals hold units in equity funds, but to a limited extent in bond funds.

Chart 3.21 Net purchases of mutual fund shares per year.  
In billions of NOK



Source: Norwegian Fund and Asset Management Association

Chart 3.22 Holdings of mutual fund units, by holding sectors.  
In billions of NOK. At 31 December 2015



Source: Statistics Norway

### 3.8.2. Passive and active funds

Securities funds can also be classified by their form of management or how the investment units are traded. Funds are commonly classified as passively or actively managed funds, exchange traded funds or so-called funds of funds.

Passively managed funds seek to recreate developments in a given portfolio of securities (the benchmark index). As the portfolio is composed to mirror a benchmark index, these funds are often called index funds. An equity index fund, for example, holds equities in various companies in approximately the same proportion as the proportion of these equities in the benchmark index. The fund's return is then expected to track the average return on the equities included in the index. Passively managed funds conduct fewer trades than actively managed funds and their costs are therefore lower (both management costs and trade-related costs).

Actively managed funds try to “beat the index” by carefully selecting investments and buying and selling stocks when changing market conditions offer “new opportunities”. With analyses and frequent purchases and sales of securities, the cost of active management is higher than for passive management. Examination of returns for the various funds shows that very few actively managed funds have outperformed index funds over time.

Although exchange traded funds (ETFs) are one of the most rapidly growing segments in the global financial market, there are few of these funds in Norway. These funds are traded over a stock exchange like equity. ETFs are usually index funds. At the end of

2015, there were only four exchange traded funds on Oslo Børs with a total market value of NOK 3bn.

Some securities funds are so-called funds of funds. These funds invest in other funds and achieve a broader diversification of risk, although this also involves an additional investment management fee for investors.

### 3.8.3. Regulation of securities funds

The Securities Fund Act regulates the organisation and scope of securities funds and fund management companies. Securities funds are regulated to safeguard the interests of their unit holders, for example by ensuring that investments are diversified to spread risk and that unit holders receive information about historical returns, risk and costs. Finanstilsynet is responsible for supervising management companies to ensure that they operate in compliance with legislation. All securities funds registered in Norway are subject to approval by Finanstilsynet.

The legislation distinguishes between securities funds and alternative investment funds (AIFs). Restrictions on investment strategies and types of financial instrument, such as derivatives, are less strict for AIFs than for securities funds. The legislation is based on the assumption that AIFs are best suited for professional investors. In order to market AIFs to non-professional investors, the management company must meet certain additional requirements (special authorisation, suitability testing and documentation, key information, appeal scheme, etc.).

A professional investor can for example be an institutional investor whose main activity is investing in financial instruments or a limited liability company with a high level of equity, turnover or balance sheet total. For a more detailed definition, see Section 10-2 of the Securities Trading Regulations.

## 3.9. Other financial undertakings

### 3.9.1. Finance companies

Finance companies mainly provide short-term loans in the form of leasing, factoring, debt instrument loans for the corporate sector and consumer loans, often credit card loans. Lending is primarily financed through short-term borrowing. Finance company lending totalled around NOK 170bn at the end of 2015. Over 30% of finance companies in Norway, measured by lending volume, are foreign companies with branches in Norway.

Factoring is a form of financing whereby a business sells its accounts receivable (i.e. its invoices) to the finance company (called a factor), which manages the invoices for a fee.

### 3.9.2. Securities firms

Securities firms or investment firms act as intermediaries in securities markets and are authorised by Finanstilsynet to offer investment services related to financial instruments. Securities firms have a crucial role in secondary market trading of financial instruments (brokerage) and in providing underwriting services for companies issuing stock on the primary market. The most important services offered by securities firms, in addition to traditional brokerage and underwriting services, are investment advisory services, analysis and guaranteeing full subscription of an issue.

Securities firms also provide active management of investors' portfolios on an individual basis and as authorised by the investor. To prevent conflicts of interest between clients and between undertakings and clients, active management is not normally provided alongside traditional brokerage, but through separate securities firms.

Securities firms are regulated by the Securities Trading Act and are subject to supervision by Finanstilsynet. Extensive statutory requirements govern securities firms' activities and organisation. The firm must be structured in such a way that the risk of conflicts of interest is kept to a minimum. In addition, the firm's management and owners must be fit to manage and own a securities firm.

At the end of 2015, there were 114 securities firms in Norway authorised by Finanstilsynet. Of these, 25 were banks authorised to operate as securities firms, including DNB.

### 3.9.3. Investment companies

Investment companies are companies with one or more owners, established to invest in an underlying portfolio of assets, normally on behalf of a number of investors. The company's structure is often based on external management and administration. Investment companies mostly invest in equities, bonds and real estate. As they are not financial undertakings, they do not need a special license to operate and are not subject to supervision by Finanstilsynet.

### 3.9.4. Venture capital companies

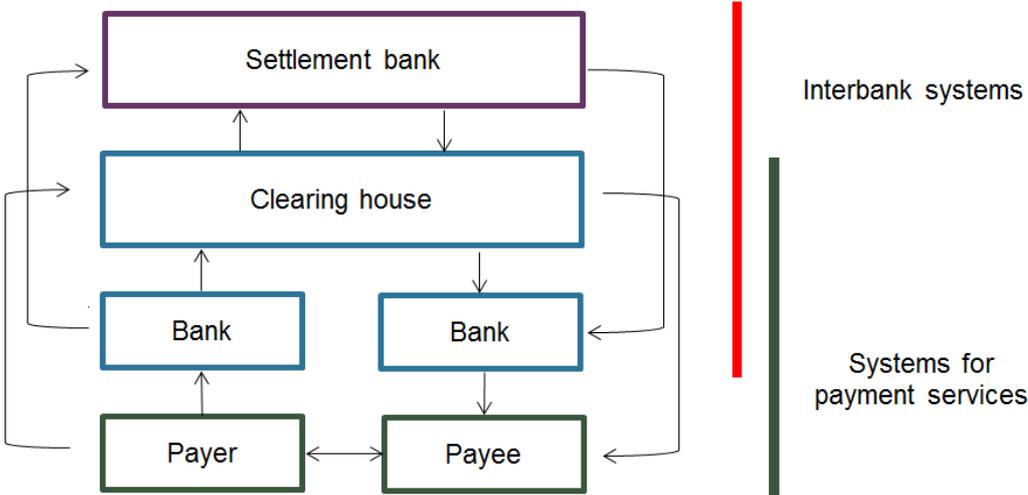
Venture capital companies are a type of investment company that invests in unlisted companies. They offer equity or debt capital financing of startups, particularly in the technology sector. Investment is motivated by the prospect of a future sale or listing. Debt capital is often provided in the form of convertible bonds, which investors can convert into shares at a later date. Venture capital companies are often organised as financing partnerships between institutional investors and affluent private individuals.

# 4. Financial infrastructure

The financial infrastructure is defined as the systems through which financial transactions between economic agents are performed. This includes all types of transaction, from everyday card payments in shops to trades in the securities and foreign exchange markets. An efficient financial infrastructure is an essential part of a modern economy. Examples of the financial infrastructure are payment systems, securities settlement systems, central securities depositories, central counterparties and trade repositories. The financial infrastructure comprises both the technical systems and the agreements and regulations governing their use. This publication treats cash as part of the financial infrastructure.

A payment system can be divided into “systems for payment services” and “interbank systems” (Chart 4.1). Systems for payment services are the part of the payment system that is aimed at customers and makes it possible for consumers and firms to withdraw cash from their bank accounts, use payment cards and make online payments. An interbank system is a system that enables banks to settle payments between themselves.

Chart 4.1 The Norwegian payment system



At the core of the Norwegian interbank system are Norges Bank’s settlement system (NBO) and the Norwegian Interbank Clearing System (NICS). Read more about NICS in *Section 4.2.2 The Norwegian Interbank Clearing System (NICS)*. NICS calculates what the banks owe each other based on all of the payments made by their customers. The result of this clearing process is sent four times daily to NBO, where the balances on the banks’ accounts with Norges Bank are adjusted accordingly.

Banks’ currency trading runs into the hundreds of billions of kroner a day. There can therefore be heavy losses if a counterparty is unable to fulfil its obligations. A global

multi-currency bank called CLS (Continuous Linked Settlement) has been created to limit this risk, with a view to preventing losses arising in the settlement of currency trades by ensuring that one side of a trade is not paid without the other side also being paid.

The securities settlement system (VPO) covers settlement of money and securities in connection with securities trading. While payments for securities are settled at Norges Bank, the actual securities are transferred through Verdipapirsentralen ASA (VPS). VPS owns and operates the Norwegian central securities depository, where ownership of securities is documented (see **Box: Central securities depositories** in *Section 4.3* and on [VPS's website](#)).

Central counterparties play an important role in financial markets. They enter into trades in financial instruments and become the buyer for the seller, and the seller for the buyer. The risk of one of the parties to a trade being unable to fulfil its side of the bargain – known as counterparty risk – is transferred to the central counterparty, which guarantees that the trade will be completed. Since April 2010, Oslo Børs has required all equities traded on the exchange to be settled through central counterparties.

## 4.1. Retail payment services

Retail payment services cover payments between households, firms and government, which are relatively low in value but high in number. A distinction is drawn here between means of payment and payment instrument.

A means of payment is a claim that is transferred between buyer and seller as payment for goods, services or other receivables. There are two main means of payment: cash, which is a claim on Norges Bank, and bank deposits (deposit money), which are claims on banks (see **Box: What is money?** in *Section 3.2*). Electronic money (e-money) is a third means of payment and consists of digital value units that are used only for electronic payments. It can take the form of both prepaid cards and balances on e-money accounts.

Payment instruments are the ways in which means of payment are transferred. These can be divided into three main groups: cash, payment cards and bank transfers (such as online payments).

When paying at the point of sale, it is mainly cards and cash that are used, but cards and bank transfers are most common for remote payments where buyer and seller do not physically meet. To further facilitate cross-border payments, the EU is working on common payment solutions (see **Box: The Single Euro Payments Area (SEPA)**).

### Box: The Single Euro Payments Area (SEPA)

SEPA is a European initiative for common payment solutions. The aim is to create a single European platform for payment systems rather than having national systems with different formats and prices. The basis for SEPA was laid by an EU regulation in 2001, setting out that transfers of euros between EEA countries must cost the same as

a corresponding domestic transfer. The regulation covers only the price of payments in euros. The regulation has been implemented in Norway and applies to payments of euros to and from Norway, but not to payments in Norwegian kroner.

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#### 4.1.1. Cash

Cash is both a means of payment and a payment instrument. Norwegian banknotes and coins constitute a claim on Norges Bank and have some similarities with promissory note. This means that the economic value is represented by the note or coin itself, and settlement between buyer and seller takes place immediately when the notes and coins are handed over.

Deposit money can be converted into cash over the counter at a bank branch, through a withdrawal from an ATM or through a point-of-sale (POS) withdrawal when making purchases of goods (cash-back). Conversely, cash can be converted into deposit money over the counter in a bank branch or using banks' cash deposit machines. The average size of an ATM withdrawal was just over NOK 1 600 in 2015, while the average POS withdrawal was around NOK 450.

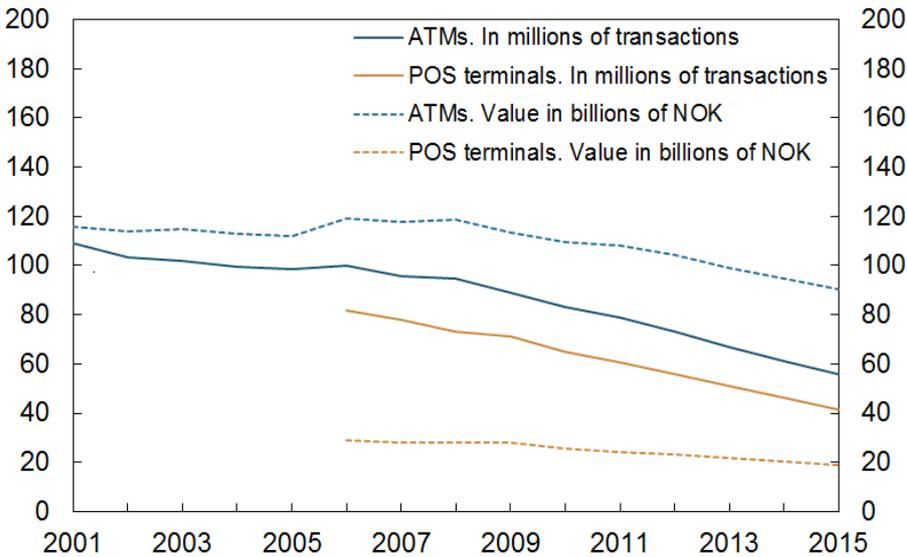
Cash is legal tender in Norway for transactions of any size. This means that payment can always be made using notes and coins issued by Norges Bank. The payee is not, however, obliged to accept more than 25 coins of any one denomination. The *Act on Financial Undertakings and Financial Groups etc. (Norwegian only)* requires banks to accept cash from customers and make deposits available to customers in the form of cash, in line with customers' needs and expectations. In other words, banks must ensure that customers have ready opportunities to convert deposit money into cash and vice versa. Deposit money is a widely accepted means of payment but is not legal tender.

The share of cash payments has fallen in recent years. Both ATM and POS withdrawals are in decline (Chart 4.2). Interview surveys suggest that 24% of payments were made in cash in 2007, and only 15% in 2013. In terms of value, the decrease during this period was from 14% to 7% (see "*Costs in the Norwegian Payment System*", *Norges Bank Papers 5/2014*). The results of the survey of the public's use of cash are, however, associated with considerable uncertainty.<sup>3</sup> The value of cash in circulation has been relatively stable in recent decades but has fallen as a share of total money (M1), private consumption and mainland GDP (Chart 4.3). A revision of the money supply statistics in 2015 resulted in decrease in cash's share of M1, especially from 2014 to 2015.

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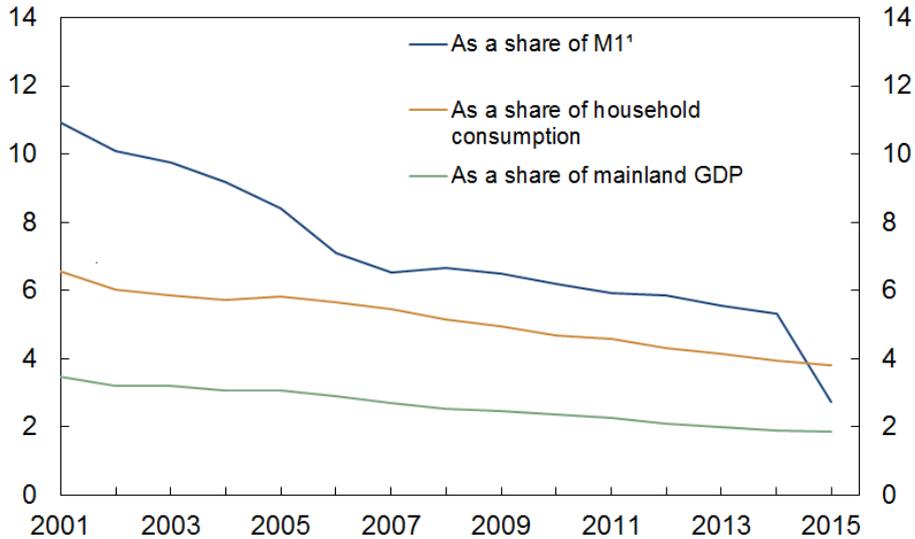
<sup>3</sup> An alternative survey of selected merchants carried out by Norges Bank suggested that cash payments account for 36% of POS payments and 20% of total sales. Only a limited number of retailers provided information on the use of cash, and the sample was not entirely representative. However, the sample included several major retail chains, and the spread in the results from the two surveys illustrates the uncertainty associated with estimates of this kind. Cash is also used for person-to-person payments, but these payments are not included in the data from retailers.

Chart 4.2 Cash withdrawals from ATMs and POS terminals. 2001–2015



Source: Norges Bank

Chart 4.3 Value of cash in circulation as a share of means of payments (M1), household consumption and mainland GDP. Percent. 2001–2015



1) M1 has been redefined from 2015.  
Sources: Statistics Norway and Norges Bank

#### 4.1.2. Payment cards

There are three main types of payment card: debit cards, charge cards and credit cards.

A debit card is issued by a bank and is linked to a bank account. Transactions are debited directly from the cardholder’s account. A charge card does not debit the cardholder’s account directly. Instead, the card issuer accumulates purchases over a given period and bills the cardholder the total amount for that period. A credit card works like a charge card but gives the cardholder the option of credit. This means that

the cardholder can choose to pay off all, part or none of the balance on the card. Any amount unpaid is rolled over to the next period, and interest accrues on it.

BankAxept is Norway's national debit card system. Owned and operated by banks in Norway through a limited company, it is by far the most widely used system in Norway. However, the use of international cards is growing rapidly. These are payment cards issued in Norway by Norwegian banks or card companies under licence from international card systems such as Visa and MasterCard. These can be debit cards, charge cards or credit cards (see box below)

**Box: How do BankAxept card payments work?**

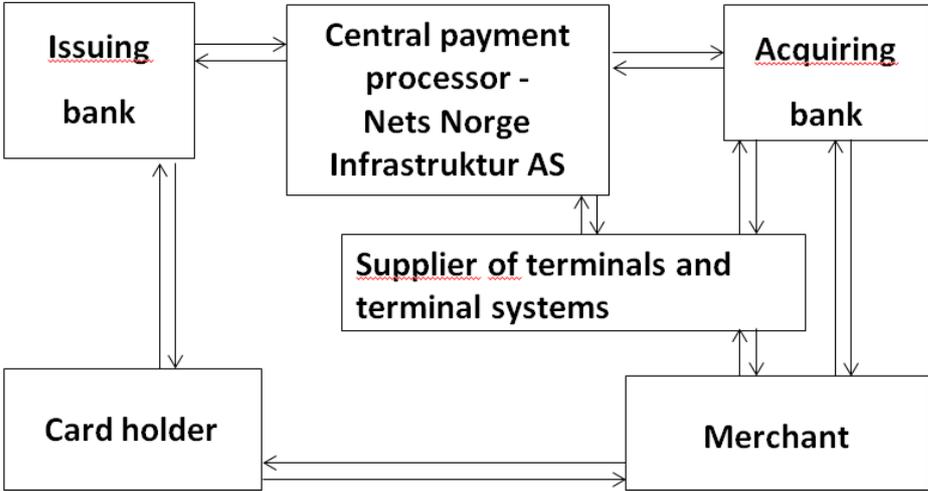
Eight out of ten card payments in Norway are made with a BankAxept card. Most of these payments come under the category of debit card transactions. The majority of BankAxept cards also include another payment solution, generally Visa, but BankAxept is automatically selected by most payment terminals unless the payer actively chooses the alternative payment solution.

To be able to accept payments with BankAxept cards, a shop (the merchant) must have an agreement with a bank that guarantees settlement of these transactions. Settlement means that the merchant's account is credited with all payments made with BankAxept cards using the shop's payment terminals in a given period. The terminals themselves can be rented or purchased from banks or other suppliers. Payers must have an agreement with a bank to link a BankAxept card to their account.

**What happens when a payment is made with a BankAxept card?**

When a customer uses a BankAxept card, the terminal reads the data on the card and asks the customer to enter a PIN. A request to authorise the payment is then generated. This is sent to a central payment processor, which checks that the correct PIN has been used and that the request comes from a genuine terminal at a real merchant. The authorisation request is then forwarded to the issuing bank (the cardholder's bank) (Chart 4.4).

Chart 4.4 Purchase of goods using BankAxept



The issuing bank checks that the criteria for authorising the transaction are met: the card has not been blocked, and there are sufficient funds. The response (yes or no) is sent by the issuing bank to the processor, which then forwards it to the terminal at the point of sale, where the result is displayed on the screen. All of this normally takes place in less than half a second.

Nets Norge Infrastruktur AS (NNI) then generates transaction data which are sent to NICS for clearing and settlement between the banks (see *Section 4.2.2 The Norwegian Interbank Clearing System (NICS)*). Clearing and settlement of these transactions take place four times each weekday. Until settlement, a hold is placed on the authorised amount in the payer's account so that this money cannot be spent twice. After settlement, NICS sends the transaction data to the acquiring bank (the merchant's bank) for the merchant's account to be credited, and to the issuing bank for the payer's account to be debited.

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There were 14.7m payment cards in issue in Norway at the end of 2015. The most common types are co-badged, combining BankAxept and an international debit card. More than half of issued payment cards are of this type, while a third are international credit cards. The most common way of paying with a payment card is where the card's chip is read by a physical payment terminal and the cardholder keys in a security code (PIN).

Contactless payments are becoming increasingly common. These use either a physical card or a mobile phone on which the card details are stored electronically. Communication between the payment terminal and the payment card or phone uses wireless technology: payment is made by holding the card/phone close to the payment terminal. The user does not normally need to enter a PIN if the amount is below a certain amount (see **Box: Mobile payments**).

### Box: Mobile payments

It has long been possible for bank customers to use their mobile phones to pay bills and transfer money, either through mobile access to online banking or through special mobile banking solutions. Recently, a variety of new mobile payment solutions have become available to the general public in the form of smartphone apps that make it possible to pay with a phone in shops and simplify transfers between private individuals. These solutions are sometimes known as digital wallets.

For now, most mobile payment solutions in the Norwegian market are based on payments and transfers being charged to a payment card (see *Section 4.1.2 Payment cards*). One of the solutions, however, can also debit a bank account or e-money account directly.

Importance has been attached to making the new solutions user-friendly so that they offer a real alternative to more traditional forms of payment, such as cash, cards and mobile banking.

When transferring money to another consumer, it now suffices to know the payee's mobile phone number. The funds are available to the payee immediately if the transfer

is between accounts at the same bank. If two banks are involved, the transfer will typically take a day, although a hold is placed on the funds in question from the moment the payer approves the transfer.

To make a payment to a merchant (in a shop or online), the user first opens the payment app (with a password or fingerprint) and establishes a connection with the merchant. A simple manual operation from the user (generally a swipe across the screen of the phone) then confirms the payment.

There are no publicly available statistics on the use of these new mobile payment apps. Download statistics reveal, however, that DNB's Vipps app had been downloaded more than 1.2m times at the end of 2015.

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Payment cards are also used for remote payments, mainly when buying goods online. In this case, users enter their card details and approve payments in an online payment terminal direct from their own PCs. Alternatively, the process can be simplified using a digital wallet (see **Box: Mobile payments**).

Some non-financial institutions also issue cards for payment purposes, such as supermarket and filling station chains. These cards can be used only in the issuer's outlets and are not therefore counted as payment cards. Nor are transactions using these cards counted as payments.

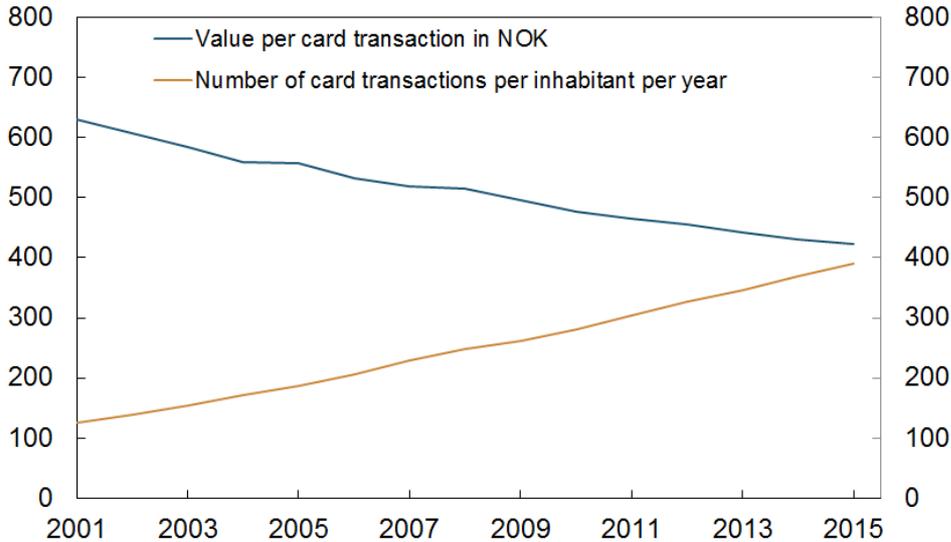
The number of purchases of goods using payment cards has grown rapidly over time. This growth is due both to the rise in the total number of payments (increased spending) and to card payments having replaced cash payments to some extent.

There were more than 2bn card transactions in 2015 (including cash withdrawals), or an average of 391 transactions per capita (Chart 4.5). The average value of these transactions was NOK 423.

#### 4.1.3. Bank transfers

Households use bank transfers to pay their mortgages, taxes and bills. Firms use them to pay other firms and to pay their employees.

Chart 4.5 Card transactions per inhabitant per year and valute per card transaction in NOK. 2001–2015



Source: Norges Bank

Bank transfers, also known as giro payments, involve the transfer of money from one account to another. There are two types: debit transfers initiated by the payee and credit transfers initiated by the payer.

Payments that a user makes using online banking are an example of a credit transfer, whereas direct debits are an example of a debit transfer. If debit transfers are combined with a bill that is sent electronically (e-billing), the payment process will be entirely automatic for the customer. Both payee and payer must have an agreement with their bank for direct debits to take place.

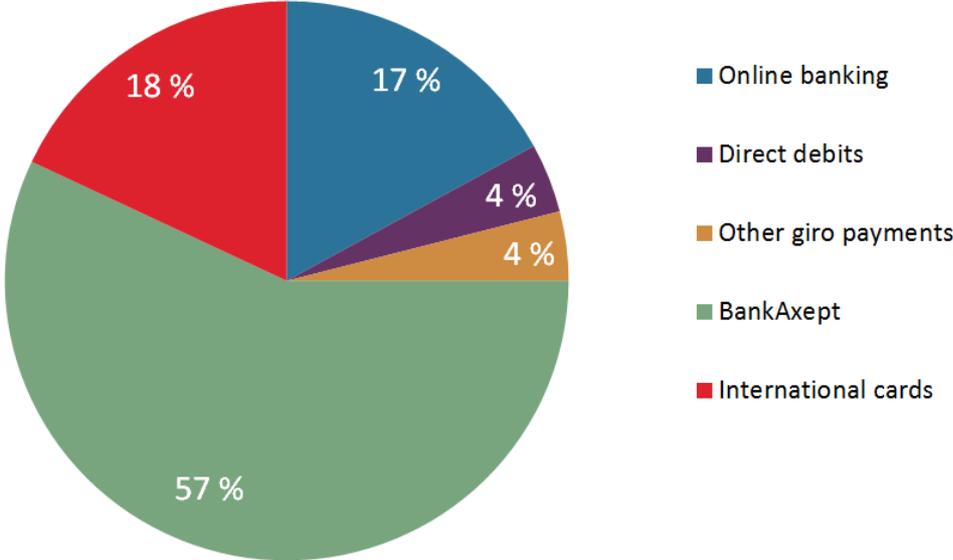
Bank transfers are used mainly for remote payments where payer and payee do not physically meet. However, some payments at point of sale can also result in bank transfers. For example, a payment with a credit card will initially count as a card payment, but eventually the customer will be sent a bill that needs to be paid. This last payment counts as a bank transfer.

The number of card payments was three times higher than the number of bank transfers in 2015 (Chart 4.6), but the total value of bank transfers was still much higher than the total value of card payments. While the average card transaction in 2015 was NOK 423, the average online banking payment was around NOK 62 500 for firms and NOK 5 400 for retail customers.

The vast majority of bank transfers made by retail customers are now electronic (Chart 4.7). Paper-based and manual transfers, such as postal giro and telegiro payments, are scarcely used these days. Standard online banking payments are by far the most common way for retail customers to pay their bills, but the use of more efficient methods, such as direct debits, is growing rapidly. These payments are made automatically when they fall due, provided that the customer's account has sufficient funds.

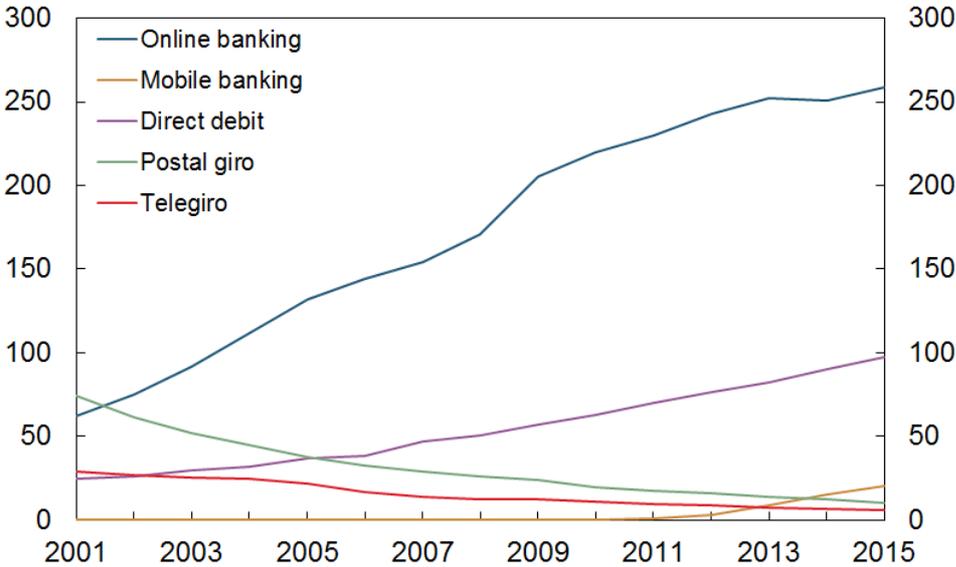
These different ways of paying vary in cost (see **Box: The cost of different payment instruments.**)

Chart 4.6 Selected payment instruments use as a share of total number of transactions. 2015



Source: Norges Bank

Chart 4.7 Debit and credit transfers by retail customers. In millions of transactions. 2001 - 2015



Source: Norges Bank

**Box: The cost of different payment instruments**

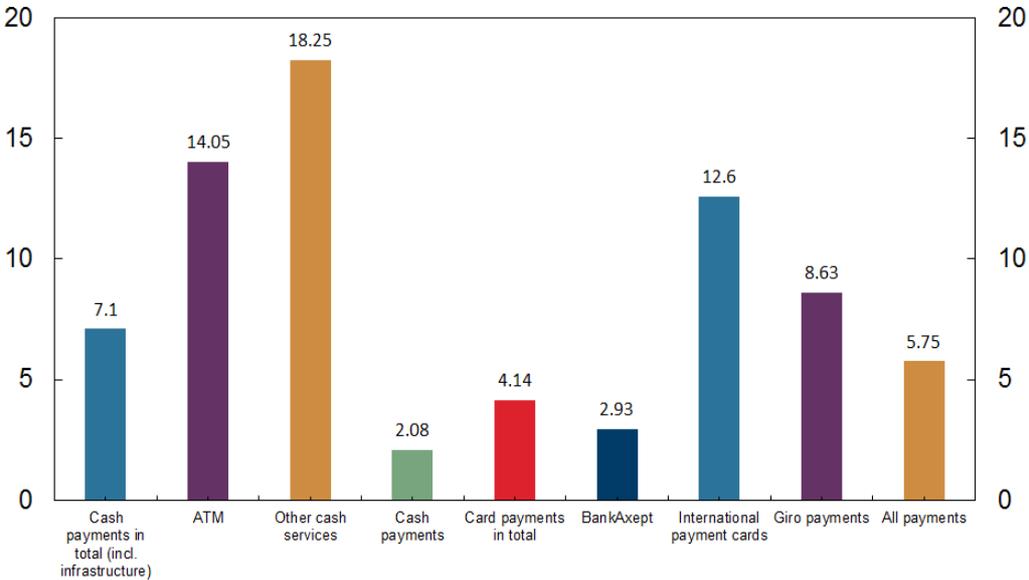
In autumn 2014, Norges Bank published a survey of payment costs based on 2013 data. The total economic cost of the use of cash, payment cards and bank transfers was

estimated at NOK 14.5bn, or 0.6% of mainland GDP. This includes costs both for those providing the services and for those using them. Compared to a similar survey in 2007, costs had come down somewhat.

Different ways of paying have different economic costs. Cash payments are somewhat more expensive than card payments as a whole, although the figures for cash payments are associated with considerable uncertainty.<sup>4</sup> One important reason for this is that the infrastructure for handling cash is to some extent manual and so more costly. Cash payments are still cheaper than international payment cards, however. A payment with an international payment card costs NOK 12-13, while a payment with a BankAxept debit card costs less than NOK 3 (Chart 4.8).

There are two main reasons for the big difference in the cost of these card systems. First, payments with international cards require more resources to be used both at the banks and at the international card associations. Payments with international credit cards give rise to costs for credit checks, financing during the credit period and sending out bills. The difference in cost also reflects the various uses of the two types of card. For example, BankAxept cards cannot be used for online payments. If online payments are excluded, the average cost of a payment with an international card falls by NOK 1.5.

Chart 4.8 Unit costs associated with the use of various payment instruments. NOK per transaction. 2013



Source: Norges Bank

<sup>4</sup> If the share of cash payments from the merchant survey is used, the unit cost for cash payments falls from NOK 7.10 to NOK 3.65 and the overall unit cost for all payments from NOK 5.75 to NOK 5.07. The total economic cost rises from 0.48% to 0.52% of GDP.

## 4.2. Interbank systems

### 4.2.1. Norges Bank's settlement system

Norges Bank is the ultimate settlement bank in the Norwegian payment system. All payments made in NOK are ultimately settled between banks in Norges Bank's settlement system (NBO). This includes ordinary payments by households and firms, large payments in the financial and foreign exchange markets, and payments involving the public sector. Average daily turnover in NBO is around NOK 220bn.

NBO is also used to implement Norges Bank's monetary policy. Read more about the implementation of monetary policy in *Section 2.1 The money market* and in **Box: Norges Bank's liquidity management and overnight lending rate** in *Section 2.1*.

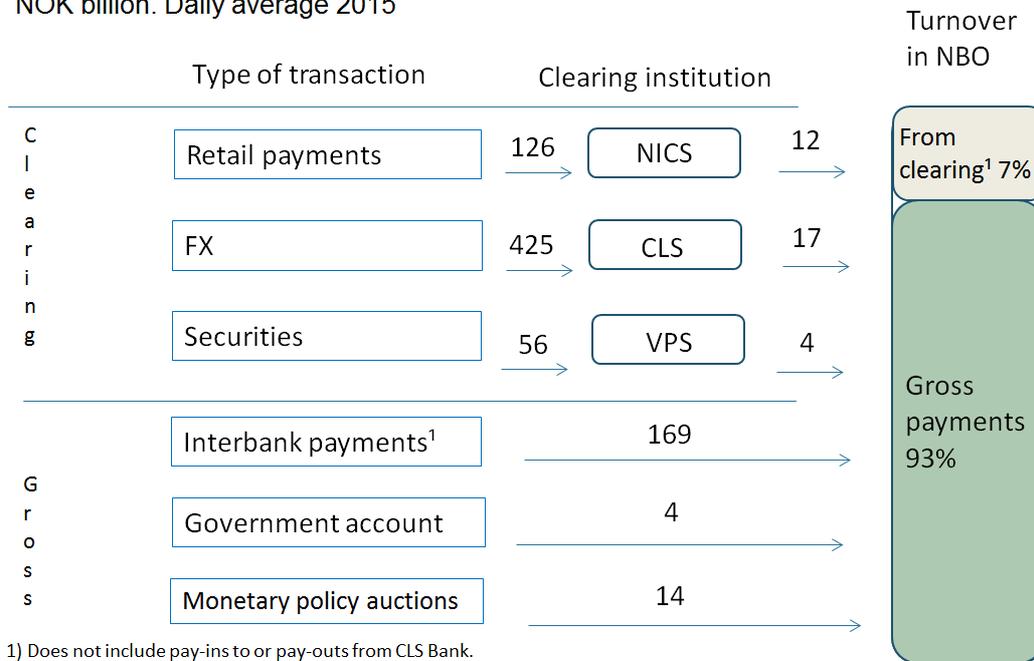
A total of 129 banks have an account with NBO, including all Norwegian banks. These banks can participate directly or indirectly in the various settlements in NBO. Direct participation means that a bank has an account with Norges Bank and sends transactions straight to NBO for settlement. Indirect (or tiered) participation means that a bank has another bank handle settlement in NBO on its behalf. Although all Norwegian banks have an account with NBO, few banks settle their transactions directly in NBO. It is mainly the largest Norwegian banks and the Norwegian branches of the Scandinavian banking groups that do so. The majority of Norwegian banks have few gross transactions and participate in net settlements through one of the big banks (see box below). In terms of value, transactions originating from foreign banks account for a substantial share of turnover in NBO.

NBO's turnover stems from the following settlements:

- Gross settlements (immediate settlement of individual transactions) account for more than 90% of turnover in NBO (Chart 4.9). These transactions include financial market transactions, generally related to banks' foreign exchange trading, liquidity management and payments on behalf of customers (Chart 4.10). All Norwegian banks with an account with NBO can participate directly in gross settlement, but only 10-15 do so actively.
- NICS Net is the settlement of net positions from the clearing system (see *Section 4.2.2 The Norwegian Interbank Clearing System (NICS)*). These payments are mainly related to ordinary customer payments but also include financial market transactions below NOK 25m.
- The securities settlement covers payments between banks relating to trading in securities. The actual securities are settled through VPS (see *Section 4.3 Securities settlement (VPO)*). Participants in VPO that do not have an account with Norges Bank settle the cash leg of securities transactions through a bank (the liquidity bank).
- Settlement of the securities lending facility for participants that do not hold the securities needed for settlement (see *Section 4.3.2 How does securities settlement work?*). SIX x-clear, a central counterparty based in Switzerland with a branch in Norway, is the counterparty for all payments in this programme.

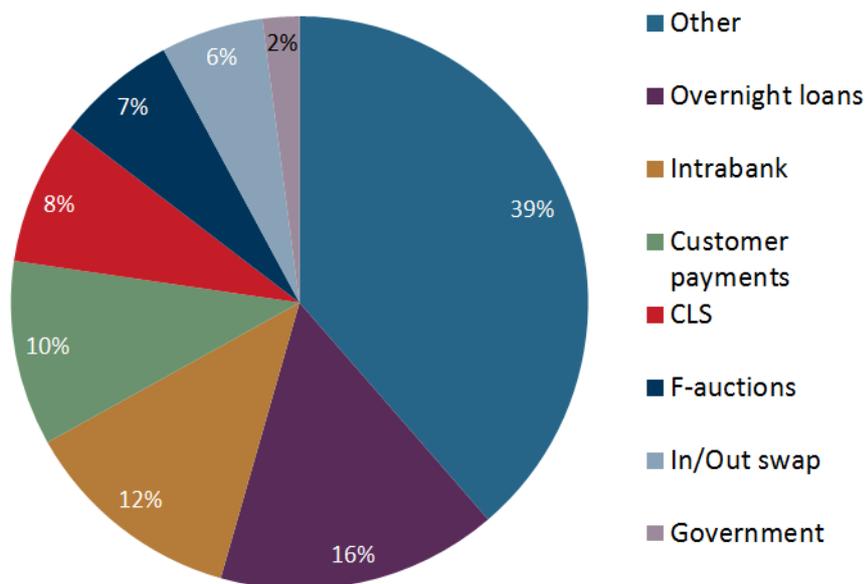
- Derivatives settlement. The participants in this settlement are central counterparties and a few large banks. It includes payments relating to option premiums, fees and interest.

Chart 4.9 Turnover in NBO.  
NOK billion. Daily average 2015



1) Does not include pay-ins to or pay-outs from CLS Bank.  
Sources: NICS Operations Office, VPS, CLS and Norges Bank

Chart 4.10 Gross settlement



Sources: NICS Operations Office, CLS and Norges Bank

Norges Bank requires banks to have sufficient funds to cover the positions they are to settle in NBO. This can be in the form of deposits or use of lending facilities at Norges

Bank. To borrow from Norges Bank, banks must pledge securities registered in a central securities depository as collateral in favour of Norges Bank. Banks' access to the central bank's lending facilities generally exceeds what they need to settle payments.

Together with Sveriges Riksbank in Sweden and Danmarks Nationalbank in Denmark, Norges Bank has developed a Scandinavian Cash Pool to facilitate liquidity management for banks that participate in settlements at two or more of the Scandinavian central banks. The pool allows banks to use deposits in one central bank as collateral for borrowings from another.

#### 4.2.2. The Norwegian Interbank Clearing System (NICS)

NICS is the banks' joint system for receiving and clearing payment transactions. Almost all payment transactions in Norway are sent to NICS for clearing before being sent to NBO for settlement. Small payments, such as card payments and bank transfers, are netted so that each bank has a single debit or credit position against the other participating banks. This clearing is performed by NICS and then sent to NBO for settlement (net settlement) four times daily:

- The early morning clearing is sent for settlement around 5.30 a.m.
- The late morning clearing is sent for settlement around 11.00 a.m.
- The afternoon clearing is sent for settlement around 1.30 p.m.
- The final clearing is sent for settlement around 3.30 p.m.

All banks participate in NICS directly. Banks can participate in the net settlement at Norges Bank either directly (tier 1 banks) or indirectly (tier 2 banks). Once clearing in NICS is complete, the tier 1 banks that serve as settlement banks for tier 2 banks assume these banks' positions in the settlement at Norges Bank. These positions are amalgamated with the settlement bank's own position so that the settlement bank has a single position in the net settlement. Once settlement in NBO is complete, the tier 2 bank's account with the settlement bank is debited or credited. At the beginning of 2016, 22 banks participated directly in net settlement in NBO, and 106 banks indirectly. The largest private settlement bank is DNB ASA, which settles on behalf of 94 banks, while SpareBank 1 SMN is the settlement bank for 11 banks, and Danske Bank for one bank.

The payments cleared through NICS are mainly below NOK 25m. Larger payments, or payments that are specially earmarked, are sent to NBO for gross settlement, either straight to Norges Bank or via NICS.

Norges Bank has awarded the licence to operate NICS to the NICS Operations Office, which is subject to supervision by Norges Bank. The NICS Operations Office in turn has outsourced the technical operation of NICS to Nets Norge Infrastruktur AS, a company in the Nets group. Although the technical operation of NICS has been outsourced, the NICS Operations Office remains responsible for its operation.

### 4.2.3. Foreign exchange settlement risk

The settlement of currency trades is associated with the risk of the other party being unable to fulfil its side of the transaction. This settlement risk is often referred to as Herstatt risk after the failure of the German bank of that name in 1974. Read more about this in "*Bank Failures in Mature Economies*", *BCBS Working Papers No. 13, April 2004* and in **Box: Herstatt risk**.

#### Box: Herstatt risk

One widely discussed incident that had significant consequences for the foreign exchange market was the failure of the German bank Bankhaus Herstatt in June 1974. This happened during the afternoon, local time, after the German settlement system had closed, but before the final settlement in the US. Many of the bank's customers, who wanted to convert German marks into US dollars, had already sent German marks to Herstatt and were expecting to receive their dollars later that day in New York. However, Herstatt's correspondent bank in New York suspended all outgoing payments on behalf of Herstatt once it became known that the bank was insolvent and had ceased operating. Some of these customers were left with considerable exposure to Herstatt, and some never had their claims satisfied. Herstatt risk has come to be used widely as an alternative name for foreign exchange settlement risk.

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### 4.2.4. The CLS foreign exchange settlement system

CLS (Continuous Linked Settlement) was set up in 2002 to reduce cross-currency settlement risk. Settlement in CLS is based on payment versus payment, which means that banks never have to deliver one side of a trade without collecting the other. The credit risk in this settlement is therefore substantially reduced, and banks only have credit risk exposure to CLS. CLS is owned by the banks participating in the settlement system and currently settles cross-currency trades in 18 different currencies: US dollars, Canadian dollars, pounds sterling, euros, Swedish kronor, Danish kroner, Norwegian kroner, Swiss francs, Australian dollars, New Zealand dollars, Singapore dollars, Hong Kong dollars, Japanese yen, Korean won, Mexican pesos, Israeli shekels, Hungarian forints and South African rand.

CLS is based in New York and is supervised by the Federal Reserve. Norges Bank and the other central banks for the currencies settled in CLS are members of an oversight committee chaired by the Federal Reserve. CLS is organised as a limited company owned by the banks that are settlement members.

Participation in CLS can be either direct (as a settlement member) or indirect (as a third party). Settlement members make all incoming and outgoing payments themselves, while third parties participate through a settlement member. All incoming and outgoing payments are made from a bank's account with the central bank for the relevant currency to CLS's account with the same central bank. Actual settlement in CLS is gross (payment versus payment), but banks pay in a net amount that CLS calculates for each currency. DNB is the sole Norwegian settlement member.

If a settlement member does not have an account with a central bank, payments are made via another bank with an account at that central bank, known as a correspondent bank. There are four correspondent banks for Norwegian kroner: DNB, Nordea, SEB and Danske Bank. These correspondent banks send and receive kroner in NBO on behalf of their participant banks. Handelsbanken pays and receives its own payments in kroner. CLS has a total of 65 settlement members. All payments in kroner to/from CLS's account with Norges Bank go through the four correspondent banks and Handelsbanken (see [CLS's website](#)).

### 4.3. Securities settlement (VPO)

The securities settlement system (VPO) covers the settlement of both cash and financial instruments. Ownership of Norwegian financial instruments is registered electronically in accounts in the central securities depository owned and operated by Verdipapirsentralen ASA (VPS). When a security is sold, the “certificate” is transferred from the vendor's account to the buyer's account at VPS, while the cash leg is settled at Norges Bank. VPO settlements take place twice a day (early and late morning). Gross daily turnover for securities settlements at VPS was close to NOK 60bn in 2015, whereas the net daily settlement volume at Norges Bank was around NOK 4bn. VPS is owned by Oslo Børs VPS Holding ASA (see **Box: Central securities depositories**).

Traditionally, each country has had its own solutions for trading and settlement of securities. In recent years, however, the EU has been working on further integration of European securities markets. This has included both the standardisation of legislation in European countries and the development by the ECB/Eurosystem of systems for payment and settlement of cross-border payments and securities transactions in the form of TARGET2 and TARGET2-Securities (T2S) (see **Box: TARGET2-Securities (T2S)**).

#### Box: Central securities depositories

One important element in an efficient and secure system for trading in securities is a dematerialised (certificate-free) central securities depository. The depository records important information about the security, such as its owner and any charges on it. A securities trade is not completed (does not gain legal protection) until the change in ownership is registered in the depository. All financial instruments can be registered in a central securities depository. Verdipapirsentralen (VPS) operates the only central securities depository in Norway, although the *Central Securities Depositories Act* of 2003 (Norwegian only) provides for others to be established.

The standard rule in Norway is that financial instruments are registered in the central securities depository in the name of the investor. In some cases, nominee registration is also permitted, where the real owner's name does not appear in the register, only that of a manager. Nominee registration is not permitted for Norwegian investors for investments in Norwegian equities.

## Box: TARGET2-Securities (T2S)

The work on creating a single market for financial services has been boosted by the development of infrastructure under the auspices of the ECB for payment and settlement of cross-border securities trades. The first of these was TARGET, a payment system for gross payments in euros covering all the euro area countries. TARGET first saw the light of day in 1999, and a new generation – TARGET2 – followed in 2007. The second is TARGET2-Securities (T2S), a system for the settlement of cross-border securities transactions.

T2S was launched in June 2015 with four central securities depositories and is due to have 23 on board by September 2017. Norges Bank and VPS will join at a later date if there is sufficient interest in this among market participants and if Norges Bank can reach a satisfactory agreement with the ECB.

Under T2S, banks still have securities accounts with central securities depositories and cash accounts with central banks, but the accounts with central banks and central securities depositories participating in T2S are linked. Settlement in the securities account and central bank account takes place on a gross basis, with securities and cash being transferred simultaneously. If central securities depositories (CSDs) choose to open accounts with one another, two banks will be able to settle securities trades with one another directly even if they are not members of the same CSD: when settling in CSD A, CSD B is debited or credited instead of the banks that have accounts with CSD B, and CSD B then credits or debits those banks.

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### 4.3.1. How are trades made?

Financial instruments are traded both on regulated trading venues (typically stock exchanges) and unregulated markets (over the counter, OTC) (see **Box: Turnover in securities: Exchange-traded and OTC** in Section 2).

An investor wanting to buy or sell equities on a regulated trading venue needs to become a customer of a securities firm (broker). The trade is initiated when the customer asks the broker to place an order in the venue's trading system, stating which securities are to be bought or sold together with the desired volume and price. The trading venue compares buy and sell orders, and trades are executed as soon as there are buy and sell orders that match in terms of price, volume and any other terms. A trade is normally settled two days after being made.

Investors in the bond market are normally large institutions, such as banks and insurers, and generally trade bilaterally outside a trading venue (OTC), agreeing between them the volume, price, settlement date and any other terms. The buyer and seller (or their brokers) send information on the trade to VPS, which “matches” the information from the two parties. As with equities, trades are normally settled two days after they take place.

#### 4.3.2. How does securities settlement work?

The securities settlement system (VPO) covers the settlement of both cash and securities. The cash leg takes place at Norges Bank, while book entry of ownership of the securities takes place at VPS.

Almost 40 securities firms (brokers) participate directly in the securities leg in VPO. These include the securities arms of large Norwegian banks, branches of foreign banks and a few Norwegian brokerages. More than half of the direct participants in the securities leg are banks that also participate directly in the cash leg at Norges Bank. Private investors and some foreign banks participate in VPO indirectly through one of these direct participants.

The process before settlement differs between equities and fixed-income instruments (bonds and notes). Trades in equity instruments are reported to a central counterparty, see *Section 4.4 Central counterparties*. The central counterparty then calculates the cash and equity positions and sends them to VPS. Trades in fixed-income instruments are sent straight to VPS by the securities firms. VPS checks that the information on purchases and sales matches in terms of price, volume and other terms.

VPS' calculation of the participants' positions before VPO takes place as follows. First, VPS sends the positions to Norges Bank, which executes the cash leg of the settlement. Norges Bank then sends a report to VPS, which enters the securities transactions in the participants' securities accounts. This solution ensures that securities change owner only after the buyer has paid and the seller has delivered (delivery versus payment). Central counterparties participate in securities settlement but generally have a position close to zero, because they act as both seller for the buyer and buyer for the seller.

Once settlement between securities firms and banks is completed, investors (and other indirect participants in the settlement) are credited or debited. In the cash leg, this means that securities firms transfer money to the investors who have sold securities, and charge the investors who have purchased securities. This can also be done prior to settlement. In the securities leg, a distinction is drawn between investors who have an account directly with VPS and those who have an account with a bank (nominee registration). In the first case (which is the standard rule), the transfer takes place directly within VPS. In the second, it takes place via the investor's account with the bank (see **Box: Central securities depositories** in *Section 4.3*).

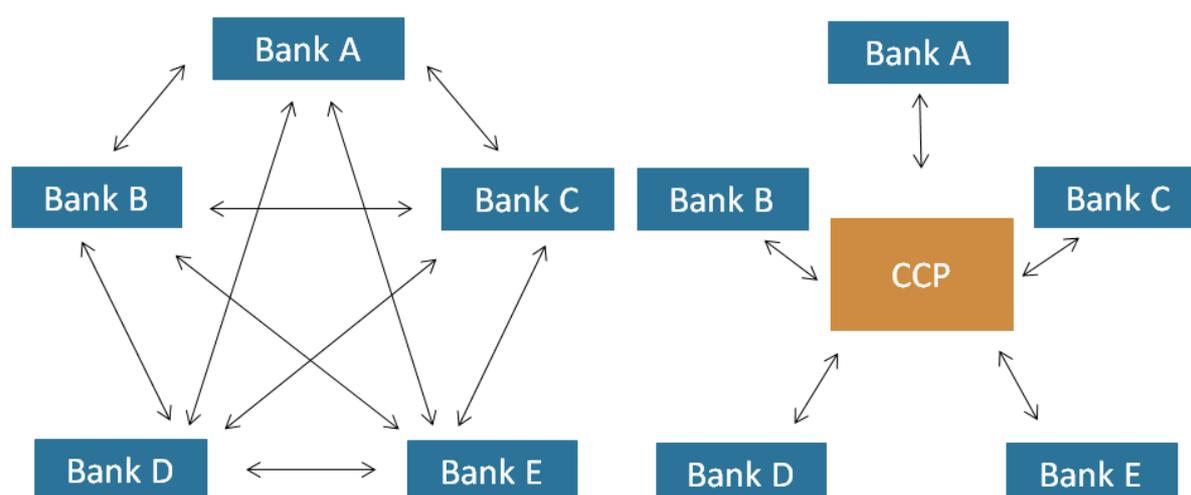
To help ensure that as many trades as possible are settled as agreed, VPS and the central counterparty SIX x-clear have established a lending programme for equities settled through VPO. This service helps settlement participants who do not hold the requisite securities to fulfil their delivery obligations at the agreed time. The lenders (investors) and borrowers (settlement participants) are not known to each other. SIX x-clear acts as a central counterparty between the two. Borrowers must post collateral for their loans. SIX x-clear manages contracts in the pool, maintains an overview of the collateral the individual borrower must provide, and calculates margin requirements, interest and fees. Loans are automatically returned if there are securities in the settlement participant's VPS account. The lending programme is linked to the late morning settlement in VPO and covers around 120 listed equities. Membership of

the programme is voluntary for settlement participants, and around 40% have chosen to join.

## 4.4. Central counterparties

A central counterparty enters into a transaction between buyer and seller and becomes the counterparty for both. The original contract is replaced with two new ones: one between the buyer and the central counterparty and one between the seller and the central counterparty. The central counterparty guarantees completion of the transactions in financial instruments that go through it (clearing), and ensures payment of any margin requirements. The parties to the trade no longer have any risk exposure to one another, but are exposed to the central counterparty instead (Chart 4.11).

Chart 4.11 Central counterparties



### 4.4.1. Use of central counterparties

The financial crisis in 2008/2009 revealed that bilateral trading in derivatives (OTC derivatives) was not adequately collateralised. In addition, the authorities had a limited overview of the huge exposures between the market participants. In light of the experience gained from the financial crisis, the G20 leaders agreed to strengthen regulation of derivatives markets. One important step was increase the scope of OTC derivatives to be settled via central counterparties. This was followed up in the US with the Dodd-Frank Act and in Europe with EMIR (see **Box: New European legislation on securities and derivatives**).

#### Box: New European legislation on securities and derivatives

The EU is working to create a single securities market in the EU with more effective competition, enhanced trading and price transparency and reduced risk when trading securities and derivatives. To achieve this, the EU has introduced a number of directives and regulations in recent years covering trading and settlement of financial

instruments. Key examples include the Markets in Financial Instruments Directives (*MiFID* I and II), the European Market Infrastructure Regulation (*EMIR*) and the Central Securities Depositories Regulation (*CSDR*).

MiFID I regulates what happens before a trade is made and aims to improve protection of investors. For example, there are requirements for the information to be provided to customers and restrictions on the types of product different kinds of customer can invest in. The directive also requires the best buy and sell orders to be made available ahead of the trade, and that the price, volume and timing of a trade are subsequently published.

MiFID II is an extension of MiFID I in response to a number of trends in the market. For example, MiFID II introduces requirements for participants that are intended to limit the risk of instability and market manipulation as a result of high-frequency trading (HFT) using computer programs. Trading models based on mathematical algorithms must be designed in such a way that they are robust to different market conditions. Participants must also supply the supervisory authorities with detailed information on the algorithms they use.

EMIR requires suitable OTC derivatives to be cleared through a central counterparty, and all trades in derivatives to be reported to a trade repository. The requirement for clearing through a central counterparty applies to financial firms that trade in derivatives outside regulated trading venues. Non-financial firms must use central counterparties for OTC derivative transactions over a certain limit.

CSDR standardises national legislation on central securities depositories and aims to promote competition between central securities depositories in different countries. The regulation paves the way for links between central securities depositories. Investors and issuers will thus be able to choose which depository a security should be registered in, where this does not contravene national legislation. Harmonisation of the rules in different countries is essential for efficient cross-border settlements on the T2S platform.

One common feature of this legislation is that providers of financial infrastructure services (central counterparties, central securities depositories, trade repositories and investment service providers) authorised in one EU member state are entitled to operate throughout the EU (known as the “single passport”). Actors outside the EU can apply to the European Securities and Markets Authority (ESMA) for third-country recognition. Providers that are authorised by the EU (either directly or on a third-country basis) are subject to pan-European supervision and oversight, which includes ESMA. The Norwegian parliament has yet to decide whether these provisions should be incorporated into the EEA Agreement and so apply in Norway.

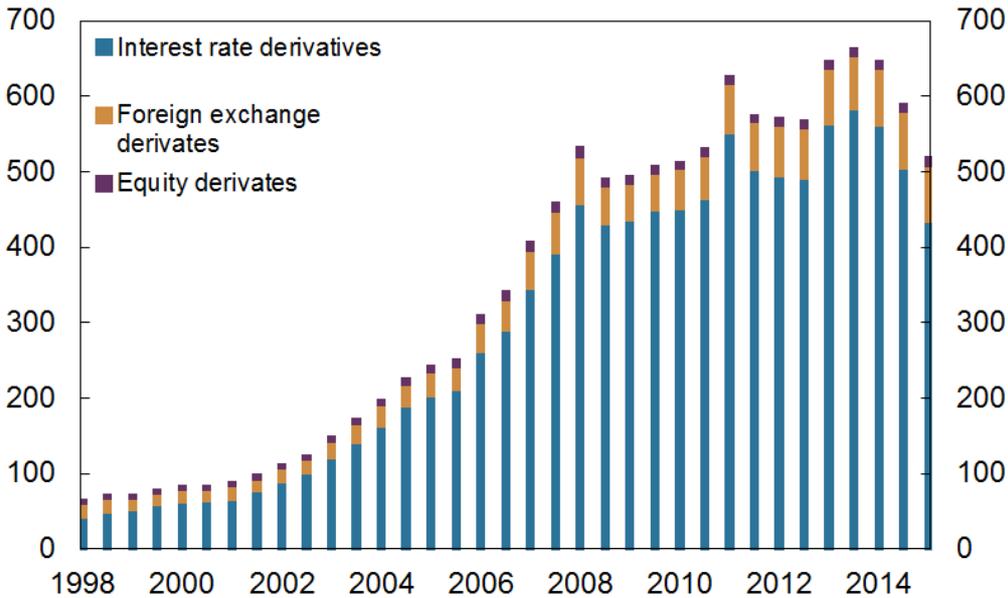
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If EMIR is implemented in Norway, there will be a clearing obligation for Norwegian banks for standard interest rate derivatives. Interest rate derivatives are by far the most widely traded derivatives (Chart 4.12).

In countries that have implemented EMIR, the clearing obligation for standard interest rate derivatives entered into force in spring 2016. It applies to interest derivatives in euros, US dollars, pounds sterling and Japanese yen (see [press release from the European Commission](#) of 6 August 2015). On 10 November 2015, ESMA proposed introducing a clearing obligation for interest rate derivatives in Norwegian kroner (see [ESMA's website](#) for more information).

Norwegian banks currently settle interest rate derivatives both bilaterally and through the UK central counterparty SwapClear, part of LCH.Clearnet Ltd. Banks use interest rate derivatives in connection with bond financing in foreign currency (see **Box: Norwegian banks' and mortgage companies' bond funding abroad** in Section 2.2). DNB Bank ASA and Nordea Bank Norge ASA participate directly in SwapClear along with several other Nordic banks. Norwegian banks use central counterparties when settling OTC derivatives as required by the counterparties to these trades. In addition, banks face higher capital requirements if they settle trades in financial instruments bilaterally rather than through an EMIR-authorized central counterparty.

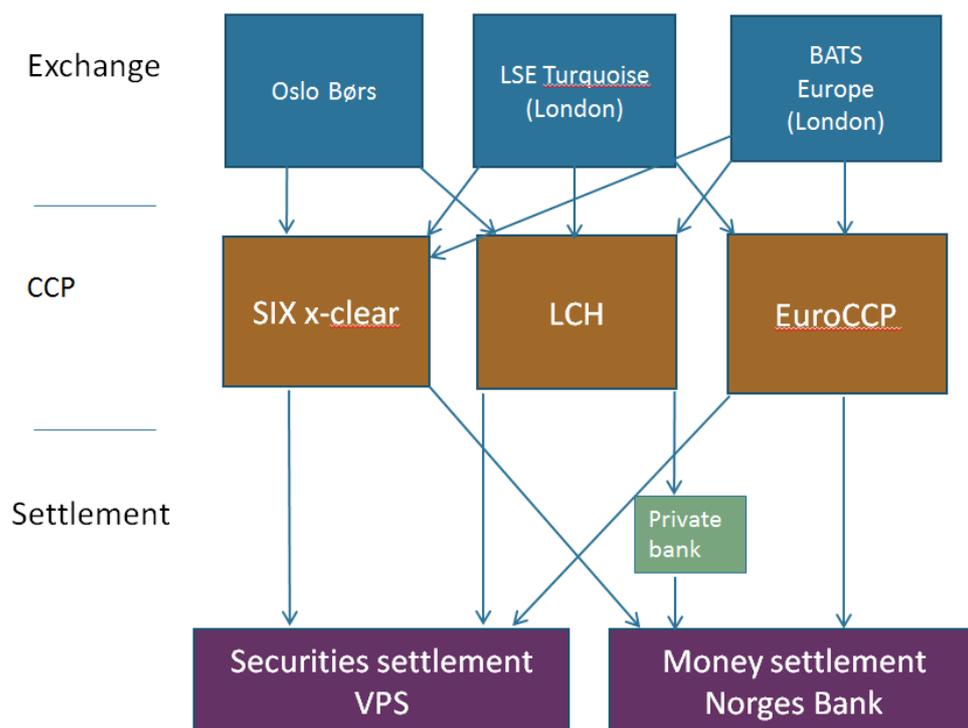
Chart 4.12 The market for OTC-derivates globally. Notional amounts outstanding. In trillions of USD. June 30 1998 – June 30 2015



Source: Bank for International Settlements

Clearing through central counterparties has also increased because many trading venues have made it a requirement. Derivatives traded on Oslo Børs have been settled through a central counterparty since 2006, and clearing of equities has been compulsory on Oslo Børs since 2010. The clearing obligation on Oslo Børs came about primarily as a result of foreign participants' interest in anonymous trading. Norwegian equities are also traded on other trading venues (Chart 4.13). Some central counterparties are active on more than one venue. This means that they have positions that need to be settled in the Norwegian securities settlement system, and so the central counterparties take part in the cash leg at Norges Bank either directly or through another bank.

Chart 4.13 Trading, clearing and settlement of equities in NOK



#### 4.4.2. Central counterparties enhance financial stability

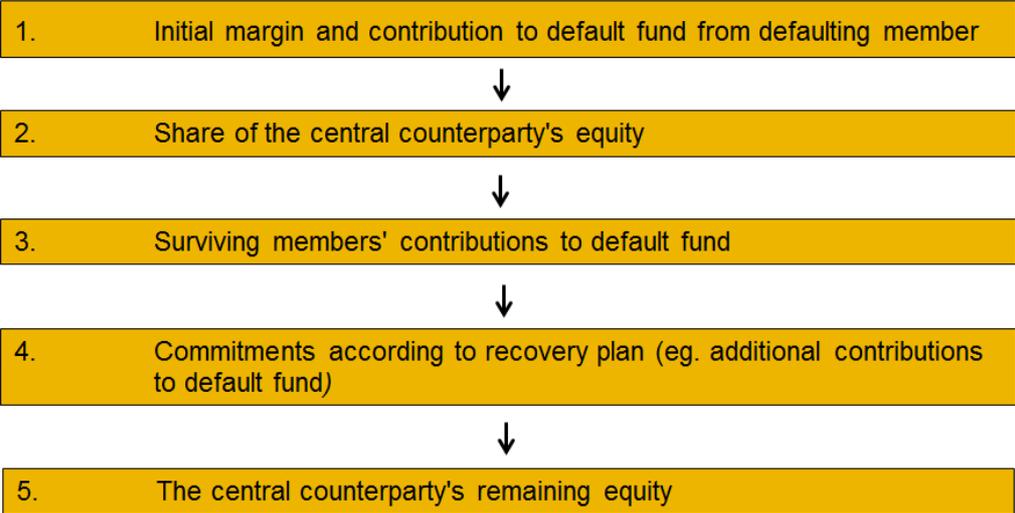
In principle, a central counterparty has a balanced position. Any fluctuations in the prices of the equities or derivatives that it clears will not therefore result in a risk of losses for the central counterparty. It is still, however, exposed to a conditional market risk. If either party fails to fulfil its side of the trade, the central counterparty's position will no longer be balanced. In this situation, the central counterparty is obliged to honour the trade with the party that has not defaulted. The central counterparty does this by closing out the position – in other words, it enters into a new agreement to buy or sell the reverse position. To limit the risk, the central counterparty will try to close out the position quickly once a participant has defaulted.

As security for the risk they assume, central counterparties require margin and contributions to a default fund. Any losses arising due to participant default are to be covered in the first instance by the margin and default fund contributions paid in by the participant that is in default. If the losses exceed these, they are to be covered by the central counterparty's equity. Any losses beyond that are to be covered by other participants' default fund contributions (Chart 4.14).

Most direct participants in a central counterparty are large banks. If a central counterparty incurs losses so great that it has to use the whole of the default fund to close out the position, Norwegian banks may be asked to pay more into the default fund. The size of these contributions depends on the agreements the central counterparties have with participants. Both the supervisory authorities and the banks

themselves need to maintain a clear picture of exposure to central counterparties and the contributions the banks may be asked to make in a crisis.

Chart 4.14 Example of a central counterparty's default waterfall



#### 4.4.3. Central counterparties and systemic risk

Central counterparties must have clear, predetermined procedures for how participant defaults are to be handled. Together with margin requirements and default funds, this contributes to a lower likelihood of problems arising than with bilateral settlement. At the same time, obligations to use a central counterparty have led to market participants' exposure being concentrated among a small number of central counterparties. This concentration is particularly great in the case of OTC interest rate derivatives. More than 95% of all OTC interest swaps settled through a central counterparty are settled through LCH.Clearnet. Read more on [LCH's website](#).

Central counterparties often operate in more than one country. To ensure that central counterparties take sufficient account of the risks they face, the authorities have introduced close monitoring and extensive cross-border collaboration. The Norwegian authorities participate in the supervisory and oversight groups of several central counterparties active in the Norwegian securities market.

# Appendix 1: Regulation of financial markets and trading venues

In financial markets, savings are channelled to investments, and risk is allocated according to participants' willingness to bear it. Moreover, many markets generate prices that become widely known and thus function as important carriers of information. These tasks cannot be properly performed unless participants have confidence in the functioning of the financial market as a whole. A securities trade requires confidence that the right to own the security is not in dispute, that everyone in the market has equal information and that the parties are honest in their actions. If participants do not have that confidence, the result will be that securities trading is associated with risk beyond the risk of the individual security. This will make it more expensive for businesses to raise capital in the securities market.

Various market imperfections can give rise to a loss of confidence. For example, asymmetric information may facilitate unlawful insider trading and price manipulation. It is a task for the authorities to help to protect investors against this. Work to reduce the risk associated with activities in financial markets takes place in different areas, including through regulation and supervision. The *Securities Trading Act* regulates the actual trading in financial instruments and sets requirements for participants. The act also regulates the intermediary function and lays down requirements for security and impartiality in this stage of the trades. The *Act relating to regulated markets (Stock Exchange Act)* and the *Security Register Act* regulate securities market infrastructure. In markets where consumers (non-professional investors) participate, consumer information and protection are key objectives of regulation.

To ensure as much as possible that all investors in Norwegian securities traded in regulated markets have equal information, the Securities Trading Act contains provisions on:

- Ongoing and periodic information requirements.
- Notification requirement of the purchase or sale of shares for persons who are close associates of a company and therefore have particular knowledge of its financial position (primary insiders).
- Disclosure requirement for large shareholders when their stakes pass specified thresholds in either direction. For stakes of up to 25%, there is a disclosure requirement for every five percentage points.
- Requirement for extensive publicly available information in connection with an initial public offering, an offering to subscribe for shares or other securities in a regulated market.

Finanstilsynet ensures compliance with the legislation and the information requirements. Read more on Finanstilsynet's website under [Listed issuers, Prospectuses](#).

Through the EEA Agreement, Norway participates in the EU single market in financial services. Norwegian legislation is therefore harmonised with EU legislation. The EU *Markets in Financial Instruments Directive* (MiFID) lays down requirements for the organisation of investment firms and their conduct of business, requirements for authorisation as a regulated market, reporting obligations to prevent market abuse, disclosure obligations relating to transactions in shares and provisions on admission to trading on regulated markets. The directive has been implemented in Norway through the Securities Trading Act and the Stock Exchange Act.

Over the past decades, various forms of derivatives (see **Box: Derivatives** in *Section 2.1.*) have become an increasingly important part of financial markets. Derivatives trading has been largely unregulated or lightly regulated. The financial crisis showed that a crisis of confidence can develop among market participants when they are insufficiently aware of the risk associated with given financial instruments and moreover lack information regarding who owns what instruments. After the financial crisis, regulation of derivatives markets has been tightened. In the EU, over-the-counter (OTC) derivatives, central counterparties and transaction registers are regulated by the “*European Market Infrastructure Regulation (EMIR)*”. This regulation has not yet been transposed into Norwegian law.

FX and money markets have been viewed as markets that function well with very little specific government regulation. For self-regulation to function, efficient markets and professional participants are essential. In these markets, confidence is largely assured by participants’ self-regulation and by the fact that participants (i.e. banks and other financial undertakings) are themselves regulated. However, in recent years there have been a number of examples of misuse of information and attempts to manipulate key prices in several unregulated markets. A number of initiatives have been taken to regulate previously unregulated activities and market participants, such as money market funds.

## Appendix 2: Bank capital regulation

The losses a bank is able to absorb depend on how much capital it holds relative to assets. The authorities have therefore a long tradition of setting minimum capital requirements. Problems at banks can be transmitted across borders. To improve the resilience of the global banking system and to establish a level cross-border playing field for banks, there has been an attempt over several decades to put in place a common set of rules governing banks' capital adequacy. This work is associated with the city of Basel, Switzerland, where much of the work has taken place in collaboration with the *Bank for International Settlements (BIS)*, which is located there.

### The international Basel rules

The *Basel Committee on Banking Supervision (BCBS)* is an international body for central banks and supervisory authorities whose work focuses on setting international standards for banking regulation. The largest advanced economies are members. The Basel Committee has formulated detailed proposals for regulation of bank capital and liquidity in three rounds: Basel I, II and III. The Committee has no supranational authority, but members have committed themselves to introducing the rules in their home jurisdictions.

The Basel Committee had its first meeting in 1975 and in 1988, Basel I was issued. This was the first global standard for regulating banks' capital adequacy, with implementation in over 100 countries. In Norway, the Basel I rules entered into force at the end of 1992. Basel I introduced minimum requirements for capital as percentage of banks' assets classified by credit risk (risk-weighted assets).

Gradually, it became apparent that the rules were insufficiently risk-sensitive and that financial institutions' credit risk management was more sophisticated than assumed in the Basel I standard. Thus, one of the intentions of Basel II, introduced in Norway in 2007, was to improve the alignment between capital requirements, the risk of assets and banks' risk management. Banks were allowed to choose between using standardised risk weights for their assets and using risk weights based on their own internal models (the internal ratings-based (IRB) approach). Most larger banks use models regardless, whether they are IRB banks or others that, on the basis of historic data for losses on various types of loan, calculate the risk associated with their loans. Expected loan losses are included in the determination of lending rates and the amount of capital the bank should hold to absorb losses.

Nevertheless, the assumption was that Basel II would not result in a decline in the regulatory capital in the global banking system. However, in practice it proved that the transition from Basel I to Basel II led to a marked decline in IRB banks' regulatory capital requirement. Without the so-called "transitional floor", the decline might have been more pronounced. Under the Basel II transitional floor, IRB banks' total risk-weighted assets may not be lower than a certain percentage of what it would have been under Basel I.

Basel II introduced three pillars for capital regulation. Pillar 1 sets minimum requirements applying to all banks. Pillar 2 is individual bank requirements based on the supervisory review process for assessing individual banks' risks. Pillar 3 deals with reporting and disclosure requirements aimed at strengthening market discipline. These pillars were continued in Basel III. The global financial crisis in 2008–2009 highlighted the need to regulate bank liquidity. Basel III introduced quantitative liquidity requirements, the LCR and the NSFR (see *Section 3.2.6 Liquidity regulation*). In addition, there are plans to introduce a leverage ratio requirement, as a supplement to the risk-weighted capital requirements.

### Capital adequacy requirements for Norwegian banks

The equity ratio, which is defined as equity as a percentage of total assets, is the traditional solvency measure for non-financial enterprises. Banks and other financial undertakings are required to have sufficient solvency in the form of capital adequacy requirements. This is defined as total capital (equity capital + hybrid capital + subordinated debt capital (Tier 2 capital)) as a percentage of risk-weighted assets. In the event of a bank failure, both hybrid capital and Tier 2 capital absorb losses after equity, hybrid capital first. Assets that cannot be used to absorb losses, including intangible assets, are deducted from equity before the capital ratio is calculated (regulatory deductions). The risk-weighting of assets means weighting different classes of assets according to their level of risk. For example, residential mortgages almost always have a lower risk weight than corporate loans, which are more risky.

The most important capital concepts in the regulation are:

Common Equity Tier 1 (CET1) capital = Equity capital – Regulatory deductions

Tier 1 capital = CET1 capital + Hybrid capital

Regulatory capital = Tier 1 capital + Subordinated debt capital

The quantity resulting from multiplying a bank's various assets (loans) by the appropriate risk weight is referred to as RWA (sum of risk-weighted assets):

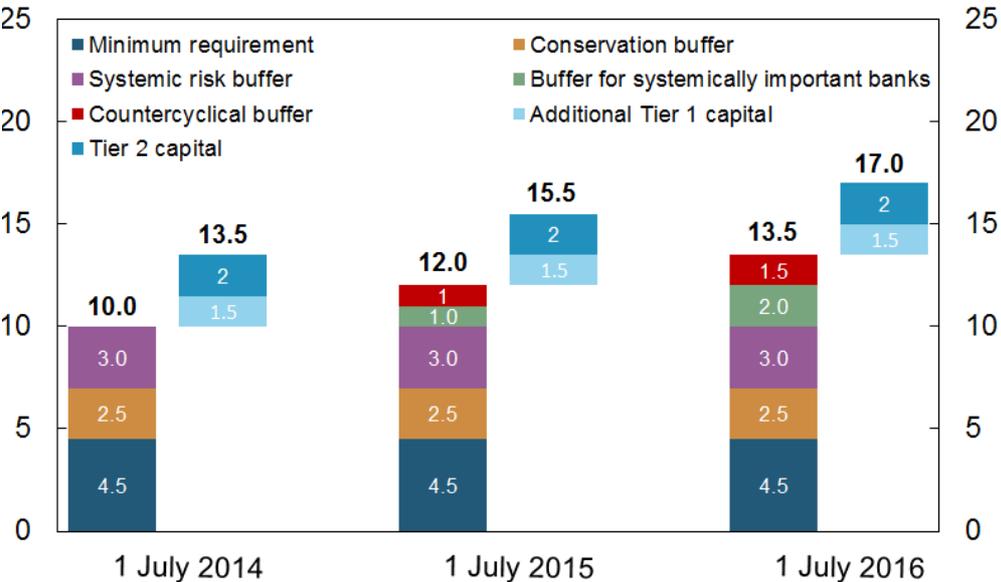
$$RWA = \sum_{vi} Asset_i * Risk\ weight_i$$

The three capital adequacy measures: CET1 capital ratio, Tier 1 capital ratio and total capital ratio are calculated by dividing the three capital concepts above by RWA.

The minimum requirement for banks' CET1 capital ratio is currently 4.5%. In addition, banks face a number of "soft" requirements, so-called buffer requirements, which must also consist of CET1 capital. Banks in breach of the buffer requirements are required to prepare a plan to strengthen their capital adequacy and may not pay dividend without Finanstilsynet's permission. If a bank is on the verge of breaching the minimum requirement, separate crisis management rules will apply (see Section

3.2.8 *Crisis management of banks*). The Norwegian regulations contain four buffer requirements: a capital conservation buffer, a systemic risk buffer, a buffer for systemically important financial institutions and a countercyclical capital buffer (Chart 5.1).

Chart 5.1 Phasing-in of capital requirements in Norway.<sup>1</sup>  
As a percentage of risk-weighted assets. 1 July 2014 – 1 July 2016



1) The minimum requirement and buffer requirements in the columns to the left each year make up the CET1 requirement. Additional Tier 1 capital and Tier 2 capital are added to arrive at the total Tier 1 requirement and total capital requirement, respectively. Source: Ministry of Finance

The **capital conservation buffer** is intended to absorb losses and ensure that capital adequacy does not fall below the minimum requirement in severe downturns.

The **systemic risk buffer** is intended to prevent and mitigate long-term non-cyclical systemic or macro risk. The size of the buffer is to be assessed every other year.

The **buffer for systemically important financial institutions** will only apply to institutions designated as systemically important. There are buffer requirements for both globally systemically important and domestically systemically important banks. The reason for this buffer requirement is that the macroeconomic consequences of problems in systemically important banks are more severe than for other banks. Finanstilsynet will by the end of the first quarter each year provide advice to the Ministry of Finance as to which banks should be designated as domestically systemically important. Financial institutions with total assets of at least 10% of mainland GDP and/or at least a 5% market share of the lending market in Norway are, as a main rule, to be designated as domestically systemically important. The Ministry of Finance has designated DNB ASA, Nordea Bank Norge ASA and Kommunalbanken AS as domestically systemically important. No Norwegian financial institutions have been designated as globally systemically important. In the Nordic region, only the Nordea Group has been designated as globally systemically important and is thus subject to an extra buffer requirement.

The **countercyclical capital buffer** is intended to help banks build capital during upturns so that they have more to draw on during a downturn. Banks should build and hold a countercyclical capital buffer when financial imbalances are building up or have built up over a period. The buffer requirement may be reduced in the event of an economic downturn and large bank losses. Norges Bank has been tasked with preparing a decision basis and providing advice to the Ministry of Finance regarding the level of the countercyclical capital buffer four times a year. (See [\*Criteria for an appropriate countercyclical capital buffer, Norges Bank Papers 1/2013\*](#) more information about the basis of Norges Bank's advice.)

In addition to CET1 capital requirements, banks face Tier 1 capital requirements and total capital requirements. These minimum requirements before buffers are 6% and 8%, respectively, of risk-weighted assets.