



NORGES BANK

**2019**

**NORWAY'S  
FINANCIAL SYSTEM**

AN OVERVIEW

# Key figures – Norway's financial system



## GDP

(gross domestic product)

NOK 3 536bn

## GDP

(mainland)

NOK 2 907bn



Government Pension  
Fund Global (GPFG)

NOK 8 256bn



Cash in  
circulation

NOK 45bn



Bank  
deposits

NOK 2 511bn



Average daily turnover in  
the foreign exchange market

NOK 333bn



Number of  
banks

126



Loans from financial undertakings to private individuals, businesses and local governments

NOK 5 351bn



Total domestic bonds outstanding

NOK 2 071bn



Oslo Børs market capitalisation

NOK 2 503bn



Total assets of insurance companies

NOK 1 674bn



Card transactions per capita per annum

475



Debt-to-GDP ratio

196,6

1 = 2.84 M.Cap = 14,344,414 M

# Norway's financial system

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# Preface and reader's guide

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*Norway's financial system* provides a general overview of the financial system in Norway, its tasks and how these tasks are carried out. This report 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. Financial system professionals will also be able to find useful information. Hyperlinks to other, more detailed Norges Bank publications and to other institutions have been inserted in the text, enabling the reader to delve more deeply into topics of interest.

The introduction provides an overall overview of all the components of the financial system and recent changes. Section 1 describes the various markets: the money, bond, foreign exchange and equity markets, and the financial derivatives markets. Section 2 discusses the most important financial institutions: banks, mortgage companies, insurance companies, pension schemes and various funds, etc. Section 3 describes the financial system infrastructure, which includes the payment system and systems for the payment and transfer of securities, foreign currency and derivatives.

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

Oslo, June 2019

# The financial system

The financial system plays an important role in the economy, with three primary tasks:

- providing consumers and businesses with borrowing and saving opportunities,
- providing payment services and
- managing risk.

In a well-functioning financial system, these tasks are performed securely and efficiently. A system that is resilient to shocks reduces the probability of financial crises.

The financial system consists of many different institutions, markets and financial market infrastructures. In this report, the financial system is divided into financial markets, financial institutions and the financial infrastructure (Table 1).

The users of the system are more or less all the members of society: businesses, public undertakings and most private individuals.

The definition of the financial system can be expanded to include, for example, institutions and mechanisms that provide security for contracts that

are entered into, supply reliable information for effective credit intermediation and risk management and perform other functions such as supervision, regulation, registration of ownership rights, accounting, auditing, or credit ratings and other financial analyses.

Norges Bank is the central bank of Norway and an important part of Norway's financial system. Norges Bank has the sole right to issue banknotes and coins and functions as the 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, ie it sets the interest rate on banks' deposits in Norges Bank. This rate forms the basis for the interest rate level in Norway. Furthermore, Norges Bank has supervisory and regulatory responsibilities with regard to the financial system and the Bank manages Norway's foreign exchange reserves and the Government Pension Fund Global. This report explains Norges Bank's roles and tasks to the extent necessary to describe how Norway's financial system functions. More information on Norges Bank's objectives and tasks can be found on the Norges Bank *website*.

Table 1

1. Financial markets	2. Financial institutions	3. The financial infrastructure
Marketplaces for issuing and trading financial instruments. The properties of these instruments may vary with regard to return, risk, maturity, etc. In financial markets, savers can invest in corporate equity or in debt by lending directly to various borrowers.	Institutions such as banks, mortgage companies, pension funds, insurance companies, mutual funds, etc. They act as intermediaries between economic agents and play important roles related to the financial system's main tasks.	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 between financial system participants.

Chart 1 What happens in the financial system

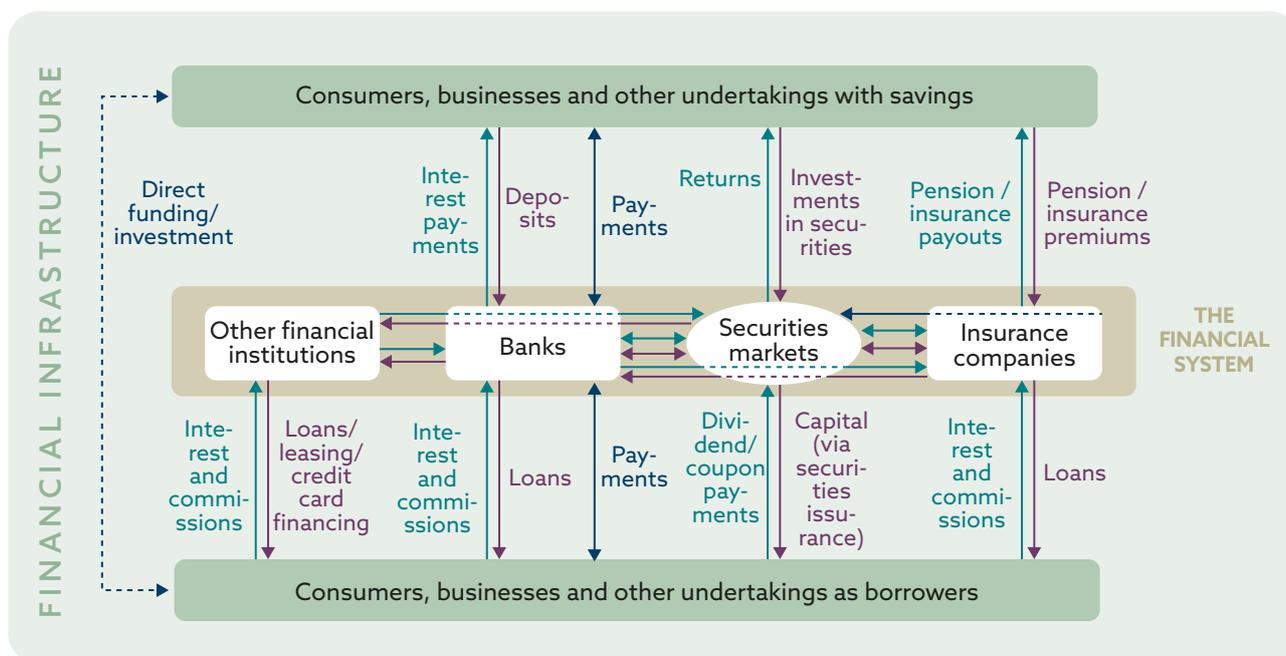


Chart 1 shows a simplified diagram of the financial system. Consumers, businesses and other undertakings with savings are shown in the box at the top. Consumers, businesses and other undertakings as borrowers are in the box at the bottom. The middle segment shows the financial system, where savings are channelled into investment through markets and undertakings. In practice, the participants are generally both savers and borrowers. Banks create money when they issue a new loan to a customer (see box: **Creating money** in Section 2). Payments and risk management also primarily take place in the financial system. The financial infrastructure makes all these transactions possible.

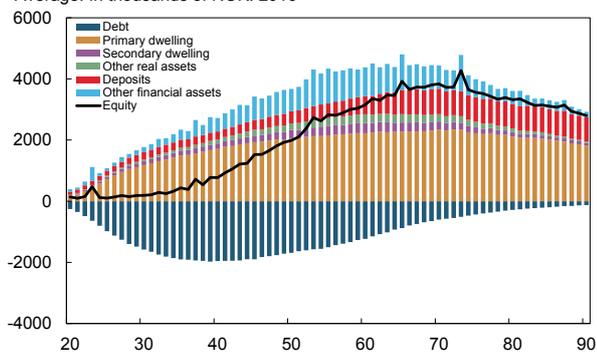
## THE PRIMARY TASKS OF THE FINANCIAL SYSTEM

### Providing consumers and businesses with borrowing and saving opportunities

Most people need to borrow money. Private individuals borrow to finance an education, a house purchase or spending on large consumption items or to cover a temporary decline in income. Similarly, most people need to store their money at times when income exceeds expenditure, ie to save. For example, consumers might save in order to contribute to a pension scheme, to have a reserve for unforeseen expenses or to have enough equity to purchase a home. The financial system enables private individuals to borrow and save and thus to spread their consumption over a lifespan, irrespective of when income is accrued (Chart 2).

Businesses might borrow to finance investments in property, equipment, development and production or to meet payment obligations in unprofitable periods. In profitable periods, businesses need invest-

Chart 2 Assets, debt and equity by age of main income earner. Average. In thousands of NOK. 2016



Source: Statistics Norway and Norges Bank

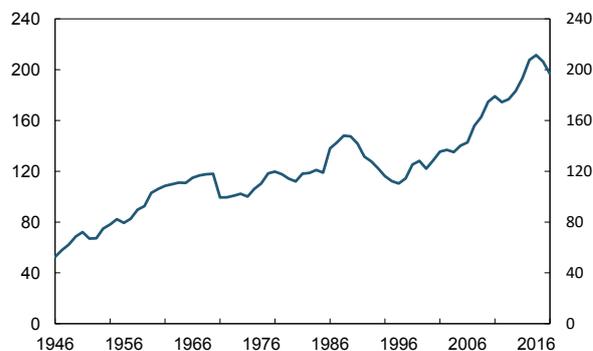
ment opportunities in order to be better equipped to deal with leaner times or manage current payment obligations and finance future investment. The financial system is intended to provide opportunities for savings to be channelled to profitable investment projects.

Central and local governments might also borrow to fund investment and important expenditure during an economic downturn. Likewise, they need saving alternatives during upturns. Since 1990, the Norwegian government has saved a large portion of the government petroleum revenues through investment in the global financial market via the *Government Pension Fund Global*.

When a country's GDP rises, the total value of both financial assets and liabilities tends to rise even more (see Norges Bank's 2018 *Financial Stability Report*). In Norway, the ratio of total private sector and local government debt (C3) to GDP has almost quadrupled since 1946 (Chart 3).

At any one point in time, some private individuals, businesses and governments will be borrowers and some will be savers. In the financial system, savings are channelled to investment both across and within these groups. As it is possible to borrow and save abroad, total savings are not necessarily equal to total investment. A well-functioning financial system channels financing efficiently, thereby promoting economic stability (see also box: **Creating money** in Section 2).

Chart 3 Total credit (C3) as a share of GDP. Percent. 1946 – 2018



Source: Statistics Norway and Norges Bank

Financial institutions and financial markets are intermediaries between savers and investors. Savers seek saving options with different lock-in periods and risk. Financial institutions and securities markets offer an extensive range of savings products. This is an area in continuous evolution, with new products emerging and existing ones being discontinued.

Banks accept and hold savings in the form of deposits and they provide loans. Only banks are permitted to accept ordinary deposits from the public. Banks distribute these 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 customers' deposits in Norwegian banks, including deposit insurance (see Section 2.2.7 *Deposit guarantees in Norway*). Savers can therefore make deposits without needing to assess how these deposits are invested by banks. For banks' customers and for society as a whole, the security provided by deposit insurance facilitates saving and investment because there is no need to be concerned about the safety of deposits.

Saving in a bank is a special form of saving because bank deposits are also used to make payments and therefore function as 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, ie they

should be liquid. (For further details, see box: **Liquidity** in Section 1.) At the same time, people that take out a mortgage usually want the option of a long repayment 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 2.2.1 *Banks' tasks*.)

Insurance companies and pension funds also act as intermediaries and accept savings that are earmarked for pensions. This capital is usually invested for the long term in Norwegian and international financial markets.

Large enterprises and central and local governments can borrow or raise share capital in securities markets, where they receive saved funds directly from savers without having to go through financial institutions. Nevertheless, banks function as intermediaries by facilitating these transactions. Such investments generally require more research and monitoring by savers.

### Providing payment services

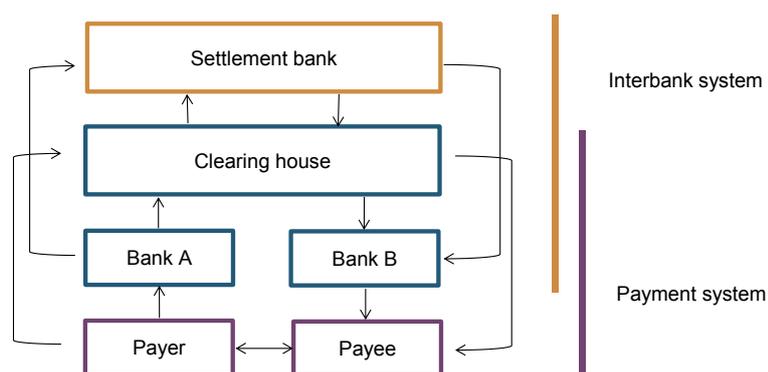
Most of us make payments on a daily basis. We pay our bills using an online or mobile banking service and pay for goods in shops. We can pay using cash or using bank deposits, referred to as deposit money. Norges Bank issues cash based on user demand. Factors determining the quantity of deposit money are described in Section 2.2.1 *Money market participants*. Deposit money can be used for making pay-

ments using, for example, an online banking service, payment cards or a mobile phone.

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 a universally acknowledged medium of exchange because they are defined as such by law. 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 in the same amount. Most transactions in the economy are settled using deposit money. For deposit money to be a universally acknowledged medium of exchange, confidence in the banking system is essential. (Read more about money in the box: **What is money?**)

There are a large number of banks and a very high number of payment transactions, including interbank transactions. Transactions using deposit money must be settled. Settlement is conducted in a settlement system, where, for example, 1000 payments between Bank A and Bank B can be collected together (netted) (Chart 4). 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 reserves, which are 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

Chart 4 The Norwegian payment system



central bank reserves by offering lending and deposit facilities to banks, referred to as market operations. Loans from Norges Bank add central bank reserves to the banking system, and term deposits in Norges Bank drain reserves from the system. The most common market operations are F-loans and F-deposits (see *Norges Bank's website*).

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.

### Risk management

Both private individuals and businesses want to insure themselves against risk. Fire, theft and auto insurance, for example, can be purchased from a non-life insurance undertaking. Life insurance companies and pension funds sell insurance that guarantees payment in the event of disability or premature death of the insured. They also offer individual private pensions and group occupational pensions as a supplement to state pensions from the National Insurance Scheme.

Businesses may also seek insurance against various economic risks associated with their activities. There may be risks associated with future prices of both intermediate goods and final products. Exchange rate risk and the risk of a change in interest rates are other examples. Businesses can eliminate or mitigate such risks by means of financial instruments and deriva-

## WHAT IS MONEY?

Money is a generally accepted means of payment. This means that money may be used as payment for goods and services and financial assets such as equities and bonds and for repaying loans. Money also has a function as a measure of value, for example the value of a good, and as a store of value. Banknotes and coins (cash) and bank deposits (deposit money) are defined as money.

Norwegian banknotes and coins are issued by Norges Bank, and the holder of Norwegian money has a claim on Norges Bank. Cash is legal tender in Norway for consumer transactions and is thus a generally accepted means of payment (see more in Section 3.1.1 *Cash*). Bank deposits refer to money issued by private banks and are liabilities on banks. Bank deposits are also generally accepted, but are not legal tender. An amount in the form of bank deposits can 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 is responsible for ensuring that issuers of bank deposits – banks – are solvent and are able to meet public demand. Norges Bank's task is to promote an efficient payment system, and thus oversee the entire financial system, and be able to take the actions normally expected of a central bank. In addition, the Norwegian Banks' Guarantee Fund guarantees bank deposits of up to NOK 2m per depositor per Norwegian bank (see Section 2.2.7 *Deposit guarantees in Norway*). Account holders, ie owners of bank deposits, gain access to their bank deposits using such payment instruments as bank cards and online or mobile banking solutions. Bank deposits are converted to cash by withdrawing cash from an ATM or over the counter.

The authorities do not determine the total volume of bank deposits or the quantity of banknotes and coins in circulation. Norges Bank issues cash on the basis of public demand. The volume of bank deposits depends, among other things, on the volume of bank lending (see box: **Creating money** in Section 2). Since bank lending is influenced by monetary policy, including the interest rate on banks' deposits with Norges Bank (the policy rate), Norges Bank is able to influence the volume of lending and thereby the volume of bank deposits.

tives. 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 resell risk to others. Capital markets also help to diversify and redistribute risk associated with investments. Investors can manage risk by owning securities with different types of desired risk. Diversification also reduces risk for those who invest their savings in mutual funds or asset management companies.

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. Banks are also subject to special government regulation.

### Financial trends

The payment system is evolving rapidly. Advances are being driven by new technology, new providers and new regulations. In recent years, a number of countries have launched solutions for real-time payments. In Norway, it is also possible for retail customers of different banks to make real-time payments to one another. A common infrastructure for banks with the capacity to handle a future increase in the use of real-time payments is currently being developed. (Read more in Section 3.)

Most payments are made electronically. Mobile phone payment applications, also called digital wallets, have become very popular in Norway over the past year, particularly for person-to-person (P2P) payments.

As a share of means of payment used by the public, cash continues to decline, while deposit money is rising. Norges Bank will investigate how the efficiency of the Norwegian payment system will be affected by a decrease in the use of cash, and whether electronic central bank money can provide desired properties for the payment system of tomorrow (see box: **Central bank digital currencies** in Section 3).

Norway's banking sector is dominated by Norwegian-owned banks, but foreign banks have gained a larger market share in recent years. The Norwegian authorities cooperate with other home state authorities on the supervision and regulation of foreign banks operating in Norway.

Consumer credit has grown rapidly in recent years. Consumer credit comprises credit card debt and other unsecured debt. Banks must therefore hold more equity against consumer credit than against residential mortgages. Government authorities and the industry have implemented measures such as the introduction of a debt register, guidelines for approval of consumer credit, invoicing requirements for credit card debt and marketing guidelines. These actions are intended to improve the functioning of the credit market through greater transparency, more accurate credit ratings and improved consumer protection. (Read more in Section 2.)

Consumer credit has been very profitable for lenders. Interest rates have been high and losses low. As banks that provide consumer credit are members of the Norwegian Banks' Guarantee Fund, their financing costs are low. High profitability has led to the establishment of a number of new banks specialising in consumer credit. In total, 14 new Norwegian banks became members of the Norwegian Banks' Guarantee Fund between 2016 and 2018.

The development of digital platforms has increased the range and number of funding options. Crowdfunding is the practice of funding a company, project, or private individual by raising financial contributions from a large number of people. Crowdfunding is typically used to raise capital for minor projects and small and medium-sized enterprises. Small businesses can often find it difficult to obtain a bank loan or raise equity capital in securities or venture capital markets. Crowdfunding can increase value added if more potentially profitable projects are realised as a result (see Section 2.8.5 *Crowdfunding*).

Digital platforms also provide a more efficient link between banks and potential customers/depositors. A deposit platform is a digital marketplace for bank deposits. Customers can be private individuals, busi-

nesses, local governments etc. Banks advertise their deposit terms and conditions on the deposit platform, giving customers a comprehensive overview of their products. A depositor becomes a customer of the bank, not of the deposit platform, which is just an intermediary (see box: **Deposit platforms** in Section 2).

## SUPERVISION AND REGULATION OF THE FINANCIAL SYSTEM

A well-functioning financial system is crucial to a modern economy. If making payments or obtaining loans became impossible, this could quickly have wide-reaching consequences for the entire economy. The financial system is therefore subject to more

### RISKS IN THE FINANCIAL SYSTEM

The financial system contributes to more effective risk management 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 a counterparty cannot settle its accounts. For example, the counterparty may be the issuer of a security, a counterparty in a derivative contract or a borrower with a bank loan. For corporate loans, credit risk can be associated with a sector (for example construction) or with individual borrowers.

**Liquidity risk** is the risk that an undertaking cannot meet its payment obligations when due without incurring substantial additional costs. Liquidity risk arises from the difference 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 longer 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 referred to as market liquidity risk (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, such as faulty procedures, errors in or attacks on IT systems, regulatory violations, fraud, fire, terror attacks, etc. Operational risk can cause or amplify other kinds of risk.

**Legal risk** can be defined as the risk of losses when a contract cannot be enforced as planned, or because collateral cannot be realised as envisaged. Legal risk can arise in international business transactions as the legal basis often varies across countries.

If one or more of these risks reaches a high enough level, the efficiency and security of the financial system may be jeopardised, ie **systemic risk**. 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 the recommendations from the ESRB of 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.

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 in the box: **Risks in the financial system**.)

The financial system is primarily regulated through legislation. A licence issued by the authorities is required to establish a financial institution or to perform specific services within the financial system. Under the licence, an institution must meet extensive requirements and is supervised by the authorities to ensure compliance. In the event of non-compliance, the licence can be revoked.

An institution may be required to hold a specific quantity of equity capital, hold liquid assets or be run by an appropriate board and management. Regulations may be direct in that certain activities are prohibited, for example, or indirect, in the form of risk-based capital requirements. Financial market regulation often applies to the marketplace itself, for example restricting the groups that may participate. There are also requirements for disclosure to the general public, market participants and the authorities.

The purpose of regulation is to ensure that the financial system is stable and efficient. The Ministry of Finance is responsible for submitting draft legislation 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. Norges Bank is the licensing authority for interbank systems, owing to its key role in, and responsibility for, the payment system.

Finanstilsynet (Financial Supervisory Authority of Norway) is primarily responsible for supervising institutions in the financial system to ensure that they comply with current legislation. Finanstilsynet can also impose new regulations on or issue recommendations on practices in the financial system. The aim of supervision is partly to ensure that the financial system's main tasks are performed in a sound manner and partly to protect user interests.

For the payment system to be efficient and secure, the banks must also be efficient and secure. Finan-

stilsynet 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 for institutions and the authorities to be prepared to handle adverse scenarios. This can mitigate negative consequences. The Ministry of Finance has an important coordinating role should a financial crisis arise. Norges Bank can contribute if there is a liquidity shortage by lending funds to banks against approved collateral.

## INTERNATIONAL COOPERATION

The financial system operates to a great extent across national borders and there is broad international cooperation on regulation and supervision to promote financial stability. *The Financial Stability Board* (FSB) was established during the global financial crisis in 2008. The FSB is a collaborative body that monitors and makes policy recommendations for the global financial system. The FSB comprises the G20 countries and the most important international organisations and committees in this area.

*The Basel Committee on Banking Supervision* (BCBS) is the most important international body for the regulation and supervision of banks. Originally, the BCBS focused on raising the standards of banking supervision and improving the exchange of information between regulators in different countries regarding the situation in international banks. After a period, the Committee recognised that there was also a need for a common regulatory framework governing the level of banks' equity capital, and the so-called Basel framework was developed. Subsequently, the BCBS has proposed regulation relating to many aspects of banks' activities (see *Appendix 2: Bank capital regulation*).

Similar collaborative bodies have now been established for insurance, the *International Association of Insurance Supervisors* (IAIS); securities markets, the *International Organization of Securities Commissions* (IOSCO); and for the payment system and other finan-

cial infrastructure, the *Committee on Payments and Market Infrastructures* (CPMI). These organisations all draft proposals for international rules applicable to their respective areas. In addition, important market participants have established collaborative bodies that draw up key market standards, eg the *International Swaps and Derivatives Association* (ISDA).

Several of the above-mentioned institutions are referred to as international standard-setters. They draft proposals for minimum standards for international rules in their fields. These rules can be incorporated into national legislation or they can remain a market standard that market participants must adhere to in practice in order to do business in the relevant area. The proposed rules are often introduced for both small and large banks in most countries. The EU regulatory framework also largely reflects international standards.

The framework conditions for Norway's financial system are determined based on the Agreement on the European Economic Area (EEA), which regulates Norway's relationship with the EU. Norway is a part of the EU single market for financial services through the EEA Agreement. This means that Norway has virtually the same financial legislation as EU countries.

An important task for standard-setters is to monitor and report on the implementation of standards by participating countries. In this connection, the International Monetary Fund (IMF) conducts regular reviews under its *Financial Sector Assessment Program* (FSAP) of countries' compliance with financial sector standards. Norway's most recent FSAP assessment was in 2015 (see IMF).

(For more information on the evolution of international regulations, see "Endringer i bankreguleringen etter finanskrisen i 2008" [Changes in banking regulations following the financial crisis in 2008], *Aktuell kommentar* 5/2017, Norges Bank (in Norwegian only).)

# 1 Financial markets

Financial markets are markets in which financial instruments are issued and traded, where savers can invest in corporate equity and lend directly to various borrowers. The main groups of financial instruments are debt instruments (bond and short-term paper markets), equity (stock markets), foreign exchange (FX) 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. This means

that the buyer accepts the seller's ask price and the seller accepts the buyer's bid price. Once the trade is cleared, it can be executed. 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.**)

## 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 (Financial Supervisory Authority of Norway). Securities that are expected to be widely traded will usually be accepted for trading on a stock exchange. For a company to be listed, ie 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.

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. 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. The introduction of MiFID II has limited the volume of equities that can be traded in "dark pools".

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. Most bonds are traded in this manner.

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 improves access to capital and the 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 institutions such as banks and insurance companies. Read more in *Appendix 1: Regulation of financial markets and trading venues*.

## 1.1 MONEY MARKET

The money market comprises 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, ie the degree to which participants have the means to meet their payment obligations as they fall due (see box: **Liquidity**). The banking sector is the largest participant in the money market. 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 central and local governments and other businesses, also utilise money markets, primarily to issue Treasury bills and short-term paper. Norges Bank is a key participant in the money market.

The banking sector's most important instruments in the money market are unsecured interbank loans, primarily overnight loans, and secured loans in the form of FX swaps. There are also markets for unse-

## LIQUIDITY

The term liquidity is used differently in different contexts.

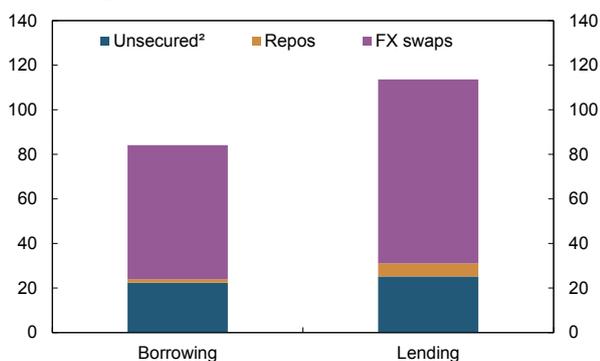
The **liquidity of an asset** means the ease with which it can be converted into money for the purchase of goods, services and other assets. Cash and bank deposits are money and thus the most liquid form of liquidity, while fixed capital such as housing is an asset with limited liquidity.

**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 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). Central bank liquidity plays a key role in the setting of short-term market rates and the execution of payments in the economy.

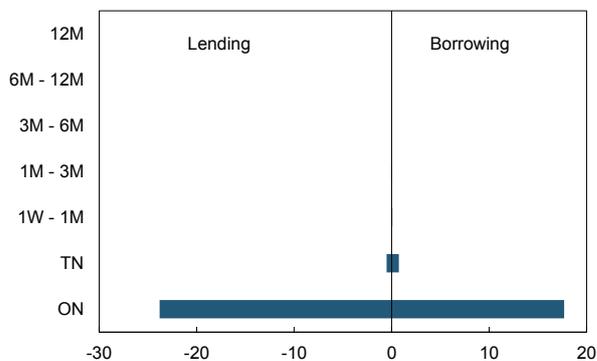
Chart 1.1 Lending and borrowing in the money market by instrument.<sup>1</sup> Daily average. In billions of NOK. April 2018



1) As not all banks participate in Norges Bank's money market survey, there may be discrepancies between reported lending and borrowing.

2) "Unsecured" only refers to unsecured loans and deposits, not short-term paper. Source: Norges Bank

Chart 1.2 Unsecured interbank lending and borrowing in the money market by maturity.<sup>1,2</sup> Daily average. In billions of NOK. April 2018



1) As not all banks participate in Norges Bank's money market survey, there may be discrepancies between reported lending and borrowing.

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

cured loans in the form of Treasury bills and short-term paper and secured loans in the form of repurchase agreements (repos).

Chart 1.1 is taken from Norges Bank's money market survey and shows daily borrowing and lending by instrument in April 2018 (see *Money Market Survey* on the Norges Bank website).

### 1.1.1 Money market participants

Participants in the money market are mostly banks. Fluctuations in banks' liquidity are primarily related to payment services, loan origination and maturity transformation (see Section 2.2.1 *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 FX swaps.

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 save in the money market by for example purchasing mutual fund units. The government is another 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 a key participant in the money market. It uses market operations to control the total quantity of central bank reserves in the banking system. Norges Bank 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**).

### 1.1.2 Unsecured money market instruments

Unsecured money market instruments are 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.

## 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 policy rate. Norges Bank achieves 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).

Liquidity management systems referred to as 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 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 details on liquidity management systems in general, see "Liquidity management system: Floor or corridor?" *Staff Memo 4/2010*, Norges Bank, "Systemer for likviditetsstyring: Oppbygging og egenskaper" [Liquidity management systems: structure and characteristics], *Staff Memo 5/2011*, Norges Bank (in Norwegian only) and "Penger, sentralbankreserver og Norges Banks likviditetsstyringssystem" [Money, central bank reserves and Norges Bank's liquidity management system], *Staff Memo 5/2016*, Norges Bank (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 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. If the sight deposit rate is changed during the maturity of the operation, the bank's allotment rate will be changed accordingly from the same date as the change in the sight deposit rate. Market 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, which is 1 percentage point higher than the sight deposit rate.

As in a corridor system, banks 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 policy rate (Chart 1.3). The NOWA rate is the first point on the "yield curve" and the very first part of the "transmission mechanism", ie how the central bank's policy rate affects longer-term interest rates: short-term money market rates influence the interest rates facing households and businesses, which in turn affect decisions concerning consumption, investment and saving.

### 1.1.2.1 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 1.2).

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.

### 1.1.3 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 businesses 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 1.1.4 *Secured money market instruments*).

Short-term paper issued by the 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. This means that these bills do not pay any interest (coupon payments), but they are issued at a discount, ie the offer price is lower than the face value, and are redeemed at maturity. The difference between the issue price and the redemption price is the "interest payment". 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. The Treasury bills are sold by auction 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 for a given minimum amount. 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 reopened 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.

### 1.1.4 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.

#### 1.1.4.1 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 col-

lateral. 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 is growing. The largest banks are the primary participants. Most repurchase agreements are made with Norwegian Treasury bills, government bonds, and covered bonds as collateral (see box: **Secured funding**). Repurchase agreements are also made with foreign securities as collateral and so-called tri-party repos, 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, government bonds, 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.

#### 1.1.4.2 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

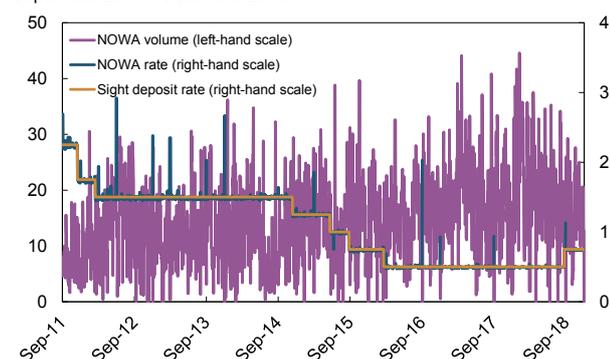
holding foreign currency and needing liquidity in NOK can swap the currency for NOK for a given period. An FX swap between two banks can also be regarded as a secured interbank loan. The FX swap market is different from the repo market in that the collateral received by the lender is in the form of another 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.

#### 1.1.5 Money market reference rates

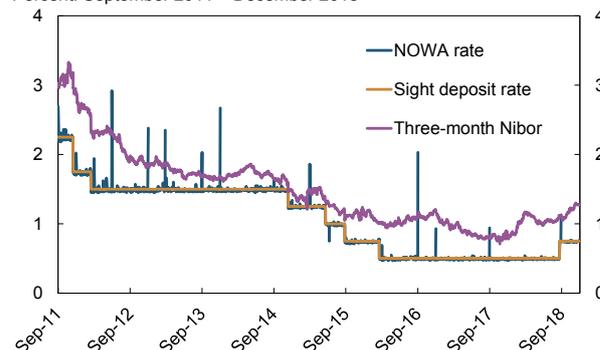
A reference rate is an interest rate that is used as a starting point for the pricing of other financial instruments. Reference rates play a critical role in the global financial system. These interest rates are linked to large sums of money through various financial products and financial contracts. Money market rates are frequently used as reference rates.

Chart 1.3 NOWA rate and reported turnover volume. NOWA rate in percent and volume in billions of NOK. September 2011 – December 2018



Source: Norges Bank

Chart 1.4 Sight deposit rate and short-term money market rates. Percent. September 2011 – December 2018



Source: Norges Bank

## 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 the future interest rate period begins, on the basis of the difference between the agreed interest rate and a selected reference rate. As a rule, the contracts start on IMM dates.

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 the 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.

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 14bn (Chart 1.3). 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 deposits made by financial institutions and businesses and 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 the same as the interest rate on banks' deposits in Norges Bank (sight deposit rate) since it was established (Chart 1.4).

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 on Nibor, see "Risk premiums in Nibor and other countries' interbank lending rates", *Staff Memo 21/2012*, Norges Bank, "A Decomposition of Nibor", *Economic Commentaries 3/2015*, Norges Bank and "What drives the risk premium in Nibor?", *Economic Commentaries 10/2016*, Norges Bank.)

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 middle four 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.

The G20 countries, via the Financial Stability Board (FSB), launched an initiative to reform interest rate benchmarks when attempts to manipulate global reference rates were uncovered and there was a decline in activity in the unsecured interbank market following the financial crisis. After consultation with the financial industry, Norges Bank has established a working group on alternative reference rates in NOK. (For more details, see *Working group on alternative reference rates (ARR)*.) The first part of the working group's work is to put forward proposals on possible alternative reference rates and how to establish these rates. Subsequently, the working group will determine how the proposed rates can be used as reference rates.

### 1.1.6 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 can pay a fixed interest rate on their bond debt, while interest rates on bank lending to households and businesses 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 the effects of such interest rate changes by entering into an interest rate swap with Nibor as the reference rate (see box: **Derivatives**). Under the terms of the swap, banks make interest payments at the Nibor rate and receive interest payments at a fixed interest rate (the swap rate), thereby hedging 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.

#### 1.1.6.1 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 institutions, businesses, the public sector, private individuals and institutional investors. An institution 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 government can use interest rate swaps as a part of government debt management. The average time to refixing of the government's debt portfolio (ie when an instrument is subject to a new interest rate) is reduced if the government enters into agreements to receive payments at a fixed interest rate and pay a floating interest rate. One of the reasons for using interest rate swaps is that reducing the average time to refixing can result in lower interest costs.

#### 1.1.6.2 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 derivatives 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 April 2016 was USD 76bn. Interest rate swaps and forward rate agreements (FRAs) accounted for USD 41bn and USD 35bn, respectively, of the total. No activity was reported in the interest rate option market. (For more information on the BIS survey, see the *Norges Bank website*.)

## 1.2 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). The principal may be repaid in instalments on the coupon payment dates or, more commonly, 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 marketplace 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 businesses are the largest issuers in the bond market. The largest investor categories include life insurance companies, pension funds, mutual 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 further details, 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 1.1 *Money market*.

### 1.2.1 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.

## 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], *Penger og Kreditt* 1/2003, Norges Bank (in Norwegian only) and “Risikopremier i det norske rentemarkedet” [Risk premiums in the Norwegian bond market], *Penger og Kreditt* 3/2005, Norges Bank (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], *Penger og kreditt* 3/2004, Norges Bank (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.

### 1.2.1.1 Maturity

Most bonds have maturities of one to ten years, but some have up to 20 to 30 years. Outside Norway, so-called "ultra-long" government bonds, with maturities of 40 to 100 years, have become somewhat more common. 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 a price agreed upon in advance.

### 1.2.1.2 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 reference rate (typically three-month Nibor) plus a fixed risk premium (see box: **Bond yields and bond risk premiums**). Coupon rates on such bonds 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 interest 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 bonds are more common than fixed rate bonds in Norway, but all government bonds are fixed rate. Some bonds feature coupons that can be refixed over the life of the bond according to specified rules.

### 1.2.1.3 Priority

A bond is 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**). Preferred claims or collateral in the form of specific assets reduce the risk that investors will not be repaid.

Table 1.1 Issuer categories in the Norwegian bond market. Volumes outstanding at year-end, in billions of NOK

	2015	2016	2017	2018
Banks and mortgage companies	772	830	857	915
Central government	338	383	390	405
Local government	83	90	99	104
Norwegian non-financial institutions (businesses)	268	272	305	321
Other countries	248	268	284	296
Other	16	19	24	22
<b>TOTAL</b>	<b>1 725</b>	<b>1 862</b>	<b>1 959</b>	<b>2 064</b>

Source: Statistics Norway

## 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. 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", *Economic Bulletin 1/2010*, Norges Bank.)

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 equal 102% the value of the covered bonds outstanding, also referred to as overcollateralisation.<sup>1</sup> 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. Overcollateralisation 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.

**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. 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. Nor are SPVs subject to supervision or capital requirements as is common for financial sector undertakings. 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 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.

<sup>1</sup> On 29 March 2017, the balance sheet requirement was changed in the Financial Institutions Regulation from 100% to 102% of the value of covered bonds outstanding.

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 *subordinated loan capital*. Subordinated loan capital will, after equity capital, absorb losses first if the borrower goes bankrupt. Equity capital has the lowest priority, below all 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. (Read more about CoCos in *Staff Memo 19/2014*, Norges Bank.)

Bonds can also be categorised according to the projects they finance. Green bonds are an example of loans that finance environmentally friendly projects. Oslo Børs has a separate list for green bonds. Projects are subject to an independent assessment before they can be listed on Oslo Børs' green bonds list. Globally, there are a number of different frameworks for classifying green bonds.

## 1.2.2 Norwegian bond issuers

The Norwegian bond market consists of bonds issued under Norwegian legislation. 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 institutions (businesses) (Table 1.1). Local governments also obtain funding to some degree by issuing bonds.

### 1.2.2.1 The central government

The central government is the largest single issuer in the Norwegian bond market. The bonds it issues are called government bonds. The government also has Treasury bills outstanding, which are described in greater detail in Section 1.1 *Money market*. Government bonds are issued in NOK with a fixed coupon

rate paid annually. The bonds are bullet bonds, ie the principal is repaid at maturity.

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 for daily payments. The government also borrows to fund lending and provide capital injections for state banks and other government lending schemes. The government lending schemes that are funded by issuing government debt include the Norwegian State Education Loan Fund, the Norwegian State Housing Bank, the Norwegian Public Service Pension Fund residential mortgage programme and Export Credit Norway.

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, ie they can easily be sold without substantially affecting the market price. 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 (see box: **Bond yields and bond risk premiums** in Section 2). In Norway, the government 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.

### 1.2.2.2 Local governments

Norwegian municipalities and counties are a smaller issuer category in the Norwegian bond market. The municipalities also borrow substantially through Kommunalbanken, which primarily obtains funding in bond markets abroad.

### 1.2.2.3 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 around

## NORWEGIAN BANKS' AND MORTGAGE COMPANIES' BOND FUNDING ABROAD

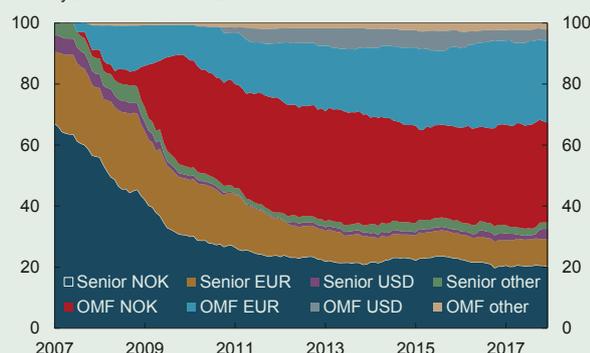
Norwegian banks and mortgage companies obtain a substantial share of their bond funding in foreign currency. At end-2017, approximately 45% of bond funding in Norway was issued in a foreign currency (Chart 1.5). Most of the bonds are issued in EUR, but the banks also issue bonds in other currencies, including USD, SEK, CHF and GBP. Mortgage companies 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**). 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.

Such FX and interest rate swaps can either last for the life of the bond or banks can roll over a series of shorter swaps. Covered bond mortgage companies utilise combined interest rate and FX 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", *Staff Memo 2/2014*, Norges Bank.)

Chart 1.5 Bond debt of Norwegian banks and covered bond mortgage companies. By currency and type of bond. Percent. January 2007 – December 2018



Sources: Bloomberg and Stamdata

half 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**).

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 businesses. 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. (For further details, see box: **Secured funding**.) At end-2018, the volume outstanding in the market for covered bonds was just over NOK 600bn, or approximately 30% of the Norwegian bond market as a whole. Most banks jointly own mortgage companies with other banks, while the largest 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.

#### 1.2.2.4 Non-financial institutions (businesses)

For non-financial institutions, bonds are an alternative to bank loans. Most Norwegian businesses are too small to issue bonds, and nearly all credit to businesses is channelled via banks. In recent years, however, an increasing number of businesses have obtained funding in the Norwegian bond market, and there has been an increase in the volume of bonds outstanding (Table 1.1). Norwegian regulations relating to the issuance of bonds are more concise and standardised than they are in many other countries, which has probably facilitated access to the Norwegian bond market for a greater number of small Norwegian firms and also some foreign businesses.

Businesses 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 businesses that are not able to obtain bank loans.

Previously, the Norwegian bond market was primarily used 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

**Table 1.2 Investors in the Norwegian bond market. Holdings at year-end, in billions of NOK**

	2015	2016	2017	2018
Banks and mortgage companies	397	453	479	542
Central government	92	106	109	98
Mutual funds	241	255	278	288
Life insurance companies and pension funds	350	380	396	402
Non-life insurance companies	72	62	65	61
Other countries	487	519	548	592
Other	85	87	84	82
<b>TOTAL</b>	<b>1 725</b>	<b>1 862</b>	<b>1 959</b>	<b>2 064</b>

Source: Statistics Norway

market are issued by businesses with high credit risk, known as high-yield bonds, also called junk bonds. At end-2018, high-yield bonds accounted for just under half of the volume of corporate bonds outstanding. High-risk enterprises include a number of foreign issuers. Since some businesses' revenues are in foreign currency, a large share of these bonds is also denominated in currencies other than NOK, particularly USD.

Fixed rate bonds are more common in the corporate bond market than in the bank bond market. Fixed coupon payments provide businesses with more predictability. Asset-backed bonds are relatively common among businesses, particularly in the real estate, oil, gas and shipping sectors, where buildings, ships, oil rigs and other fixed assets serve as collateral.

### 1.2.3 Bond investors

The largest investor categories in the Norwegian bond market are life insurance companies, pension funds, banks and mutual funds (Table 1.2). Foreign investors are the dominant category in the government bond market and, compared with other countries, the share of bonds held by foreign investors is high in 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 are therefore substantial investors in the government bond, covered bond and municipal bond markets, although they also purchase bonds issued by businesses 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 2.5 *Insurance companies* and Section 2.6 *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 2.2.6 *Liquidity regulation*.)

Mutual 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. Mutual funds are the largest investor category in the bank bond market and also buy covered bonds and municipal bonds. (Read more in Section 2.7 *Mutual funds*.)

### 1.2.4 Primary bond market

The market for issuing bonds is called the primary market. It is a trading venue where participants with long-term borrowing needs can meet those seeking long-term investment. While government bonds are mainly 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 reopenings.

#### 1.2.4.1 Auctions

Government bonds are usually issued by Dutch auction on Oslo Børs. In Dutch auctions, all the successful bidders in an auction pay the price quoted by the lowest bidder, unlike American auctions, where bidders pay the price they submitted. In the 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 in order of price, from highest to lowest.

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.

In 2018, syndication was used for the first time to sell Norwegian government debt. This method of selling debt using syndicated bonds is widely used (see description of the book-building process below).

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

#### 1.2.4.2 Book-building process

Bonds are often 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 are willing 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 issuer pays the underwriter for these services. Issuers often advertise bond issuances in advance. This is especially common if the issuer is not known to the investors.

#### 1.2.4.3 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. 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 because the price will generally be lower when there is an investor who wants a special issue.

#### 1.2.5 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 the VPS. (Read more in Section 3.3 *Securities settlement (VPO)*.)

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**.) Bonds can also be registered in alternative trading venues, such as Oslo ABM (Alternative Bond Market), which is subject to less extensive reporting requirements.

### 1.2.5.1 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>1</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 reduce the government's borrowing costs. Only a small share of government bond trades take place electronically on the exchange. Most are agreed upon directly between the trading parties. Primary dealers can borrow bonds from the government in order to be able to quote ask prices at any given time. The government can lend government bonds to primary dealers on request for up to a week at a time. The government has its own stock of all its securities for this purpose.

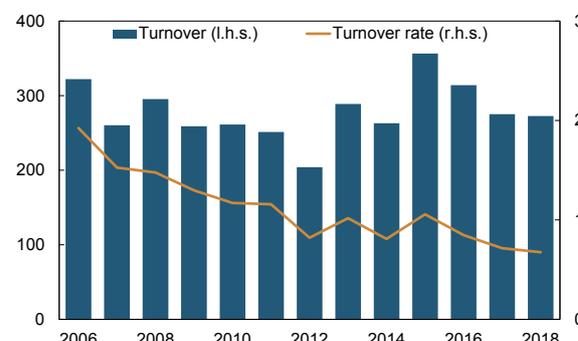
On an international scale, the turnover of listed Norwegian government bonds is low. The turnover rate has fallen markedly over the past 15 years (Chart 1.6). The turnover rate is frequently used as an indicator of liquidity in the secondary market. It provides an indication of trading activity in relation to the volume outstanding in a given period. A high numerical value for the turnover rate suggests an active secondary market.

Trades between parties that are not members of Oslo Børs are not captured in exchange 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.

### 1.2.5.2 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

Chart 1.6 Turnover and turnover rate<sup>1</sup> of Norwegian government bonds. In billions of NOK. 2006 – 2018



1) The turnover rate is the sum of turnover over one year divided by average outstanding volume in the same year.  
Sources: Oslo Børs and Norges Bank

other securities. Brokers often quote indicative prices, ie the prices they might be willing to buy or sell the bonds for. Customers must make contact to obtain precise price quotes and to 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 quoted continuously through the day. The reference list is intended to improve the liquidity of the securities and to promote them to investors.

### 1.2.6 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 often acts as trustee. The presence of a trustee is important in that it provides assurance to bond investors that their rights are being safeguarded.

<sup>1</sup> Detailed conditions for primary dealers are available here: <https://www.norges-bank.no/en/topics/Government-debt/Secondary-market/>

## 1.3 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 foreign exchange (FX) market is the market for the purchase and sale of currencies. The exchange rate is the price of one currency in terms of another and is decided in the FX market. Exchanging one currency for another or using traveller's cheques account for a very small share of the activity in the FX market. 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 another currency in this currency's banking system (for example Swedish krona (SEK) in a Swedish bank). The way currency trades are settled is explained in Section 1.3.3 *Trading structure and turnover in the FX market*. There are certain risks associated with the settlement of currency trades, where time differences between national settlement systems involved in the trades can be considerable. This is discussed in Section 3.2.3 *Foreign exchange settlement risk and the CLS foreign exchange settlement system*. A list of standard currency codes is available (see box: **Currency codes (ISO 4217)**).

### 1.3.1 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 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, ie 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 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) were thereby rendered superfluous. The first two letters are based on the ISO 316-1 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 the Norwegian krone, the code is NOK, NO for Norway and K for krone. 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.

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.

### 1.3.2 FX market instruments

#### 1.3.2.1 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.

### 1.3.2.2 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.

### 1.3.2.3 FX derivatives

Derivatives are instruments whose value is determined by fluctuations in the value of an underlying asset. The most commonly used derivatives in the FX market are FX swaps and FX options (see box: **Derivatives**).

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**).

## 1.3.3 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 brokers 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, ie 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 via large international banks using 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 algorithms.

An algorithm is a computer program used to quote prices or make investment decisions in financial markets. An example of this is an algorithm that automatically quotes a bank’s bid and ask prices up to a certain volume. Algorithms can also be programmed to divide up large transactions into many small trades in order to limit exchange rate effects. In addition, they can be used to identify exchange rate trends or 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. Algorithms can change prices a large number of times per second. Electronic trading venues such as Thomson Reuters Eikon and EBS have decided that prices quoted by market makers cannot be removed until a certain amount of time has passed, for example one second, even if no trades are made at that price. This is referred to as the minimum quote life.

### 1.3.3.1 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 Eikon and it has traditionally been an important trading platform for trades in currency pairs such as GBP/USD, EUR/GBP, AUD/USD, NZD/USD, 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, EBS is the most widely used platform for EUR/USD, USD/JPY, EUR/JPY, USD/CHF and EUR/CHF. Previously, the market was primarily divided between Thomson Reuters Eikon 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 platforms operated by a single bank. One of the largest multibank platforms is FXAll, which was purchased by Thomson Reuters Eikon in 2012. 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 2015, more than 11 000 financial institutions in over 200 countries used the system and more than 6.5bn messages were sent via SWIFT. The SWIFT main office is in Brussels.

### 1.3.3.2 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* for more information).

The BIS survey is extensive, and close to 1300 financial institutions from 52 countries participated in the 2016 survey. The survey showed that average daily

turnover in the Norwegian FX market was NOK 333bn in April 2016 (Table 1.3). (Read more on the *Norges Bank website*). Close to 34% of turnover was in the spot market, while more than 65% was in the forward market. Virtually all trades in the forward market involved FX swaps. FX options and currency swaps accounted for a very small portion of turnover.

In the NOK spot market, turnover has traditionally been highest in EUR, while in the forward market, turnover has been 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, EUR and JPY against other currencies. In the forward market, USD is the benchmark currency.

### 1.3.3.3 Reference exchange rates

Oslo Børs has listed official exchange rates in Norway since the stock exchange opened in 1819 and until 1 September 2001, when Norges Bank took over. Exchange rate listing is now normally undertaken daily at 2.15 pm. The rates are not binding and are only meant to provide a snapshot of the FX market. Starting on 1 July 2016, the ECB took over the quoting of

**Table 1.3 Average daily turnover in Norway's FX market in April. In billions of NOK and percent of total**

	1998	2001	2004	2007	2010	2013	2016
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%)	112,0 (33,7%)
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%)	219,0 (65,8%)
- 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%)	5,4 (1,6%)
- 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%)	213,6 (64,2%)
Cross-currency basis swaps	-	0,2 (0,1%)	0,1 (0,1%)	0,3 (0,2%)	2,4 (1,8%)	0,9 (0,8%)	0,6 (0,2%)
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%)	1,0 (0,3%)
<b>TOTAL</b>	<b>67,0</b> <b>(100%)</b>	<b>117,9</b> <b>(100%)</b>	<b>100,0</b> <b>(100%)</b>	<b>192,5</b> <b>(100%)</b>	<b>131,4</b> <b>(100%)</b>	<b>124,3</b> <b>(100%)</b>	<b>332,7</b> <b>(100%)</b>

Sources: BIS and Norges Bank

exchange rates and the publication time was then moved from 2.30 pm to around 4 pm. 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 Eikon and are often 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 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, ie 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 Eikon Matching trading platform are used to calculate the WM/Reuters fixes.

### 1.3.4 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. The purchase and sale of foreign exchange for travel and holidays in Norway today largely takes place at exchange bureaus in the largest cities and at airports and train stations.

## 1.4 EQUITIES

Equities are shares in a business that represent an ownership interest in that business's equity capital (ie, the value of its assets less its liabilities). The market value of all the shares in a business represents the market value of its equity capital. Equity markets are markets for issuing new equities (primary market) and for trading equities (secondary market). Equity markets distribute capital and spread risk among investors and businesses/projects.

### 1.4.1 Corporate structure and funding

Entrepreneurs starting a business must invest their own equity capital or raise equity capital from other investors. Sufficient equity capital is necessary for both startups and existing companies to obtain loans from banks and/or markets. Equity capital and any loans, referred to as debt or debt capital, are used to cover establishment and development costs and to fund machinery, goods and other equipment a business needs for its daily operations.

Fresh equity capital can be raised by issuing equities, or ownership shares, in the business. The most common corporate structure is the limited liability company, where shareholders' liability is limited to their contribution to the company's equity capital. Shareholders are otherwise not liable for the company's debt or other obligations. Norwegian limited liability companies can either be public (ASA) or private (AS) and are regulated by the Norwegian *Public Limited Liability Companies Act* and the *Limited Liability Companies Act* (electronic versions not available), respectively. This legislation includes provisions relating to accounting, dividend distributions and share capital write-downs, which are intended to protect a company's creditors. An AS requires a minimum of NOK 30 000 in share capital, while an ASA requires a minimum of NOK 1m. Requirements are higher for ASAs because these are companies with a large number of shareholders and/or that wish to be able to raise capital from the general public. Listed limited liability companies must be ASAs. Boards of ASAs are required to be gender-balanced, but in an AS, one and the same person may be the company's sole shareholder, board member and employee.

The accounting profit or loss from the company's activities is added to (or deducted from) equity capital. Earnings therefore influence the value of the shares. Earnings also often set an upper limit on dividends that can be paid to shareholders. The portion of earnings that is not paid out as dividend can be used to repay debt or finance new projects. When the business posts a loss, equity capital is reduced and the company can go bankrupt if the loss exceeds the total value of equity capital. In the event of bankruptcy, debt capital is given priority over equity capital. Thus, equity investments involve higher risk than investments in debt capital (eg bonds). Greater risk implies that equity capital should be expected to yield higher returns than debt capital over time. A high equity capital ratio improves a company's ability to survive periods of loss and makes it easier to raise new debt capital. Companies operating in an industry where earnings are highly volatile normally have higher equity capital ratios than those operating in industries where earnings are more stable.

### 1.4.2 Equity markets

For shareholders holding shares as a financial investment, buying and selling shares easily will be important. Shares in an ASA are therefore 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. Equity markets provide a way of transforming illiquid investments in fixed assets, expertise and specialised production equipment, into more liquid holdings for investors. The sale of a few shares does not normally affect the share price, but the sale of large volumes of shares over a short period can reduce the share price. The problem of executing transactions of the desired size without affecting share prices is referred to as market liquidity risk (see box: **Liquidity**).

Investors as a group conduct a form of continuous indirect monitoring of companies' operations via the price of new issues (primary market) or via the ongoing price discovery process in the secondary market (trading on the stock exchange). For investors to be willing to buy shares, the subscription/market price must be attractive enough for the company's expected earnings to satisfy buyers' required rate of return adjusted for the risk that earnings will not be

as expected (risk-adjusted return). Companies/projects with low profitability or poor management are "punished" by lower share prices. Listing on the stock exchange contributes to diversification of ownership, and profitability assessments of projects and management are therefore conducted by a number of investors. For assessments to be as accurate as possible, companies are required to submit reliable information, such as periodical financial reporting. Stock exchanges and legislators have 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*).

As it can be costly to promote a company/project to investors in the equity market, small companies/projects have in practice little direct access to capital from equity markets. An alternative source of equity capital has emerged: crowdfunding. (For more information on crowdfunding, see Section 2.8.5 *Crowdfunding*.)

Equity markets allow investors to diversify their investments across companies and 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 well-functioning equity markets, it is also easier for companies to specialise, and risk can thereby be reduced by diversifying investments. (Read more about diversification in box: **Diversification** in Section 2.)

An efficient and secure system for registering the ownership of securities, known as a central securities depository, reduces the costs associated with investing in securities.

### 1.4.3 Size of the Norwegian equity market

At end-2018, the market value of listed equities, registered with the Norwegian central securities depository (VPS), was NOK 2 407bn, while the market value of unlisted equities registered with the VPS was NOK 458bn. Most Norwegian limited liability companies are neither listed nor VPS-registered. Oslo Børs ASA operates venues for trading equities and equity

certificates (see next section), 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-2018, 193 equities were listed on Oslo Børs, while 17 equities were listed on Oslo Axess and 28 equities on Merkur Market.

#### 1.4.3.1 Other equity instruments

Equity certificates are equity instruments issued by savings banks. There are clear similarities between equity certificates and shares 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 equity capital and that the composition of savings banks' governing bodies is subject to specific requirements. Thirty-nine savings banks have issued equity certificates, 21 of which were listed on Oslo Børs in 2018. Oslo Børs has established an Equity

Certificate Index (OSEEX), which includes all of the listed equity certificates.

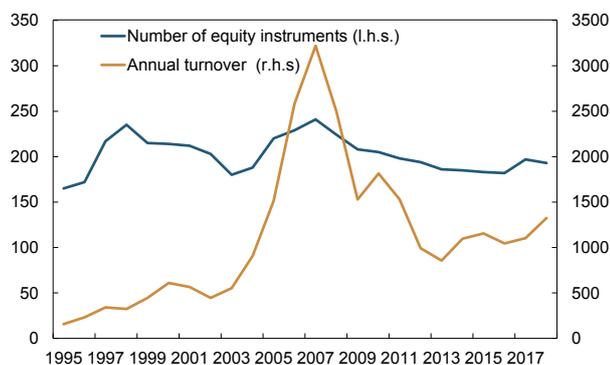
Shares and equity certificates are both equity instruments. Chart 1.7 shows developments in equity instrument turnover on Oslo Børs and in the number of listed equity instruments since 1995.

The turnover rate is influenced by price developments for equity instruments (Chart 1.8). 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 1.8). The number of trades has also remained fairly high since the crisis, possibly influenced by increased algorithmic trading. Turnover has nonetheless declined, and increased competition for trading in Norwegian equities from alternative market venues and foreign stock exchanges may have contributed to the lower turnover.

#### 1.4.4 Issuers

Chart 1.7 shows developments in the number of equities and equity certificates listed on Oslo Børs. The number of new companies on Oslo Børs may be

Chart 1.7 Annual turnover and number of equity instruments<sup>1</sup> listed on Oslo Børs.<sup>2</sup> Turnover in billions of NOK. Number of equity instruments at year-end. 1995 – 2018

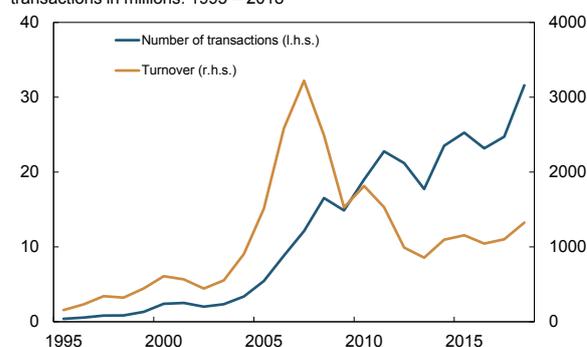


1) Equity instruments = shares and equity certificates.

2) Turnover includes ETFs on Oslo Børs. Turnover and equity instruments listed on Oslo Axess and Merkur Market are not included.

Source: Oslo Børs

Chart 1.8 Annual turnover and annual number of transactions in equity instruments<sup>1</sup> on Oslo Børs.<sup>2</sup> Turnover in billions of NOK. Number of transactions in millions. 1995 – 2018



1) Equity instruments = shares and equity certificates.

2) Does not include turnover and equity instruments on Oslo Axess.

Source: Oslo Børs

affected by the business cycle. It may be easier to raise capital in the market 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 delisted from Oslo Børs is that it is taken over by another company. Companies that go bankrupt will also be delisted. In some cases, majority shareholders also want to delist 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.

### 1.4.5 Investors

Developments in the shareholder structure for companies listed on Oslo Børs since 1997 are shown in Chart 1.9. The two largest categories of shareholders on Oslo Børs are foreign nationals and the Norwegian government, both with ownership interests of at least a third of the total market. The third largest share-

holder category is other businesses. Less than 4% of equity instruments on Oslo Børs are held by Norwegian private individuals. 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 further 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.

### 1.4.6 Equity indices on Oslo Børs

Equity indices are computed to measure the value of the equity market as a whole and of different segments of the equity market. The most widely used equity indices are called price indices and total return indices. Changes in both share prices and dividends received are used to compute total return indices, and the weights of the equities in the index are changed daily based on price developments. Price indices are similar, but dividends received are not included. 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

Chart 1.9 Shareholder structure for companies listed on Oslo Børs. Percent. At year-end. 1999 – 2018

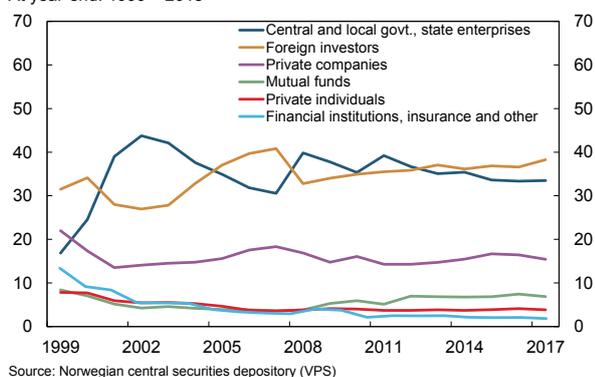
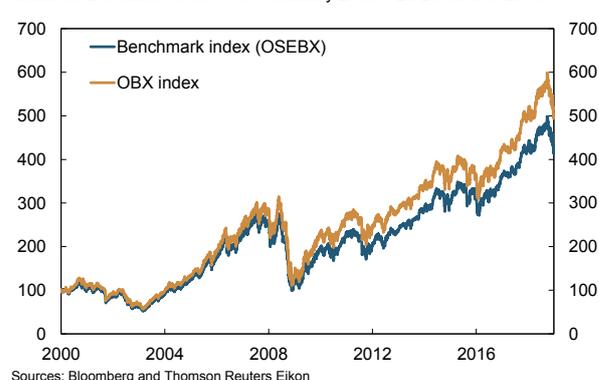


Chart 1.10 Main Norwegian stock market indices. Index. 30 December 1999=100. 1 January 2000 – 28 December 2018



containing a representative selection of all the shares listed on Oslo Børs. The selection is based on share turnover and diversification across groups of industries. Oslo Børs revises the index biannually and implements changes on 1 December and 1 June. As of 1 June 2018, 70 equities were included in the OSEBX. The OSEBX equity weights are free-float adjusted, ie equities that are not expected to be traded, such as the government's shareholdings and the strategic holdings of shareholders with controlling influence are not included when shares in the index are weighted.

The Oslo Børs index (OBX) comprises the 25 most traded equities on Oslo Børs. The composition of equities in the index is revised biannually. The OBX index is intended to 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 derivatives trading, it is important to be able to buy and sell the various OBX index components (the underlying securities). Chart 1.10 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.

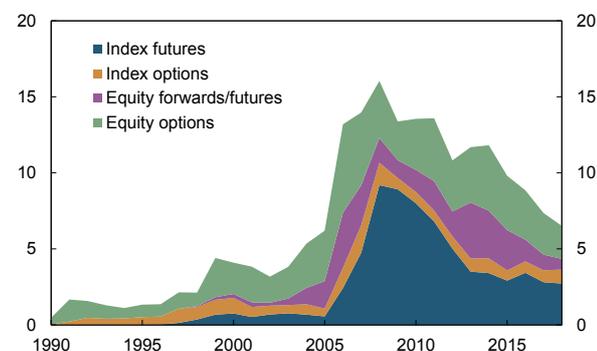
### 1.4.7 Equity-related derivatives

The characteristics of different types of derivative are explained in box: **Derivatives**. Exchange-traded derivatives are standardised with regard to the underlying instrument and terms of delivery. On Oslo Børs, options and futures on the OBX index, and options, futures and forwards for the most liquid equities are traded. Listed derivatives are settled via a clearing house, which acts as central counterparty (CCP) for both buyer and seller (see Section 3.3 *Securities settlement (VPO)*).

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 edged down as a result of a decrease in the number of index derivatives (Chart 1.11).

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.

Chart 1.11 Number of trades in standardised equity derivatives contracts on Oslo Børs. In millions of trades. 1990 – 2018



Source: Oslo Børs

## 2 Financial institutions

Financial institutions function as intermediaries between economic agents. Their main tasks are to enable businesses and private individuals to borrow money and invest savings, execute payments, handle cash and assess, redistribute and price risk. The role of financial institutions in money and capital markets is described in Section 1 *Financial markets*. The Financial Institutions Act lists the entities that can be defined as financial institutions (see box: **Financial Institutions Act**).

Banks constitute the largest and most important category of financial institution. They have the exclusive right to accept deposits from the public 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. Private individuals and businesses hold accounts in banks in order to receive or pay wages and bills. Banks also lend to private individuals for home purchases or to businesses wishing to invest in new equipment. Mortgage companies may also lend money but may not accept deposits (see Section 2.3 *Mortgage companies*). These companies have taken over a large share of residential mortgage financing since 2007, when a new type of mortgage company issuing covered bonds was authorised. Insurance companies offer life insurance, non-life insurance and credit insurance (see Section 2.5 *Insurance companies*). Together with pension funds, they channel savings and manage risk.

Table 2.1 provides an overview of various types of financial institution in Norway grouped by size.

### FINANCIAL INSTITUTIONS ACT

The new Act on Financial institutions and Financial Groups (*Financial Institutions Act*) 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, including ensuring that financial institutions operate in an appropriate and sound manner. The Act lays down requirements for the establishment, operation and wind-up of financial institutions. Under the Act, the following kinds of entities are considered financial institutions:

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

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

Table 2.1 Types of financial undertaking in Norway. At 31 December 2018

	Number	Total assets (in percent of GDP)
Norwegian banks	127	111
Branches of foreign banks	14	42
Mortgage companies	33	65
Finance companies	44	6
State lending institutions	3	11
Life insurance companies	12	45
Non-life insurance companies	57	7

Sources: Statistics Norway and Norges Bank

## 2.1 FINANCIAL GROUPS

A single financial group can comprise several types of financial institution and this type of horizontal integration has shown a growing trend over time.

A financial group can more easily offer customers a complete range of products and services than a single institution, exploiting economies of scale in areas such as 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 can have 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 in order to engage in insurance activities, investment management and the like. A financial group, such as the SpareBank 1 Alliance, can offer these services.

Table 2.2 provides an overview of the eight largest financial groups in Norway and their main line of business. Of these, six mainly engage in banking, while the remainder specialise in insurance.

DNB, the SpareBank 1 Alliance, KLP, Storebrand and the Eika Alliance are the largest Norwegian-owned financial groups. They offer most kinds of financial services. DNB, the SpareBank 1 Alliance and the Eika Alliance mainly engage in banking, while the other two focus on insurance.

## 2.2 BANKS

Banks offer a number of products and services to economic agents, including short-term and long-term loans. They differ from other types of financial institution because they have the exclusive right to create and accept deposits from the public. 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 vary according to interest rate terms and restrictions on withdrawals. Among the types of account offered by banks are ordinary current accounts, savings accounts or high-interest accounts and the home savings scheme for young people (BSU) account. Deposits can be withdrawn as cash from ATMs, in shops and

**Table 2.2 Largest Nordic banking groups operating in Norway. By market capitalisation. At 7 June 2019**

Financial group	Main business line
Nordea	Banking
DNB	Banking
Sampo	Insurance
SEB	Banking
Handelsbanken	Banking
Swedbank	Banking
Danske Bank	Banking
Gjensidige	Insurance

Source: SNL Financial /S&P MI

in bank branches, or used directly to make payments using debit cards or via an online or mobile banking service. The increased prevalence of computers and smart phones has increased the use of online and mobile banking, resulting in fewer bank branches and ATMs in Norway. (For more on the role of banks in the payment system, see Section 3 *Financial infrastructure*.)

Banks offer several types of loan, such as residential mortgage loans, commercial loans and consumer loans. Loans can vary by type of interest (fixed or floating), length of fixed-rate periods, currency and form of repayment (annuity 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. The borrower is free to make repayments or borrow more up to this limit. *The Regulation on requirements for new residential mortgage loans* now sets a cap on new home equity lines of credit at 60% of the dwelling’s value. The borrower pays interest only on the amount drawn at any given time. Furthermore, banks can exchange foreign currency and provide financial advice. Some banks choose to offer only a limited range of loans or services. With high lending growth in the consumer credit market in recent years, a number of banks specialising in consumer credit have increased market share. Moreover, several newly established banks

## CONSUMER CREDIT

Consumer credit refers to credit card debt and other forms of unsecured debt. Consumer credit amounted to around NOK 110bn, or just above 3% of total household borrowing at end-2018. Interest rates on consumer debt are generally much higher than on collateralised loans. Banks and finance companies' margins on consumer loans are higher, which can be an advantage as expected default rates and losses are considerably higher for consumer loans than for other kinds of loans to private individuals. To increase lenders' resilience to losses, risk weights for consumer loans are higher than for lower-risk loans, such as residential mortgages. Higher risk weights result in higher capital requirements. (Read more in *Appendix 2: Bank capital regulation*.)

Consumer credit to Norwegian households has grown by 10%–15% annually in recent years. By comparison, growth in total household debt has remained fairly stable at around 6% over the past couple of years. Credit card debt accounts for around half of consumer credit. Credit card issuers normally offer credit with an interest-free period.

A number of new consumer credit providers have entered the market over the past 10 years, primarily relatively new operators. The new specialised consumer credit banks have primarily funded lending and rapid growth by a corresponding increase in deposits. Consumer credit banks attract deposits by offering markedly higher deposit rates than other banks. The combination of high interest rates and deposits that are largely guaranteed by the Norwegian Banks' Guarantee Fund make consumer credit banks attractive to depositors.

To improve the consumer credit market and strengthen the position of consumers, the authorities are introducing a number of measures.

Two regulations have been laid down, one on the invoicing of credit card debt and another on the marketing of consumer credit. In addition, the Storting has adopted the Act on consumer credit information. The Act strengthens finance companies' ability to perform sound credit assessments as it gives new creditors access to information about a borrower's existing debt. It also protects consumers from taking on too much debt. In addition, Finanstilsynet has issued a regulation on prudent consumer lending practices, based on previous guidelines. Read more about consumer credit in Section 4 of the 2016–2017 Financial Markets Report (in Norwegian only).

have targeted this segment of the credit market (see box: **Consumer credit** and "Strong growth in consumer credit", *Economic Commentaries* 1/2017, Norges Bank).

Norwegian banks are classified as either savings banks or commercial banks, but this distinction has become less relevant over time. The main difference between commercial and savings banks is related to ownership structure and not to the services they offer customers (see also box: **Evolution of the Norwegian banking sector over the past 50 years**).

### 2.2.1 Banks' tasks

#### 2.2.1.1 Providing opportunities to save and borrow

Banks play an important role as an intermediary between prospective savers and prospective borrow-

ers. Savers deposit their cash in deposit accounts with a certain rate of return in the form of interest payments. Amounts can be withdrawn as and when needed by depositors. The banks transform many small and liquid deposits into fewer, and on the whole, larger and long-term loans.<sup>2</sup> But banks do not only function as intermediaries between depositors and borrowers. Banks create money when they issue a new loan to a customer (see box: **Creating money**).

Banks assess the probability that a borrower will default. If the borrower does not pay, the loss falls on the bank. There are economies of scale to be achieved in gathering and processing information, issuing credit

<sup>2</sup> See Holden, S. (2016), *Makroøkonomi*. Cappelen Damm, for a more detailed and explanatory presentation (Norwegian only).

## EVOLUTION OF THE NORWEGIAN BANKING SECTOR OVER THE PAST 50 YEARS

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). A savings bank, on the other hand, may not be established as a limited liability company. Savings banks have traditionally been organised as mutually owned foundations, with equity primarily comprised of previous years' retained earnings. Savings banks are expected to support local communities, even if no legal obligation exists, both by offering reliable banking services and by using some of their profits to support local activities.

From around 600 savings banks in 1960, the number has fallen to slightly over 100 today. A description of this process can be found on *The Norwegian Savings Banks Association* website (in Norwegian only). While commercial banks increasingly became nationwide institutions, savings banks increased in number in regional Norway. With changes in settlement patterns and industry structure, savings banks had to become larger 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 evolved through the 1990s. SpareBank 1 Gruppen was established in 1996, while the Eika Alliance (Terra Gruppen between 2000 and 2013) was established in 1997. The idea behind forming alliances was to establish joint product companies for non-banking activities, while actual banking activities continued at the individual banks.

In 1985, foreign banks were authorised to engage in banking activities in Norway. This was the beginning for the subsidiaries and branches of foreign banks that subsequently became important participants in the Norwegian banking market. There was a series of mergers between Norwegian banks and a number of acquisitions by foreign banks in the late 1980s and the 1990s, leading to a substantial reduction in market share for Norwegian commercial banks. At end-2018, there were 21 Norwegian commercial banks, including subsidiaries of foreign banks.

Today's largest Norwegian financial group, DNB, was formed through a series of mergers. In 1990, Norway'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 DnB 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", *Staff Memo 9/2016*, Norges Bank.) For a complete overview of the different types of bank in Norway, see *Finanstilsynet's registry* and *Finance Norway's website*.

ratings, following up borrowers and formulating loan contracts. Banks can also access confidential information on existing and potential customers. Information about a borrower's personal identity number, income and degree of capability for work, etc, is necessary for establishing a contract, but customers may be reluctant to provide this information to "just any" provider of goods or services, due to its sensitive nature. Owing to the cost involved in gathering information, most private individuals and small and medium-sized businesses will borrow from banks and not directly

in the bond market (see Section 1.2.2.4 *Non-financial institutions (businesses)*). Banks charge fees and interest as payment for loans and other services. Banks pay a lower interest rate on deposits than the interest they receive from loans. The difference is referred to as the interest rate margin.

A borrower may have a substantial and immediate need for capital, to buy a home or purchase production equipment, for example. However, the borrower's income, which will be used to repay the loan, is spread

## CREATING MONEY

Money is defined as a generally accepted means of payment (See box: **What is money?** in the introduction and box: **Definitions of money supply measures** for a more detailed and precise description of money).

Banks do not only function as intermediaries between depositors and borrowers. Banks create money when they issue a new loan to a customer. A new loan increases the customer's deposit account by the same amount. Customer deposits are money. The customer can then choose to use the deposit to pay for a car, for example. The deposit is then transferred to the car dealer, who 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 create 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 will "disappear". The same thing occurs when banks issue bonds that are purchased by individuals and businesses and when individuals or businesses purchase foreign currency. When a customer exchanges NOK for foreign currency, the NOK deposit will be withdrawn from a Norwegian bank and thus "disappear" from the Norwegian money supply. The customer will receive a foreign currency deposit that is not included in measures of the Norwegian money supply. Tax payments to the central government (but not to local government) also reduce the money supply. These payments 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. (For further details, see "Om pengemengden" [On the money supply], *Staff Memo 14/2013*, Norges Bank (in Norwegian only).)

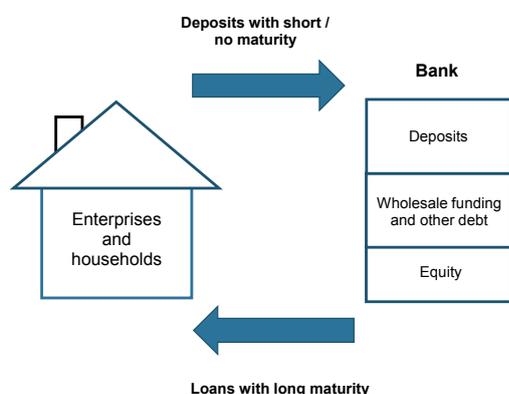
Bank lending depends on opportunities for making profitable loans. This is affected by factors such as the level of funding costs, regulatory requirements and the ability of businesses and households to repay loans. Loan volumes will then determine the volume of bank deposits created in the banking system. At the same time, banks must ensure that they hold sufficient central bank reserves or other liquid assets to make payments to other banks (funding liquidity) and satisfy the authorities' capital and liquidity requirements. Bank deposits are one form of bank funding. Banks also require funding in the form of equity capital. In addition, banks may require other forms of funding, such as bonds or short-term paper. (For an overview of Norwegian bank funding, see Section 2.2.3 *Banks' assets and funding*.)

"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. See also: "Hvordan skapes penger?" [How is money created?], a post on [bankplassen.norges-bank.no](http://bankplassen.norges-bank.no), a blog written by Norges Bank staff, 4 January 2019 (in Norwegian only).

over several years. The borrower therefore needs a long-term loan. Savers on the other hand may prefer to have immediate access to their funds. Banks meet the needs of borrowers and savers by offering borrowers long-term loans, while offering savers immediate access to their funds. The transformation of short-term deposits into long-term loans is called maturity transformation (Chart 2.1). 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 have available to pay depositors. Banks also hold deposits with the central bank and have access to the central bank borrowing facilities, which helps them to manage fluctuations in customer deposits. A situation may nonetheless arise when a bank's solvency 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, a deposit guarantee scheme has been introduced, which is intended to protect the funds of small savers, even if the bank experiences

Chart 2.1 Maturity transformation



problems. The guarantee scheme in Norway currently covers deposits of up to NOK 2m (see also Section 2.2.7. *Deposit guarantees in Norway*).

In addition to maturity transformation of customer deposits, banks perform maturity transformation when they borrow in the market at maturities that are shorter than the maturities of the loans they have extended to customers. Interest rates on short-term loans are normally lower than interest rates on long-term loans. Banks will therefore earn more when they choose short-term funding over long-term funding. Banks can modify the maturity structure of their market funding to achieve a better match with the maturity of their customer loans. This reduces maturity transformation, but also reduces refinancing risk (see box: **Risks in the financial system** in the introduction).

Financial markets also contribute to maturity transformation (see Section 1.2 *Bond market* and Section 1.4 *Equities*).

### 2.2.1.2 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 investment projects with an adequate level of profitability. This means the price for or interest rate on loans assessed to be high-risk (eg unsecured consumer loans) will be higher than on low-risk loans. If the borrower provides the lender with collateral, eg a mortgage on a dwelling, the lender's risk of losses is reduced and the interest rate on the loan will be lower.

## DEFINITIONS OF MONEY SUPPLY MEASURES

The money supply is divided into:

- *Monetary base (M0)*. The sum of Norwegian banknotes and coins in circulation and the deposits of banks, mortgage companies and other elements of the money-holding sector held with Norges Bank, ie central bank reserves or central bank money. The money-holding sector comprises households, non-financial enterprises (businesses), local government administration and financial institutions other than banks and mortgage companies. 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 from which, irrespective of purpose, direct payments and withdrawals may be made without incurring costs other than ordinary transaction fees.
- *M2* is defined as the sum of M1 and the money-holding sector's deposits in NOK and foreign currency in accounts redeemable at notice for up to three months and/or with an agreed maturity of up to two years.
- *Broad money (M3)*. M3 is the sum of M2 and the money-holding sector's holdings of repurchase agreements, excluding holdings of clearing houses, and short-term paper and bonds with a maturity of up to two years issued by the money-issuing sector.

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

## NORWAY'S BANKING SECTOR IS RELATIVELY SMALL

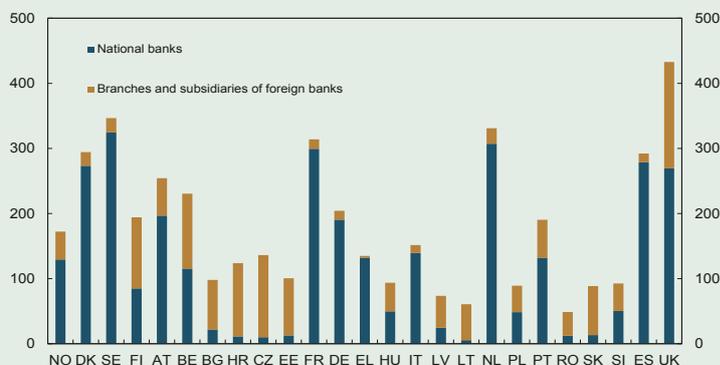
Banking is very international. Most countries have a considerable number of foreign banks, which operate through subsidiaries and branches and engage in direct cross-border activities, as do their own banks in other countries. A country's banking sector can therefore be defined in different ways, including to what extent a bank's other subsidiary companies are included in the definition, particularly bank-owned mortgage companies.

If the banking sector is measured in terms of a balance sheet total that includes subsidiaries, ie a consolidated balance sheet, Chart 2.2.a shows that the Norwegian banking sector is relatively small compared with other western European countries, but large compared with eastern European countries.

Nor is the proportion of foreign subsidiaries and branches particularly high in Norway. The fairly small size of eastern European banking sectors primarily reflects lower income levels.

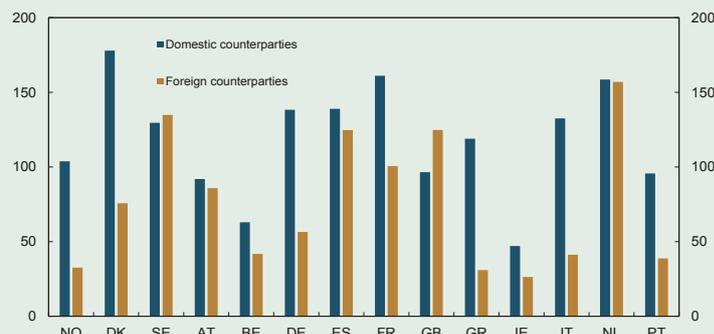
Comparisons with western European countries (Chart 2.2.b) show that the Norwegian banking sector's relatively small size primarily reflects Norwegian banks' limited activity abroad compared with most other countries. Read more about this in "*En internasjonal sammenligning av norsk banksektor*" [The Norwegian banking sector in an international comparison], *Staff Memo 9/2018*, Norges Bank (in Norwegian only).

Chart 2.2.a Distribution of total assets of selected countries' banking systems by national banks, subsidiaries and branches, respectively in each country. Consolidated figures. Percent of GDP. 2017



Source: Updated figures from: "*En internasjonal sammenligning av norsk banksektor*" [An international comparison of the Norwegian banking sector] (In Norwegian only), Norges Bank *Staff Memo 9/2018*

Chart 2.2.b Distribution of total assets of national banks by domestic and foreign counterparties. Percent of GDP. 2017



Source: Updated figures from: "*En internasjonal sammenligning av norsk banksektor*" [An international comparison of the Norwegian banking sector] (In Norwegian only), Norges Bank *Staff Memo 9/2018*

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 monitored by owners, the banks' lenders and supervisory authorities. This reduces the likelihood that they will assume risks greater than their risk-bearing capacity.

### 2.2.1.3 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 3 *Financial infrastructure*). Only banks may hold an account in Norges Bank (with some exceptions).

## 2.2.2 Structure of Norway's banking sector

Compared with other European countries, Norway's banking sector is fairly small relative to total GDP (see box: **Norway's banking sector is relatively small**).

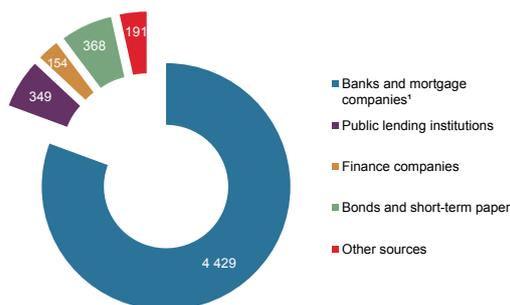
Banks and mortgage companies account for around 80% of total domestic credit to Norwegian households and businesses (Chart 2.3). This is a far higher share of total credit than in the US, for example, where the bond market plays a more important role. Norwegian households borrow almost exclusively from banks and mortgage companies, while Norwegian businesses borrow mostly from banks and to some extent in the bond market.

Although there are a large number of banks in Norway's banking sector, the degree of concentration is relatively high. The largest bank, DNB, has a lending market share of around 30% in both the retail and corporate market (Chart 2.4). By comparison, there are three large banks in Denmark and four in Sweden with high market shares.

The Norwegian banking market is dominated by Norwegian-owned banks. The other banks are subsidiaries or branches of foreign banks. The subsidiaries are owned by foreign banks, but are separate Norwegian legal entities, regulated in the same manner as other Norwegian banks. On the other hand, branches are not separate legal entities and are regulated by their home state authorities. Nordic banks dominate among the foreign banks in Norway, but Santander Consumer Bank (a subsidiary of a Spanish bank) also has a significant presence.

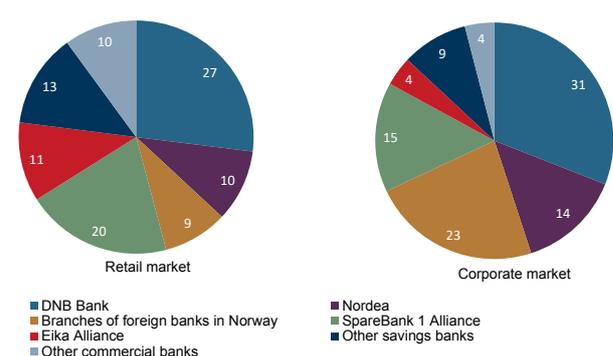
Foreign banks' market share is higher in the corporate market than in the retail market, with a 37% share in the corporate market and a 19% share in the retail market. Over the past 20 years, foreign subsidiaries and branches have increased their market shares in the Norwegian banking market (see "Branches of foreign banks and credit supply", *Economic Commentaries 3/2017*, Norges Bank). On 2 January 2017, the Norwegian subsidiary of the Swedish financial group Nordea was converted into a branch of the Swedish Nordea Bank AB, and the Nordea Group has since moved to Finland, establishing Nordea Bank Abp in Finland. Nordea is the second largest bank in Norway. The conversion of Nordea resulted in a sharp rise in

Chart 2.3 Credit to households and businesses by credit source. Gross domestic credit. In billions of NOK. At 31 December 2018



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

Chart 2.4 Lending market shares. Percent. At 31 December 2018



Source: Norges Bank

**Table 2.3 Largest banking groups in Norway by total assets. At 31 March 2019**

Banking group	Part of	Head office/main area
DNB Bank ASA	DNB ASA	Oslo / Norway
Nordea Bank Norge ASA	Branch of a Finnish bank	Oslo / Norway
Danske Bank Norge	Branch of a Danish bank	Trondheim / Norway
SpareBank 1 SR-Bank	SpareBank 1 Alliance	Stavanger / Rogaland, Hordaland, Agder
Handelsbanken Norge	Branch of a Swedish bank	Oslo / Norway
Sparebanken Vest	Independent savings bank	Bergen / Western Norway
SpareBank 1 SMN	SpareBank 1 Alliance	Trondheim / Trøndelag, Northwestern Norway
Santander Consumer Bank AS	Subsidiary of a Spanish bank	Oslo / auto and consumer loans
Sparebank1 Østlandet	SpareBank 1 Alliance	Hamar / Hedmark, Oppland, Oslo, Akershus
Sparebanken Sør	Independent savings bank	Arendal/ Agder, Telemark
SpareBank 1 Nord-Norge	SpareBank 1 Alliance	Tromsø / Troms, Nordland, Finnmark
Skandiabanken ASA	Independent commercial bank	Norway
SEB AB Oslofilialen	Branch of a Swedish bank	Oslo / investment banking
Swedbank Norge	Branch of a Swedish bank	Oslo / commercial and investment banking

Sources: Banking groups' quarterly reports and Norges Bank

the market share of the foreign-owned branches. Danske Bank and Handelsbanken are the other large foreign-owned branches (see Table 2.3 for an overview of the largest banks in Norway).

Today's savings bank sector comprises a large number of savings banks. Most are very small, but are members of large alliances. The SpareBank 1 Alliance comprises 14 banks, most of which are large in their regions, while the Eika Alliance comprises close to 70

smaller savings banks. About 15 savings banks remain outside formalised alliances even though some have joint holdings in covered bond mortgage companies and insurance companies, for example.

### 2.2.3 Banks' assets and funding

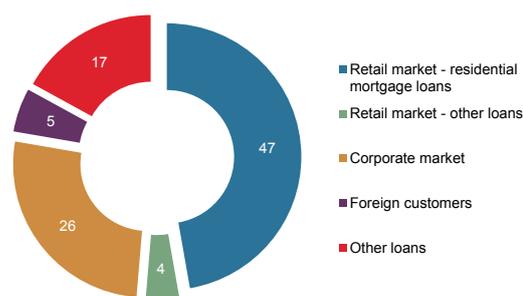
Loans account for the majority of Norwegian banks' assets (Chart 2.5). The largest single loan items are residential mortgages and commercial real estate loans (Chart 2.6 and Chart 2.7). Lending to these

**Chart 2.5 Assets and funding. Norwegian-owned banks and covered bond mortgage companies.<sup>1</sup> Percent. At 31 December 2017**



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

**Chart 2.6 Lending breakdown. Banks and mortgage companies in Norway. Percent. At 31 December 2018**



Source: Norges Bank

## DEPOSIT PLATFORMS

A deposit platform is a digital trading venue for bank deposits. Banks and potential customers/depositors are linked together on the platform. Customers can be private individuals, businesses, local governments etc. Banks advertise their deposit terms and conditions on the deposit platform, giving customers a comprehensive overview of their products. Customers can then choose a bank and digitally manage their deposits.

A depositor becomes a customer of the bank and not of the deposit platform, which is just an intermediary. Via the deposit platform, customers can open accounts in a number of banks and deposit their money there. This makes it easy for customers to change banks and continually ensure that they have the best terms and conditions among the deposit platform's partner banks.

Deposit platforms give banks access to funding and are also marketing platforms, targeting potential new customers. This can be particularly advantageous for smaller banks and can promote competition between banks. As a rule, deposits are subject to a required savings period and are therefore an advantage in the context of banks' liquidity requirements.

Deposit platforms are still few in number, in Norway and in Europe.

sectors has increased in recent years. Consumer credit has grown rapidly over the past few years, but still represents a small share of total credit to households. 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 USD and EUR.

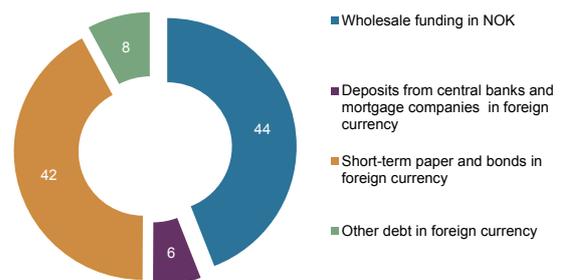
Norwegian banks fund most of their activities with deposits and bonds (Chart 2.5). Customer deposits account for over a third, while long-term wholesale funding accounts for about 30%. These two funding sources are assumed to be generally stable. Banks with stable funding are more resilient to periods of turbulence. Small savings banks are financed by cus-

Chart 2.7 Lending to the corporate sector. Banks and mortgage companies in Norway. Percent. At 31 December 2018



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

Chart 2.8 Wholesale funding<sup>1</sup> by currency. Norwegian-owned banks and mortgage companies.<sup>2</sup> Percent. At 31 December 2018



1) Total liabilities less customer deposits and equity.

2) All banks and mortgage companies excluding branches and subsidiaries of foreign banks in Norway.  
Source: Norges Bank

tomers deposits to a greater extent than the large banks, while foreign subsidiaries and branches are largely funded by the parent bank in the foreign banking group. DNB also relies to some extent on short-term wholesale funding in the form of commercial paper issued in currencies other than NOK.

Linking banks with potential customers/depositors is now more efficient due to the development of digital platforms. Deposit platforms are digital trading venues for bank deposits and provide banks with access to funding, but they are also marketing platforms, targeting potential new customers (see box: **Deposit platforms**). Over half of banks' wholesale funding is raised in foreign currency (Chart 2.8 and discussion in box: **Norwegian Banks' and mortgage companies' bond funding abroad** in Section 1). Smaller savings banks rely on funding in NOK to a greater extent than large banks. (See "Norwegian banks' foreign currency funding of NOK assets", *Staff Memo 2/2014*, Norges Bank, for a more detailed review of Norwegian banks' foreign currency funding.)

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 2.2.5 *Capital adequacy regulation*.

More statistics are available on *Statistics Norway's website*.

#### 2.2.4 Regulating banks - why and how?

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

The aim of banking regulation is to promote the stability and efficiency of the financial system. Regulation is intended to reduce the probability of future financial crises and ensure that banks are able to perform their tasks as efficiently as possible. Regulations can entail costs in the form of a reduction in financial services. If the gains of regulation are higher than the costs,

society as a whole will benefit. (See "Why regulate banks?", *Staff Memo 16/2013*, Norges Bank, for a further discussion of why banks are regulated.)

Especially owing to maturity transformation, banks are vulnerable to large withdrawals of deposits and a loss of wholesale funding (see Section 2.2.1 *Banks' tasks*). In the event of substantial funding shortfalls, a bank may quickly find itself in a situation that threatens its existence. In addition, banks are closely inter-linked. Problems at one bank can easily spread to others, creating domino effects that can jeopardise the entire financial system. (See "Smitte mellom banker - Systemrisiko som følge av bankenes sammenkobling" [Contagion in the banking sector - Systemic risk owing to banks' interconnectedness], *Staff Memo 13/2016*, Norges Bank (in Norwegian only).)

Deposit guarantees are 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 guarantee schemes. Retail customers are not ordinarily able to adequately assess a bank's risk level to determine whether their deposits are correctly priced or to judge a bank's solvency.

The first regulations were aimed at promoting adequate and stable access to banking services. The safety net that was put in place first (deposit insurance and central bank borrowing facilities) may have created a kind of stability that encouraged risk-taking and increased the volume of services provided (behavioural risk). 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* (Financial Supervisory Authority of Norway) supervises banks and other financial institutions to ensure regulatory compliance. If a bank or other financial institution 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 categories of debt and as a last resort, Finanstilsynet may revoke the financial institution's licence. If a bank is on the verge of failing or the authorities decide to close it, crisis resolution rules will apply (see Section 2.2.8 *Crisis management in the banking sector*).

Historically, banking crises have had considerable influence on the design of banking regulation (see "Bank regulation and bank crisis", *Working Papers* 18/2009, Norges Bank). 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 has also been observed 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", *Occasional Papers* 33/2004, Norges Bank and "Norges Bank's financial sector role in the period 1945–2013, with a particular focus on financial stability", *Staff Memo* 9/2016, Norges Bank. "Bedre rustet mot finanskriser – Finanskriseutvalgets utredning" [More resilient to financial crises – Report of the Financial Crisis Commission], *Official Norwegian Reports (NOU) 2011:1* (in Norwegian, with English summary), provides a detailed review of the global financial crisis in 2008.)

### 2.2.5 Capital adequacy regulation

The aim of capital adequacy regulation is to ensure that financial institutions hold sufficient loss-absorbing capital relative to the risk they assume. This capital, which primarily comprises equity and other loss-absorbing capital, is required 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. The crisis highlighted the need for stricter banking regulation in many areas, and banks' capital requirements were raised.

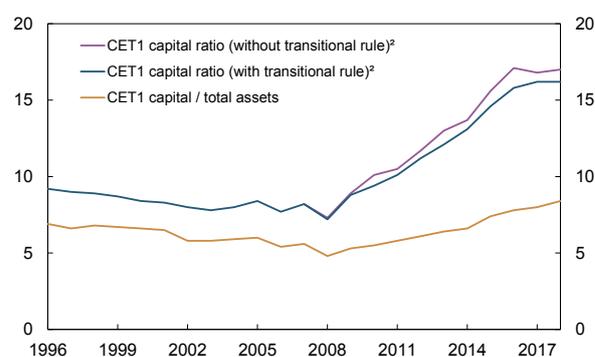
Since the trough in 2008, Norwegian banks' Common Equity Tier 1 (CET1) capital ratios have increased considerably. CET1 capital as a percentage of total assets has also increased, although far less (Chart 2.9).

Norway is subject to EU capital adequacy legislation, which is based on the Basel III framework and which entered into force in the EU in January 2014. (See Finanstilsynet's consultation document *Gjennomføring av CRD IV i norsk regelverk* [Implementation of CRD IV in Norwegian regulations] (in Norwegian only) and *Norway's implementation of the European Union's prudential framework (CRR/CRD IV)* 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. (For a more detailed presentation of the capital requirements in Norwegian regulations, see *Appendix 2: Bank capital regulation*.)

### 2.2.6 Liquidity regulation

In Norway, the global financial crisis of 2008 was primarily a liquidity crisis, which revealed the need for better management of banks' liquidity and funding structure (see box: **Liquidity** in Section 1 for an intro-

Chart 2.9 Common Equity Tier 1 (CET1) capital ratios and CET1 capital as a percentage of total assets.<sup>1</sup> Percent. 1996 – 2018



1) Consolidated figures are used for banks that are banking groups. Parent bank figures are used for the other banks.  
2) See Appendix 2: Bank capital regulation for an explanation of the transitional rule.  
Source: Finanstilsynet

duction to the concept of liquidity). Banks can reduce liquidity risk by holding deposits from a large number of small depositors, having long maturities on wholesale funding and holding sufficient liquid assets (liquidity buffers) in the form of marketable securities or central bank reserves. By maintaining liquidity buffers, banks will be more resilient to periods of market turmoil. Banks can use the assets as collateral for new loans or sell them as a way to avoid additional borrowing.

The liquidity rules require 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 financial market stress. (For a more detailed description of liquidity regulation, see Norges Bank's 2014 *Financial Stability Report*.)

The LCR requirement was finalised in the EU in 2014 and has now also been finalised in Norway. The Norwegian liquidity requirements harmonise with the EU liquidity regulations. (See *Press release from the Ministry of Finance, 25 November 2015* (in Norwegian only) and Norges Bank's 2017 *Financial Stability Report*.)

The Net Stable Funding Ratio (NSFR) requirement proposed by the EU requires banks to hold sufficient stable funding to cover their illiquid assets. The requirement is intended to make banks' funding structure more robust. Retail loans are an example of illiquid assets. Stable funding includes Tier 1 capital, bonds with long residual maturity and several types of customer deposit. The requirement will be introduced in the EU two years after final approval.

### 2.2.7 Deposit guarantees in Norway

Membership of the Norwegian deposit guarantee scheme became a statutory requirement for savings banks in 1924 and for commercial banks in 1961. Under current law, membership is obligatory for all Norwegian banks, including subsidiaries of foreign banks. Deposit insurance rules are intended to protect small, uninformed depositors, eliminating the need for them to monitor the bank's financial situation and reducing the risk that they will withdraw their funds in a panicked response to rumours that the bank is in trouble. The Norwegian deposit guarantee scheme covers

deposits of up to NOK 2m per depositor, 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* provides the deposit guarantee. Banks are charged an annual fee to the Fund. The Fund is responsible for ensuring that depositors gain access to guaranteed deposits no later than seven working days after the Ministry of Finance has decided that a bank is to be placed under public administration. The same deadline applies if a bank is not permitted to pay out the guaranteed deposits to the depositors for other reasons.

Branches of foreign banks in Norway are, in principle, not covered by the Norwegian guarantee scheme. Deposits held by Norwegian customers in these banks are protected 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.

In 2011, the amount insured by deposit guarantee schemes in the EU was fully harmonised at EUR 100 000. The 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* (in Norwegian only).)

### 2.2.8 Crisis management in the banking sector

If a large, important bank has been at risk of failing, the authorities in most countries have intervened to ensure the bank's continued operation, fearing serious consequences for the financial system if the bank had to be closed. Rescue operations have been in the form of loans on favourable terms and loan guarantees or capital injections. In almost all cases, no losses have been imposed on creditors. This is referred to as a bailout. A bailout provides banks' creditors with a form of implicit guarantee for their loans, which may induce them to conduct risk assessments that are less thorough than they otherwise

would have been. Creditors have come to expect that the authorities will also bail them out in the future. This is often referred to as moral hazard. Banks have been able to take on more risk without having to pay their lenders for the increase in risk. This increases lending as well as risk in the banking system.

Since 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 failing banks to ensure continuity of the bank's critical functions, but without providing banks with public funds.

An important element of the Directive is the bail-in tool. In a bail-in, the authorities write down the value of the bank's debt and/or convert part of the debt into equity without closing the bank. When creditors, including those of systemically important banks, face a real risk of losses, they will assess banks' risks more thoroughly and set the interest rate on their loans to banks more in accordance with a bank's risks. Banks' funding costs will rise, and banks' appetite for risk will be lower. Lending will decline and risk in the entire financial system will be reduced (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], *Staff Memo 12/2014*, Norges Bank (in 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, the use of bridge institutions (temporary public ownership of a failing bank prior to restructuring and sale), the establishment of national resolution authorities and a resolution financing arrangement, and the drawing up of living wills (contingency plans and plans for bank recovery and resolution). An important part of each bank's recovery plan is the minimum requirement for liabilities and other capital that can be easily written down or converted into equity, referred to as the MREL (Minimum Requirement for own funds and Eligible Liabilities). The BRRD is now transposed into Norwegian law, and the amendments to the *Financial Institutions Act* entered into force on 1 January 2019. (See "New regulatory framework on recovery and resolution in the

banking sector" on page 19 of Norges Bank's 2017 *Financial Stability Report*.)

Deputy Governor Jon Nicolaisen discussed fundamental issues relating to bank resolution in his speech *Should banks be bailed out?*, given in 2015.

## 2.3 MORTGAGE COMPANIES

Mortgage companies originate long-term mortgages for households and businesses. 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: **Secured funding** in Section 1).

### 2.3.1 Covered bond mortgage companies

New rules were introduced in Norway in June 2007 allowing mortgage companies with a special licence 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. There were 25 covered bond mortgage companies at the end of 2018.

Under Norwegian law, Norwegian covered bonds must be issued by a covered bond mortgage company. 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 must set strict 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 stable funding. Jointly owned mortgage companies enable also smaller banks to obtain funding in international capital markets. ("Norwegian covered bonds – a rapidly growing market", in *Economic Bulletin* 2010 (Vol. 81, 4–19), Norges Bank, provides a detailed review of Norwegian covered bonds and covered bond companies.)

### 2.3.2 Other mortgage companies

Some mortgage companies are not authorised to issue covered bonds and primarily issue ordinary unsecured senior bonds. There are only a few of these companies in Norway.

Kommunalbanken (the Norwegian state agency for local government funding) is the largest of these, with total lending at NOK 304 billion at the end of 2018. Kommunalbanken provides credit to the Norwegian

local government sector. All of Norway's municipalities are customers of Kommunalbanken.

If all Norwegian municipalities were to borrow directly in capital markets, the costs involved would be high. 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 a limited company wholly owned by the government and has been assigned the highest possible credit rating (AAA). It has been designated by the Ministry of Finance as systemically important and is therefore subject to additional capital requirements.

## 2.4 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). This share has fallen sharply (Chart 2.10).

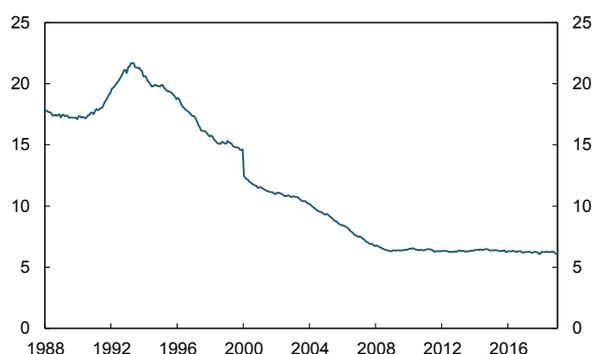
Household loans via these lending schemes have decreased in particular. Today, the largest government lending institutions are the Norwegian State Housing Bank, the Norwegian State Educational Loan Fund, Innovation Norway and the Norwegian Export Credit Guarantee Agency (GIEK) (see box: **Government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

Loans from government lending institutions are financed by government borrowing. The Norwegian government has the highest possible credit rating and can therefore borrow at a low rate.

## 2.5 INSURANCE COMPANIES

Insurance is a contract that guarantees compensation for financial loss as a result of arbitrary, unforeseen events. According to the encyclopaedia *Store norske*

Chart 2.10 Credit from state lending institutions.  
As a percentage of domestic credit (C2). January 1988 – December 2018



Source: Statistics Norway

## 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 amounted to about NOK 150bn at the end of 2018, which is around 3% of gross domestic debt.

### 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 1m customers, and financial support for students totalled NOK 30bn in 2018. The Fund's lending portfolio amounted to about NOK 184bn (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 27 countries. Its lending portfolio amounted to NOK 18bn at end-2018 (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 had around NOK 88bn in outstanding guarantee liabilities at end-2018 (see *Norwegian Export Credit Guarantee Agency's website*).

### Export Credit Norway

Export Credit Norway is a public limited company and not a financial institution, 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 institutions 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, and at end-2018 its lending portfolio totalled NOK 61bn (see *Export Credit Norway's website*).

*leksikon* (Norwegian only), the roots of insurance go back to 2250 BC. 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 undertaking, in order to distribute risk among its members (customers). A necessary condition for such an arrangement to function is that there are a sufficient number of customers who want to insure themselves against this risk. A loss incurred by an insured party is covered by the insurance undertaking. The policyholder makes a regular, recurring payment, known as a premium, to the insurance undertaking. The insurance undertaking uses these premiums to build up reserves that can be drawn down in the event of losses. Mutual fire insurance companies were among the first insurance companies in modern times. They arose in the wake of the great fires of London and Copenhagen. Fire insurance companies could distribute losses among a large number of members who faced a risk of fire, at the same time as a fire would seldom affect many members at the same time. The first fire insurance company in Norway was Christiania Brand-Assurance-Casse, founded in 1753, and was based on voluntary membership by homeowners in Christiania (now Oslo).

Insurance premiums are calculated as expected loss plus an amount to cover the cost of operating the insurance scheme. A basic principle in insurance is that the insurance premium paid by the customer should be commensurate with the risk taken by the insurance undertaking. This could in principle indicate a pricing of the insurance premium at the individual level. However, this could easily be perceived as unfair and could be difficult to implement in practice. Customers 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 customers is called adverse selection. Since income from premiums is supposed to cover expected expenditure, the company will have to increase its premiums. Normal-risk customers may then be reluctant to take out insurance, which in turn increases the ratio of high-risk customers. In a worst-case scenario, the insurance

undertaking could be forced to withdraw the insurance product.

### 2.5.1 Types of insurance

Insurance can be classified in several ways. Based on the type of risk covered by the policyholder's insurance contract, insurance can be divided into life insurance, non-life insurance and credit insurance. 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**).

Insurance can also be classified by the insured object (person, property or asset insurance). Examples of insurance of the person are pension, health and accident insurance. Insurance of property 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 undertaking is the original issuer of the insurance contract (primary insurance) and cases where some of the liability has been taken over by another undertaking (reinsurance). Even insurance companies need to insure themselves against major unforeseen events or a large number of claims, eg large pay-outs owing to natural disasters such as earthquakes and floods, and reduce risk by purchasing reinsurance for this purpose.

Life insurance accounts for the largest share of the insurance market in Norway, representing about 60% of the income from premiums (Chart 2.11). Most premium income at life insurance companies is derived from pension insurance (Chart 2.12). Pension insurance comprises collective occupational pensions and individual pension schemes. 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 2.13).

## 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 in addition to 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 savings and pension schemes.

Occupational 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. A central feature of collective pension agreements in Norway in recent years is the transition from defined benefit to defined contribution occupational pension schemes. The most important difference between the two schemes is related to who bears the return risk on the accumulated assets in the period until benefits are paid (accumulation period).

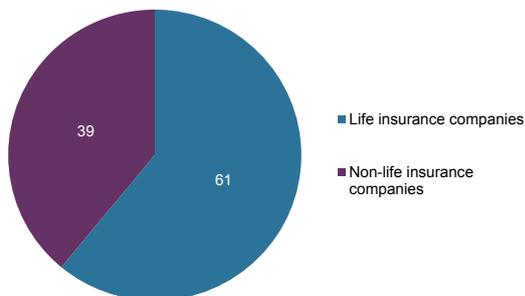
In a defined benefit pension scheme, retirement benefits are paid as a predetermined percentage of the employee's final earnings at the agreed pension age. With this scheme, pension payments are predictable for the employee. The employer pays an annual premium into the pension scheme. The size of the premium depends on factors such as the employee's years of service, age, wage level and the return achieved by the life insurance undertaking. The employee bears no risk for the return on accumulated contributions. A defined benefit pension scheme provides a guaranteed future rate of return on contributions from the insurance undertaking 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 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 level of pension payments will depend on the size of the contributions (pension capital) and the return on this capital. The costs of the scheme, ie the premiums to be paid, are predictable for the employer. The employee bears all the risk related to returns on pension capital.

Occupational pensions have been mandatory in Norway since 2006. It became compulsory for private sector businesses to establish an occupational pension scheme (primarily in businesses 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 96 883 in 2018). 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.

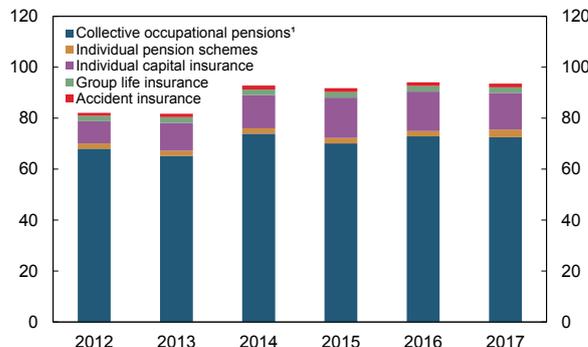
An employee who leaves a private business that has a defined benefit pension scheme receives a paid-up policy. Paid-up policies are insurance contracts that do not require additional premium payments and entitle the holder to future pension payments. An employee will also receive a paid-up policy if the business chooses to discontinue the defined benefit scheme in favour of a defined contribution scheme or if the business closes down.

Chart 2.11 Insurance companies in Norway. By premium income. Percent. 2017



Source: Statistics Norway

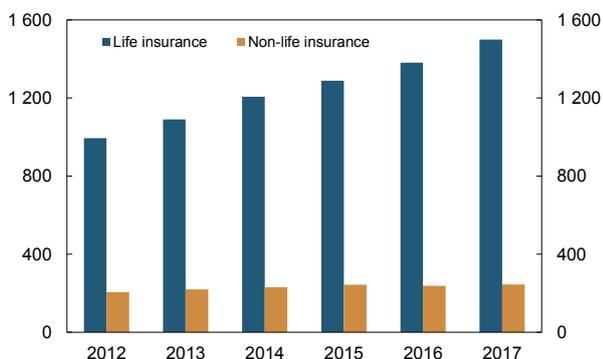
Chart 2.12 Life insurance companies' premium income by segment. In billions of NOK. 2012 – 2017



1) Includes pension schemes under the Company Pensions Act, the Defined Contribution Pensions Act and the Occupational Pensions Act. Data unavailable for occupational pension schemes in the period 2012-2013.

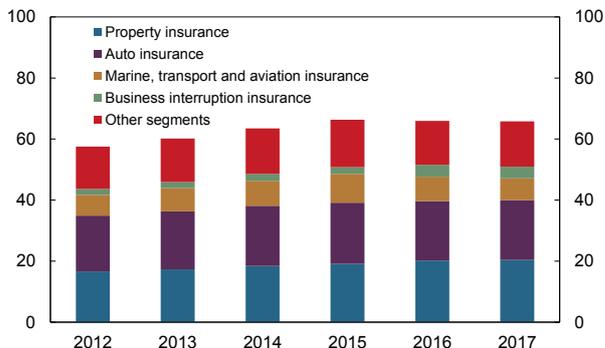
Source: Statistics Norway

Chart 2.13 Total assets of insurance companies. In billions of NOK. 2012 – 2017



Source: Statistics Norway

Chart 2.14 Non-life insurance companies' premium income by segment. In billions of NOK. 2012 – 2017



Source: Statistics Norway

Auto insurance and property insurance make the largest contribution to non-life insurance companies' premium income (Chart 2.14), followed by marine, transport and aviation insurance.

In 2018 Q4, there were 18 life insurance companies and 83 non-life insurance companies in Norway. Ranked by premium income, KLP, Storebrand Livsforsikring, DNB Livsforsikring, and Nordea Liv are the largest life insurance companies (Chart 2.15). Gjensidige, If Skadeforsikring, Tryg and SpareBank 1 Forsikring are the largest companies in the non-life market (Chart 2.16).

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. These are referred to as technical provisions.

For the insurance market to function efficiently, customer confidence in the integrity of insurance contracts is important. This is especially true of contracts for long-term pension saving. Insurance companies are therefore subject to specific regulation to safeguard the rights of customers (see box: **Regulation of insurance companies**).

## REGULATION OF INSURANCE COMPANIES

The current solvency framework for insurance companies in the EEA, Solvency II, was adopted by the EU in 2009 and introduced in January 2016, but with long transitional arrangements. Solvency II does not apply to pension funds. Solvency II is more sensitive to risk than the previous framework, Solvency I.

Under Solvency II, both assets and liabilities are calculated at market value. The market value of liabilities is calculated by discounting future liability cash flows using risk-free market rates. The capital requirement is determined by a stress test, which ensures that the insurance undertaking will be able to withstand severe shocks to factors (such as equity and bond prices) that affect the insurance undertaking's equity capital.

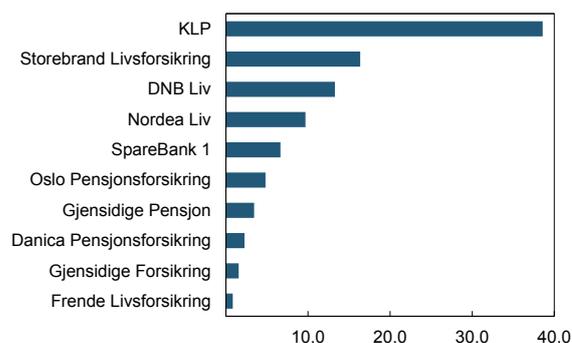
A low interest rate environment is challenging for life insurance companies under Solvency II. With low interest rates, the current value of insurance liabilities is increasing. At the same time, life insurance companies are finding it increasingly difficult to achieve sufficient returns to meet the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

## 2.6 PENSION FUNDS

In Norway, occupational pension savings are managed by both life insurance companies and pension funds. A pension fund is an autonomous institution established by a private business or the public sector offering one or more collective occupational pension schemes. There were 87 private and public sector pension funds in Norway at end-2018. The largest of these are shown in Chart 2.17. Pension funds in Norway hold total assets of about NOK 346bn. At end-2018, 56% of pension fund assets were invested in bonds and 36% in equities (Chart 2.18).

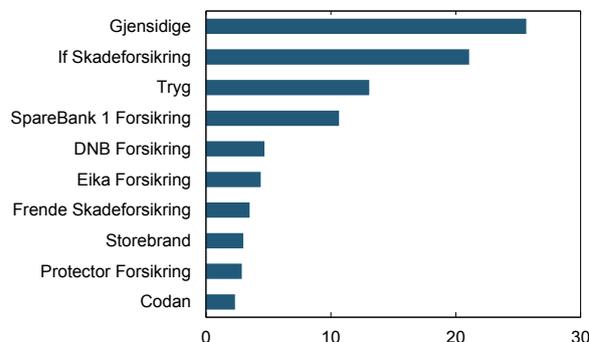
While life insurance companies are regulated under Solvency II (see box: **Regulation of insurance compa-**

Chart 2.15 Life insurance market shares by premium income. Percent. 2018 Q4



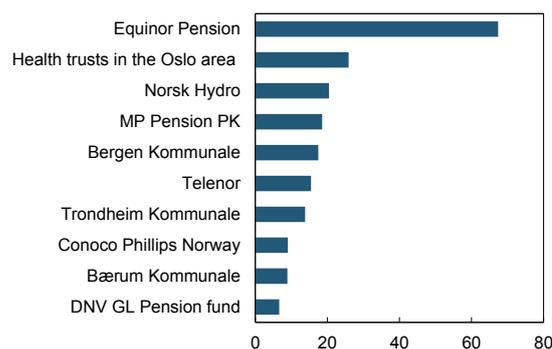
Source: Finance Norway

Chart 2.16 Non-life insurance market shares by premium income. Percent. 2018 Q4



Source: Finance Norway

Chart 2.17 The largest private and public (municipal) pension funds. Total assets in billions of NOK. At 31 December 2018



Source: Finanstilsynet

nies), pension funds are regulated under the Institutions for Occupational Retirement Provision (IORP) Directive. However, from 1 January 2019, pension funds must comply with a capital requirement based on a simplified application of the rules under Solvency II.

Statens pensjonskasse (SPK, the Norwegian Public Service Pension Fund) is not included in the figures for pension funds. 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. The Storting (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 businesses generating 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 551bn at end-2018. SPK offers housing loans to its members. SPK housing loans totalled NOK 43bn at end-2018.

Kommunal Landspensjonskasse (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 undertaking. This means that when a

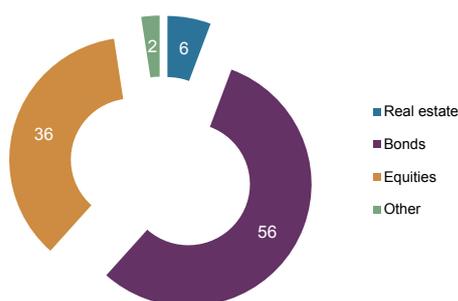
pension scheme is established, KLP customers invest capital and thus become the company's owners. KLP's main product is occupational pensions for municipal employees. KLP pension schemes are fully funded. At end-2018, public sector pension scheme assets accounted for NOK 508bn of the KLP group's total assets of NOK 676bn.

## 2.7 MUTUAL FUNDS

A mutual fund, or securities fund, is a collective investment scheme whereby a large number of unitholders pool their investments in securities markets. A securities fund management company authorised by Finanstilsynet administers and manages the assets in the portfolio. Fees and other charges, deducted from the assets under management, cover the security fund management company's expenses. Thus, unit holders are charged for the management of the fund.

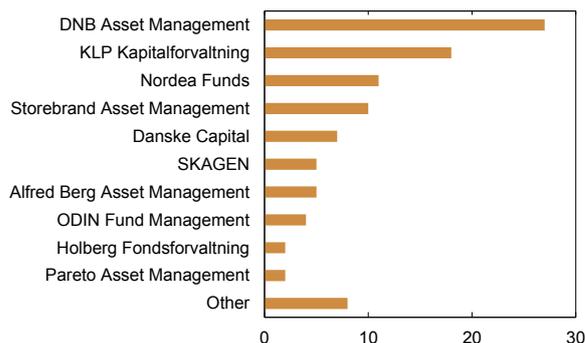
Capital from unit holders in mutual funds goes to financing issuers of securities. There may be a number of advantages for an investor in investing in a mutual fund rather than in individual equities and bonds. First, mutual funds can benefit from economies of scale, which lowers costs. One example of this is reduced costs for analysing and selecting securities. Second, it is easier to spread risk across a large number of securities. This is known as diversification. Third, professional investment managers may potentially be able to offer better returns and risk management.

Chart 2.18 Types of pension fund asset as a percentage of total assets. Based on a selection of pension funds. At 31 December 2018



Source: Finanstilsynet

Chart 2.19 Market shares of mutual fund management companies. Percent. At 31 December 2018



Source: Norwegian Fund and Asset Management Association

Among the drawbacks of mutual funds are that investors have less influence on investment decisions and that mutual funds involve the payment of fees and other charges to the mutual fund management company.

**Diversification** means spreading risk by allocating investments across several securities. Since different securities rarely involve the same risk or 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 mutual funds can be owned by banks, insurance companies or others (Chart 2.19, which shows the largest fund managers). Each management company usually offers a large number of funds with differing investment profiles.

### 2.7.1 Mutual funds classified by asset

Assets under management by mutual funds in Norway totalled NOK 1129bn at end-2018. These funds can be classified by investment instrument (Chart 2.20):

- Equity funds invest in equities and account for about half of total assets under management by mutual 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), also called specialised funds and hedge funds. These funds have modest levels of assets under management in Norway.

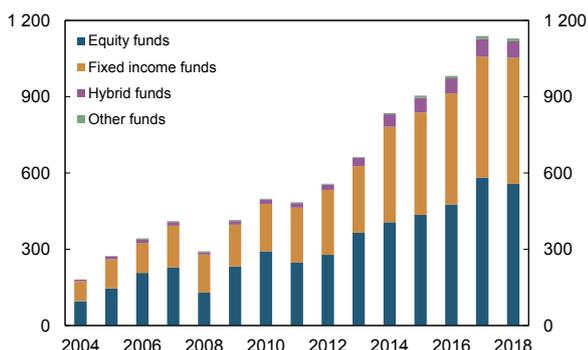
Total capital in mutual funds declined by 1% in 2018, or NOK 10bn. The decline in total fund capital in 2018 was driven by a fall in market value, despite the positive contribution from net subscriptions. The NOK 32bn in fresh capital was primarily invested in fixed income funds (Chart 2.21).

Units in Norwegian mutual funds are primarily owned by life insurance companies and pension funds (Chart 2.22). They hold a substantial share of units of bond funds and equity funds. Private individuals primarily hold units in equity funds, but to a limited extent in bond funds.

### 2.7.2 Other classifications of mutual funds

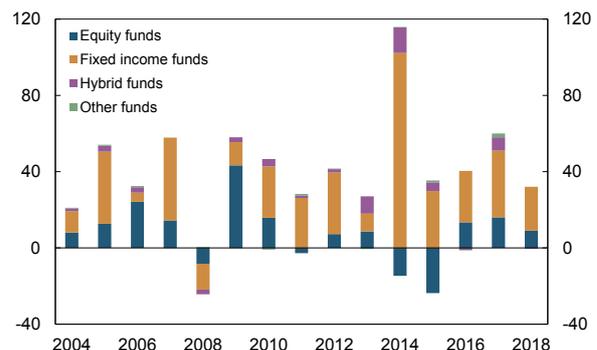
Mutual funds can also be classified by their form of management or how the investment units are traded. Funds are commonly classified as passively or actively

Chart 2.20 Assets under management by mutual funds, by type of fund. In billions of NOK. At year-end. 2004 – 2018



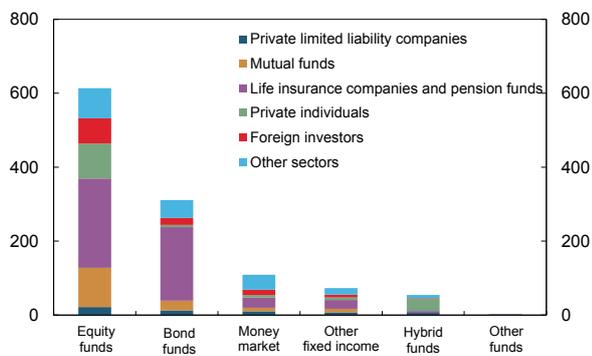
Source: Norwegian Fund and Asset Management Association

Chart 2.21 Mutual fund net subscription. In billions of NOK. 2004 – 2018



Source: Norwegian Fund and Asset Management Association

Chart 2.22 Mutual fund unit holders. Holdings in billions of NOK. At 31 December 2018



Source: Statistics Norway

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). These funds are therefore often called index funds. An equity index fund may aim for the same return as the benchmark index by holding a portfolio of equities that is approximately the same as the benchmark index. For liquidity reasons and to reduce costs, index funds may refrain from holding equities that represent only a small share of the benchmark index. The fund's return is nevertheless expected to closely track the index.

Actively managed funds try to "beat the index", i.e. obtain a higher return than the index at the same level of risk. The manager then carefully selects investments, buying and selling stocks when changing market conditions offer opportunities for higher returns. 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 few actively managed funds have outperformed index funds over time.<sup>3</sup>

Although exchange-traded funds (ETFs) have been one of the most rapidly growing segments in the global financial market, there are few of these funds in Norway. ETFs are traded over a stock exchange like equities and may be either index or actively traded funds. At end-2018, there were four exchange-traded funds on Oslo Børs, with total assets of NOK 3bn.

Some mutual funds are so-called funds of funds. These funds invest in other funds and achieve diversification of risk, although for investors this means more expensive management, with fees payable both to the fund itself and to the funds that make up the portfolio.

### 2.7.3 Regulation of mutual funds

The Securities Fund Act regulates the organisation and scope of mutual funds and fund management companies. Mutual 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 Norwegian mutual funds are subject to approval by Finanstilsynet.

## 2.8 OTHER FINANCIAL INSTITUTIONS

### 2.8.1 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. The loans are primarily financed through short-term borrowing. Finance company lending totalled around NOK 194bn at end-2018. Approximately 35% of finance companies in Norway, measured by lending volume, are foreign companies with branches in Norway.

<sup>3</sup> See, for example, Fama, E.F. and K.R. French (2010): "Luck versus Skill in the Cross-Section of Mutual Fund Returns", *Journal of Finance*, Vol. LXV no 5.

Factoring is a form of corporate financing whereby a business sends its accounts receivable (invoices) to the finance company, which then immediately pays (lends) about 80% of the value of these invoices to the business. The finance company receives payment for the invoices and transfers the balance to the business minus fees and interest.

### 2.8.2 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 and in providing underwriting services for companies issuing stock on the primary market, known as corporate services. 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, systems and physical information barriers must be established between active management and other business areas.

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 end-2018, there were 96 securities firms with a Norwegian licence. Of these, 21 were banks authorised to operate as securities firms, and 22 were branches of foreign securities firms.

### 2.8.3 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 institutions, they do not need a special license to operate and are not subject to supervision by Finanstilsynet.

### 2.8.4 Venture capital companies

Venture capital companies are a type of investment company that invests in unlisted companies. They offer equity or debt capital financing to startups, often companies 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.

According to the Norwegian Venture Capital & Private Equity Association, Norwegian funds that invest in unlisted companies (often referred to as private equity funds) had NOK 8.5bn in assets under management at end-2017. The distribution of assets was as follows: NOK 6.6bn in takeover funds, NOK 1.7bn in venture funds and NOK 0.2bn in seed funds.

### 2.8.5 Crowdfunding

The development of digital platforms has increased the range of funding options. Crowdfunding is the practice of funding a business or a private individual by raising financial contributions from a large number of people. With traditional funding models, a limited number of investors, sometimes only one bank or a few large investors, are asked to invest a substantial amount. In contrast, crowdfunding uses digital platforms to reach many small potential investors who may each wish to invest relatively small amounts.

A funding transaction involves three different types of agents: investors who invest (crowdfunders), a company or a private individual seeking funding and the crowdfunding company that facilitates the funding via a digital platform.

Financial crowdfunding can be divided into two categories:

- *Lending-based crowdfunding (peer-to-peer lending (P2P))*. The crowdfunder (the lender) lends money to the company or the private individual (the borrower). The loan is brokered by a crowdfunding company via a digital platform.
- *Equity-based crowdfunding*. The crowdfunder pays an amount in return for ownership in a company in the form of unlisted shares. The crowdfunding offering is brokered by a crowdfunding company via a digital platform.

Financial crowdfunding is typically used to raise capital to fund small projects, but private individuals can also receive access to consumer credit via crowdfunding digital platforms. Most financial crowdfunding platforms facilitate financing for small and medium-sized enterprises (SMEs). SMEs can often find it difficult to obtain a bank loan or raise equity capital in securities or venture capital markets. Financial crowdfunding allows individuals to invest directly in projects or companies that they would not have had easy access to otherwise. For companies, the cost of raising capital can be lower. Crowdfunding can thus increase value added if other potentially profitable projects are realised as a result.

The term crowdfunding also includes non-financial crowdfunding:

- *Donation-based*. Worthy causes and small companies and projects can apply for funding on such platforms. The funder does not receive any compensation.
- *Rewards-based*. Support for more commercial projects where the funder pledges an amount and receives a reward from the project owner such as a discount on the future product (pre-sale) or a product sample.

Crowdfunding has grown rapidly in a number of countries. Crowdfunding is widespread in China and the US, while the largest crowdfunding market in the EU is the United Kingdom (see *Official Norwegian Reports (NOU) 2018: 5 Kapital i omstillingens tid – Næringslivets tilgang til kapital [Capital in a time of restructuring – access to capital in the business sector]* (in Norwegian only) for more information).

In Norway, the extent of lending- and equity-based crowdfunding has been relatively limited so far, but new agents are continually entering the market, and crowdfunding is a growing industry.

Currently, there is no common international and harmonised regulation of financial crowdfunding. An EU regulation has been proposed, but has not yet been approved. Under the proposal, crowdfunding platforms can apply for approval as a European Crowdfunding Service Provider (ECSP). Norway does not have a specific regulation for crowdfunding, but the Ministry of Finance has adopted a change to the Financial Institutions Regulation that exempts lending via crowdfunding platforms from the licensing requirement subject to certain conditions. The change to the Regulation entered into force on 1 June 2019.<sup>4</sup> The Ministry of Finance has also circulated for comment a proposal on rules for lending-based crowdfunding.<sup>5</sup> The proposals only apply to platforms that facilitate loans to businesses. The consultation document contains draft amendments to the Financial Institutions Act and a draft regulation on loan intermediation services. Crowdfunding agents must also comply with existing regulations, including the Financial Institutions Act, the Securities Trading Act and the Alternative Investment Fund Act.

<sup>4</sup> The platforms must be managed by a crowdfunding company or a financing company, and total lending cannot exceed NOK 1 million per year, see *Forskrift om endring i forskrift om finansforetak og finanskonsern [Regulation on changes to the regulation on financial institutions and financial groups]* (in Norwegian only).

<sup>5</sup> Circulated for comment: *Forslag til regler for lånebasert folkefinansiering [Proposal on rules for lending-based crowdfunding]* (in Norwegian only).

# 3 Financial infrastructure

The financial infrastructure refers to the systems that enable economic agents to conduct financial transactions, 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”. A payment service system is the part of the payment system that is aimed at customers and that 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 among themselves.

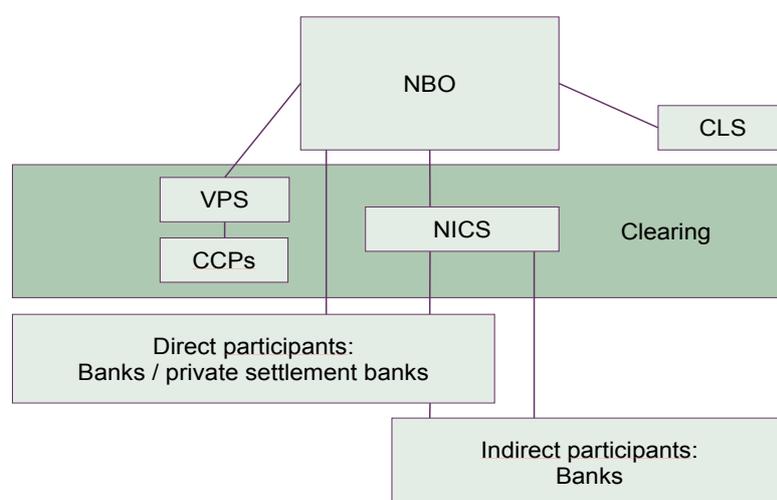
At the core of the Norwegian interbank system are Norges Bank’s settlement system (NBO) and the Nor-

wegian Interbank Clearing System (NICS) (Chart 3.1). 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 five times daily to NBO, where the balances on the banks’ accounts with Norges Bank are adjusted accordingly. (Read more about NBO in Section 3.2.1 *Norges Bank’s settlement system (NBO)* and about NICS in Section 3.2.2 *The Norwegian Interbank Clearing System (NICS)*.)

As banks’ currency trading runs into the hundreds of billions of kroner a day, losses can be heavy if a counterparty is unable to fulfil its obligations. To limit this risk, a global multi-currency bank called CLS was created (see Section 3.2.3 *Foreign exchange settlement risk and the CLS foreign exchange settlement system*), with a view to preventing the risk of losses in the settlement of currency trades by ensuring that one side of a trade is not paid unless the other side has also been paid.

The securities settlement system (VPS) covers settlement of cash and securities. Payment for the securities is settled at Norges Bank and the actual securities are transferred through Verdipapirsentralen ASA (VPS). VPS owns and operates the Norwegian central

Chart 3.1 Chart 3.1 The Norwegian payment system<sup>1</sup>



<sup>1</sup> This chart has been simplified for clarity and does not give a complete picture

Source: Norges Bank

securities depository, where ownership of securities is documented. (Read more on the *VPS website*.)

Central counterparties play an important role in financial markets (see Section 3.4 *Central counterparties*). 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 thus transferred to the central counterparty (CCP), 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 a CCP.

### 3.1 RETAIL PAYMENT SERVICES

Retail payment services generally cover payments between households, businesses and government authorities, 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 and services. 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 the introduction). Electronic money (e-money) is a third means of payment and consists of digital value units that are used only for electronic payments. Customers can make e-money payments using 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).

Cards and cash are primarily used for point of sale payments, while cards and bank transfers are more commonly used for remote payments where buyer and seller do not physically meet. To further facilitate cross-border payments, EU countries are working together to develop common payment solutions (see box: **The Single Euro Payments Area (SEPA)**).

#### 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 instead of having national systems with different formats and prices. The basis for SEPA was laid in an EU regulation in 2001 stipulating that the cost of cross-border transactions in euros between EEA countries must be the same as the cost of a domestic transaction. The regulation applies to the price of payments in euros. It has been implemented in Norway and applies to payments in euros to and from Norway, but not to payments in Norwegian kroner.

#### 3.1.1 Cash

Cash is both a means of payment and a payment instrument. Norwegian banknotes and coins constitute a claim on Norges Bank and share some similarities with a promissory note. This means that the note or coin itself represents a financial value, 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 or post-in-shop, by making a withdrawal from an ATM or at a point-of-sale (POS) in connection with a goods purchase (cash-back). Conversely, cash can be converted into deposit money over the counter at a bank branch or post-in-shop or using a bank's cash deposit machine. Deposit money is converted into cash and vice versa at face value (NOK 100 in deposit money is converted into NOK 100 in cash). The average size of an ATM withdrawal was just over NOK 1 700 in 2018, while the average POS withdrawal was just under NOK 500. Statistics for withdrawals over the counter are not available.

Cash is legal tender in Norway. Under the *Financial Contracts Act* (in Norwegian only), a consumer has the right to settle an obligation to a payee in cash.

The payee is not, however, obliged to accept more than 25 coins of any one denomination. *The Financial Institutions Act* 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. This means that banks must provide the facilities to enable customers to convert deposit money into cash and vice versa. Deposit money is a generally 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 3.2). Surveys and data collection suggest that approximately 10% of point-of-sale and person-to-person (P2P) transactions in 2019 were made using cash. According to data collected in 2017, approximately 20% to 25% of payments in the grocery trade were made in cash.

The value of cash in circulation has been relatively stable in recent decades but has fallen as a share of total money (M1), household consumption and mainland GDP (Chart 3.3). The share amounted to 2.0% in 2018, which is very low compared with other countries (Chart 3.4).

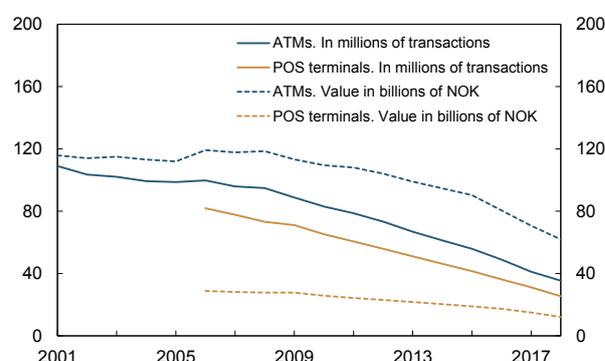
### 3.1.2 Payment cards

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. 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.

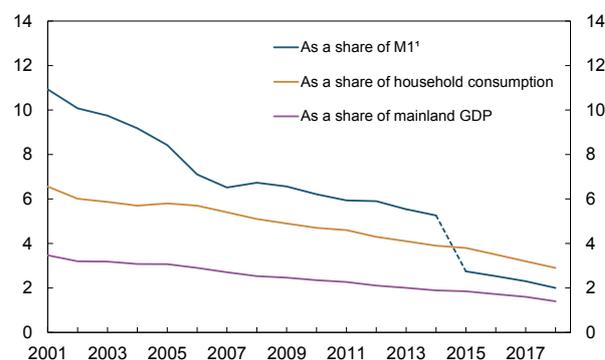
BankAsept is Norway's national debit card system. Owned and operated by banks in Norway through a limited company, it is by far the most widely used system in Norway. However, the use of international cards is growing rapidly. These are payment cards issued in Norway by Norwegian banks or card com-

Chart 3.2 Cash withdrawals from ATMs and POS terminals. 2001 – 2018



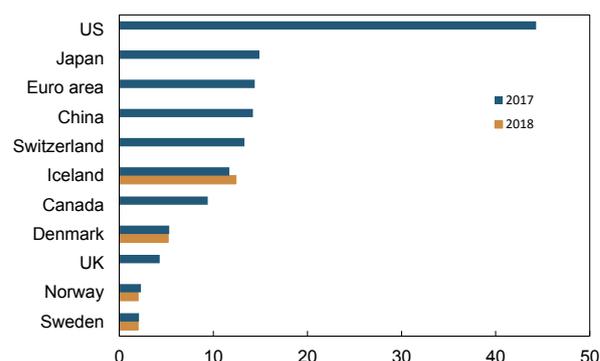
Source: Norges Bank

Chart 3.3 Value of cash in circulation as a share of means of payments (M1), household consumption and mainland GDP. Percent. 2001 – 2018



1) M1 was redefined in 2015.  
Sources: Statistics Norway and Norges Bank

Chart 3.4 Cash as a share of means of payments (M1) in selected countries. Percent. 2017 and 2018 (Nordic countries)



Sources: BIS, Central Bank of Iceland, Danmarks Nationalbank, ECB, Statistics Norway, Statistics Sweden and Norges Bank

## HOW DOES A BANKAXEPT CARD PAYMENT WORK?

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

To be able to accept payments using BankAxept cards, a point of sale (the merchant) must have an agreement with both BankAxept and 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.

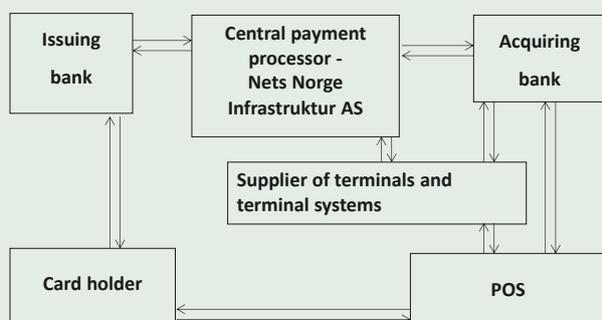
### What happens when a payment is made with a BankAxept card?

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 3.5).

The issuing bank checks that the criteria for authorising the transaction have been met: that the card has not been blocked and that 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 3.2.2 *The Norwegian Interbank Clearing System (NICS)*). Clearing and settlement of these transactions take place five 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 in Norges Bank, 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.

Chart 3.5 BankAxept payment process



## 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 referred to as digital wallets.

There are primarily two mobile payment solutions at physical points of sale in Norway today: Apple Pay and Google Pay. For person-to-person mobile payments, there is one main solution: Vipps. Vipps is owned by DNB, the SpareBank 1 Alliance, a group of independent savings banks, the Eika alliance and Sparebanken Møre. Vipps, Apple Pay and Google Pay can all also be used for online shopping.

Mobile payment solutions in Norway allow users to make payments and transfers from a payment card (see Section 3.1.2 *Payment cards*) or a bank account.

To make a point of sale payment (in a shop or online), the user first establishes a connection with the merchant via either the traditional card terminal or a dedicated terminal for mobile payments, then a simple verification operation by the user approves the payment.

panies under licence from international card systems such as Visa and MasterCard. These can be debit cards, charge cards or credit cards (see box: **How does a BankAxept card payment work?**).

There were 14.6m payment cards in issue in Norway at end-2018. 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 still via a physical payment terminal. The terminal reads the card's chip and the cardholder then keys in a security code (PIN).

However, 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 payment is below a certain amount (see box: **Mobile payments**).

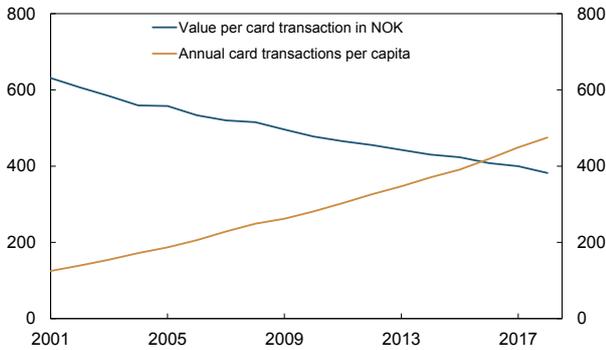
Payment cards are also used for remote payments, mainly when buying goods online. In this case, users enter their card details and approve payments in an online payment terminal direct from their own computers. Alternatively, the process can be simplified using a digital wallet (see box: **Mobile payments**).

Some businesses, such as some supermarket and filling station chains, also issue cards for payment purposes. These cards can only be used in the issuer's outlets and are therefore not regarded as payment cards. Nor are transactions using these cards considered payments.

The number of goods and services purchases made using payment cards has grown rapidly over time, partly because of a rise in the total number of payments (increased spending) and partly because card payments have to some extent replaced cash payments.

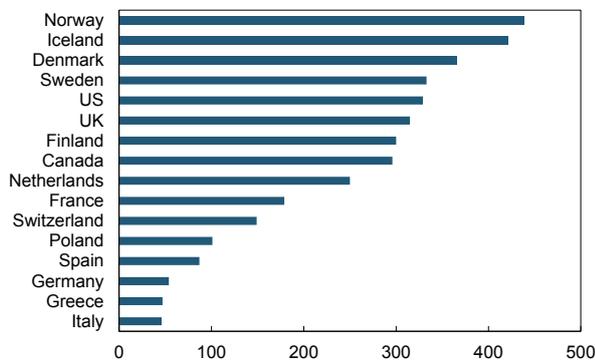
There were close to 2.5bn card transactions in 2018 (goods and services purchases and cash withdrawals), or an average of 475 transactions per capita

Chart 3.6 Annual card transactions per capita and value per card transaction in NOK. 2001 – 2018



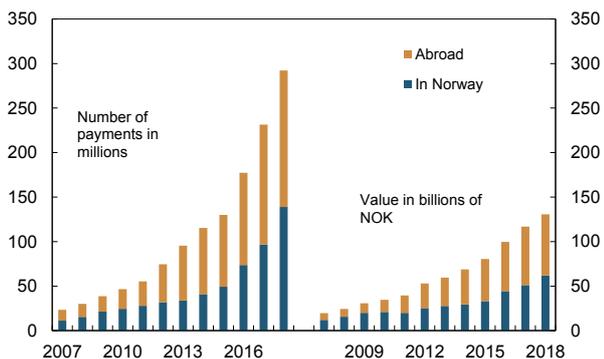
Source: Norges Bank

Chart 3.7 Card transactions per capita in selected countries. 2017



Sources: BIS, Central Bank of Iceland, ECB and Norges Bank

Figur 3.8 Online payments using Norwegian payment cards. 2007 – 2018



Sources: BIS, Central Bank of Iceland, ECB and Norges Bank

## REAL-TIME SETTLEMENT OF PAYMENTS

In recent years, real-time payment solutions have been introduced in a number of countries, such as the UK (2008), Sweden (2012) and Denmark (2014). The solutions in these countries share two important characteristics. First, a payment reaches the payee a few seconds after it is made. Second, banks are not exposed to credit risk, even though payments are immediately available to customers.

In Norway, the banking industry established the solution "Instant payments" in 2012, whereby payments are immediately available to recipients. However, banks are exposed to credit risk as interbank settlement does not take place in real time. Thus, the solution is not completely satisfactory. On the initiative of Finance Norway and Norges Bank, a solution for settling real-time payments without credit risk for banks is currently being developed.

See Norges Bank's 2019 *Financial Infrastructure Report* for more information on real-time payments and the progress made to establish a solution for real-time payment settlement in Norway.

(Chart 3.6). The average value of these transactions was NOK 382.

Norway has one of the highest levels of card usage in goods and services purchases (Chart 3.7). At the other end of the scale are the Mediterranean countries and Germany. Germany is one of the advanced economies where card usage is lowest. On average, German consumers use a payment card less than once a week.

Online payments have seen strong growth in recent years (Chart 3.8). In 2018, there were 292m such transactions using Norwegian payment cards. Payments to foreign and Norwegian websites each account for around half of the online payments.

The total value of online payments in 2018 was NOK 131bn. The average value of these payment transactions was around NOK 450. Online payments in 2018 accounted for around 12% of all payments using Norwegian payment cards. In terms of value, these payments accounted for just over 15% of the total value of payments using Norwegian payment cards.

There has also been a considerable increase in mobile payments. Person-to-person payments (P2P) is the payment segment that has shown the sharpest increase, whereas mobile payments at physical points of sale and online have not increased to the same extent.

### 3.1.3 Bank transfers

Households use bank transfers to pay bills and make payments to others. Businesses use them to pay bills and wages.

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. Pay-

ments 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 an invoice that is sent electronically (e-invoicing), the payment process will be fully automatic for the customer. Both payee and payer must have an agreement with their bank for direct debits to take place.

Debit and credit transfers are used mainly for remote payments where payer and payee do not physically meet. 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 an invoice or bill that needs to be paid. This last payment is recorded as a debit or credit bank transfer.

The number of card payments was more than three times the number of bank transfers in 2018 (Chart 3.9). Nevertheless, the total value of bank transfers was still much higher than the total value of card payments. While the average card transaction in 2018 was around NOK 350, the average online bank transfer was close to NOK 23 000.

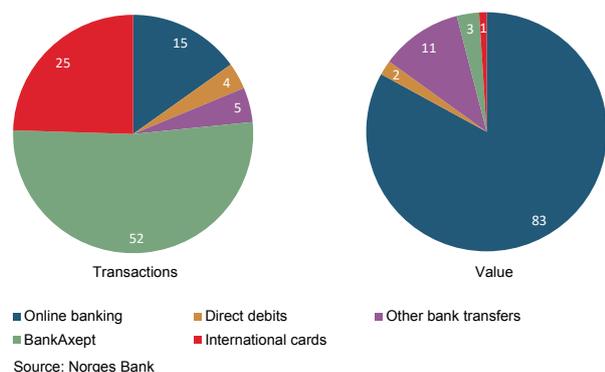
## REVISED PAYMENT SERVICES DIRECTIVE (PSD2) AND THE INTERCHANGE FEE REGULATION

The European Commission proposed a revised Payment Services Directive (PSD2) in 2013. The Directive entered into force in the EU in 2018 and in Norway on 1 April 2019, but it will take some time for PSD2 to be fully implemented while secondary legislation is being put into place. The primary purpose of PSD2, together with inter-bank fee and SEPA regulations, is to promote low-cost, modern and efficient payment services and to protect customers.

The Directive provides for two new types of payment service:

- Payment initiation services (PIS), whereby a PIS provider can initiate a payment order from a customer's payment account. A PIS provider can, for example, be a company that offers a payment application for smart phones as an independent service or as part of their overall range of services.
- Account information services (AIS), whereby an AIS provider can access customer account information. An AIS provider can, for example, be a mobile application that provides customers with an overview of their financial balances in different financial institutions. Such services can be bundled with payment applications, and marketing and advisory services.

Chart 3.9 Use of selected payment instruments as a share of total transactions and total value. Percent. 2018



The vast majority of bank transfers made by retail customers are now electronic (Chart 3.10). Paper-based and manual transfers, such as postal giro and telegiro payments, are rarely 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. The number of instant payments has also increased rapidly. Instant payments are received by the payee almost immediately after the payment has been initiated by the payer. These payments are made automatically when they fall due, provided that the customer's account has sufficient funds.

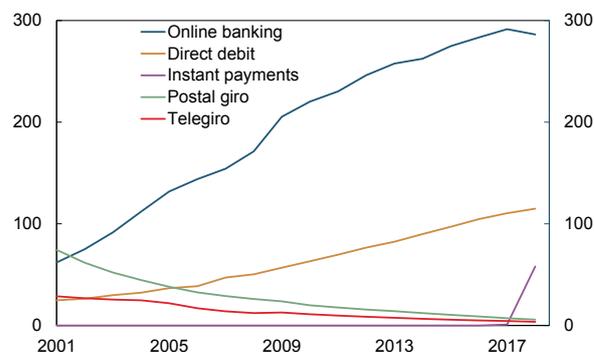
(For more information on retail payment services, see "Retail payment services 2018", *Norges Bank Papers* 1/2019.)

## 3.2 INTERBANK SYSTEMS

### 3.2.1 Norges Bank's settlement system (NBO)

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 248bn.

Chart 3.10 Debit and credit transfers by retail customers. In millions of transactions. 2001 – 2018

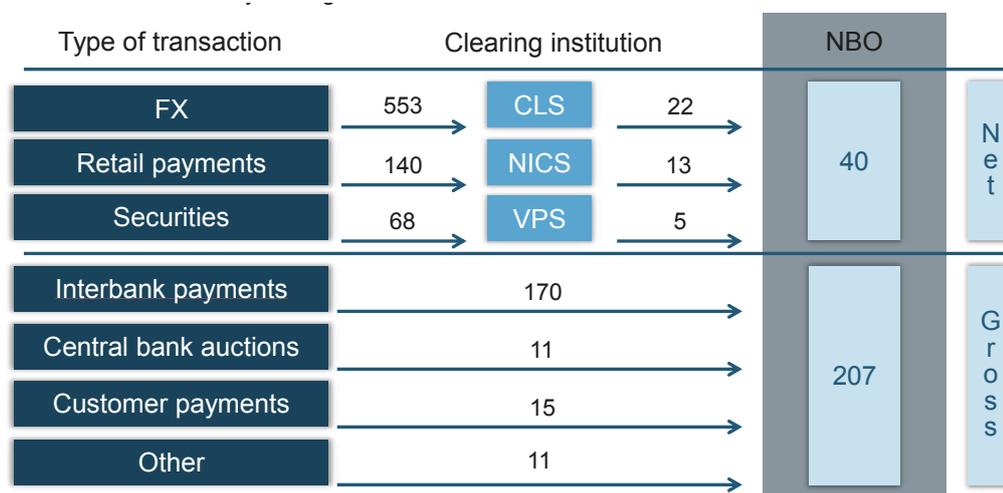


NBO is also used to implement Norges Bank's monetary policy. Read more about the implementation of monetary policy in Section 1.1 *Money market* and in box: **Norges Bank's liquidity management and overnight lending rate** in Section 1.

A total of 127 banks have an account with NBO, including most 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 relies on another bank to perform settlement in NBO on its behalf. Although all Norwegian banks have an account with NBO, few banks settle their transactions directly in NBO. These are primarily the largest Norwegian banks and the Norwegian branches of Scandinavian banking groups. The majority of Norwegian banks have only a few gross transactions and participate in net settlements through one of the big banks. Foreign banks without branches in Norway can hold accounts in Norges Bank, but choose to participate indirectly in the settlement in Norges Bank. 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:

Chart 3.11 Turnover in NBO. In billions of NOK. Daily 2018



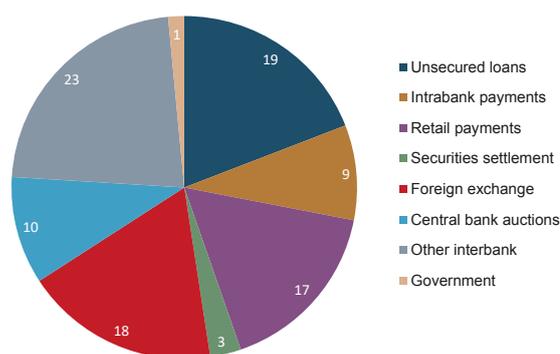
Sources: NICS Operations Office, VPS, CLS Services and Norges Bank

- Gross settlements (settlement of individual transactions in real time) account for more than 90% of turnover in NBO (Chart 3.11). These transactions include large financial market transactions, often related to banks' foreign exchange trading, liquidity management and payments on behalf of customers (Chart 3.12). The average size of these transactions was just over NOK 104m in 2018. All Norwegian banks with an account with NBO can participate directly in gross settlement, but only 10–15 banks do so.
- NICS Net is the settlement of net positions from the clearing system (see Section 3.2.2 *The Norwegian Interbank Clearing System (NICS)*), primarily comprising ordinary retail payments, but also including some small-scale financial market transactions (below NOK 25m).
- Securities settlement is the settlement of securities transactions, including payments between banks related to securities transactions. The actual securities are settled through VPS (see Section 3.3 *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 (liquidity bank).

- Derivatives settlement. The participants in this settlement are central counterparties and a few large banks. Derivatives settlement comprises the settlement of payments relating to option premiums, fees and interest (see Section 3.4 *Central counterparties*).

Norges Bank requires banks to have sufficient funds to cover the positions they intend to settle in NBO. This can be in the form of deposits or use of the lending facility at Norges Bank. To gain access to the

Chart 3.12 Gross settlement by transaction type. Percent. August 2015



Sources: NICS Operations Office, CLS and Norges Bank

## CENTRAL BANK DIGITAL CURRENCIES

A number of central banks, including Norges Bank, are considering whether to issue a generally accepted central bank digital currency (CBDC) in the future. This form of money is a claim on the central bank in the official currency and would serve as a supplement to cash.

Technological advances have brought this issue to the fore. Falling cash usage has raised the question of whether new functions will be needed in order to ensure that payment systems remain efficient and robust and to maintain confidence in the monetary system. If so, then the introduction of a CBDC could be an appropriate measure to address weaknesses that could otherwise emerge. At the same time, the introduction of CBDCs could impact bank funding and financial stability. CBDCs can take different forms depending on purpose.

CBDCs raise complex issues. There is limited international experience to draw on. More analysis is needed to assess purpose, the type of solution that best serves the purpose and the benefit of CBDCs relative to financial and other costs. This is a long-term process.<sup>1</sup>

<sup>1</sup> See *Norges Bank Papers 1/2018* for a more detailed discussion of central bank digital currencies.

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

The Scandinavian Cash Pool has been developed by Norges Bank in collaboration with the Riksbank (Sweden's central bank) and Danmarks Nationalbank (Denmark's central bank) to facilitate liquidity management for banks that participate in settlements at some or all of the Scandinavian central banks. The Pool allows banks to use deposits in one central bank as collateral for loans from another.

## 3.2.2 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-value payments, such as card payments and bank transfers, are netted so that each bank has a single debit or credit position against other participant banks. The clearing is performed by NICS and then sent to NBO for settlement (net settlement) five times daily: at 5.30 am, 9.30 am, 11.00 am, 1.30 pm and 3.30 pm.

All the 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 settle these banks' positions at Norges Bank. These positions are then added to 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 2019, 21 banks participated directly in net settlement in NBO and 103 banks indirectly. The largest private settlement bank is DNB ASA, which settles on behalf of 92 banks, while SpareBank 1 SMN is the settlement bank for 10 banks and Danske Bank for one bank.

Most of the payments cleared through NICS are below NOK 25m. Large-value payments, or specially marked payments, are sent to NBO for gross settlement, either directly to Norges Bank or via NICS.

Norges Bank has awarded the licence to operate the Norwegian Interbank Clearing System (NICS) to the financial industry's infrastructure company Bits AS (Bits)<sup>6</sup>, which is subject to supervision by Norges Bank. Bits 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, Bits remains responsible for its operation.

<sup>6</sup> The responsibility for operating NICS was transferred from the NICS Operations Office to Bits AS in 2017.

### 3.2.3 Foreign exchange settlement risk and the CLS foreign exchange settlement system

Foreign exchange (FX) settlement involves the risk of counterparty default, often referred to as Herstatt risk after German bank of that name, which failed in 1974 (for more about Herstatt risk, see “Bank Failures in Mature Economies”, *BCBS Working Papers No. 13*, April 2004, and box: **Herstatt risk**).

CLS was set up in 2002 to reduce FX settlement risk. Settlement in CLS is based on payment versus payment (PvP), which means that banks do not have to deliver on one part of a trade until they have received the other part. This means that settlement risk is substantially reduced and the transacting banks only have credit risk exposure to CLS. CLS currently settles FX trades in 18 different currencies. In addition to Norwegian kroner, CLS settles FX trades in US dollars, Canadian dollars, pounds sterling, euros, Swedish kronor, Danish 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 Bank is located in New York and is supervised by the US central bank, the Federal Reserve. Norges Bank and the other central banks whose currencies are settled by CLS Bank are members of an oversight committee chaired by the Federal Reserve. CLS Bank is organised as a limited liability company owned by 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. DNB is the only Norwegian settlement member. Actual settlement in CLS is gross (payment versus payment) in private bank money (bank deposits, also known as inside money) in CLS Bank, but banks pay in a net amount calculated by CLS for each currency. Settlement members pay and receive funds through CLS’ central bank account via their own accounts.

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

### 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 customers’ claims were never met. Herstatt risk has come to be used widely as an alternative term for foreign exchange settlement risk.

a correspondent bank. There are four correspondent banks for Norwegian kroner: DNB, Nordea, SEB and Danske Bank. These correspondent banks send and receive Norwegian kroner in NBO on behalf of their participant banks. CLS has a total of 65 settlement members. Funds in NOK are paid and received through CLS’ Norges Bank account via the four correspondent banks and Handelsbanken (see the *CLS website*).

### 3.3 SECURITIES SETTLEMENT (VPO)

The securities settlement system (VPO) has a cash leg and a securities leg. Ownership of Norwegian financial instruments is registered electronically in accounts in the central securities depository owned and operated by Verdipapirsentralen ASA (VPS). VPS operates the only Norwegian central securities depository where important information about securities is registered, such as owners’ names and whether the securities have been pledged as collateral. A securities trade is not completed (does not gain legal protection) until the change in ownership is registered in

VPS. All financial instruments can be registered in a central securities depository.

The total market value of securities registered in VPS is currently about NOK 5 800bn. When a security is sold, the security itself 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 three times a day (early morning, late morning, and afternoon). Gross daily turnover for securities settlements at VPS was just over NOK 68bn in 2018, whereas the daily net settlement value at Norges Bank was around NOK 4.8bn. VPS is owned by Oslo Børs VPS Holding ASA.

Traditionally, each country has had its own solutions for trading and settlement of securities. In recent years, however, the EU has worked to promote further integration of European securities markets by standardising legislation in European countries and developing TARGET2 and TARGET2-Securities (T2S), the ECB/Eurosystem payment system for processing cross-border payments and securities transactions (see box: **TARGET2-Securities (T2S)**).

### 3.3.1 How are trades made?

Financial instruments are traded both on regulated trading venues (for example stock exchanges) and unregulated markets (see also box: **Turnover in securities: exchange-traded and OTC** in Section 1).

Before buying or selling equities on a regulated trading venue, an investor must be 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.

### 3.3.2 How does securities settlement work?

A total of 36 entities participate directly in the securities leg of VPO, including the securities departments of large Norwegian banks, branches of foreign banks, some Norwegian brokerages and central counterparties (CCPs), 20 of which also participate directly in the cash leg at Norges Bank. Participants at Norges Bank are banks and CCPs. Private investors and a number

## TARGET2-SECURITIES (T2S)

The work to create a single market for financial services has been strengthened by the development of infrastructure for cross-border securities settlement (Target2-Securities (T2S)) under the auspices of the European Central Bank (ECB).

T2S is currently used by 24 central securities depositories (CSDs). Except for the Danish central securities depository, VP securities, all CSDs settle in euros. Norges Bank and VPS may join at a later date if there is sufficient interest among market participants and if Norges Bank can reach a satisfactory agreement with the ECB.

Under T2S, banks still have securities accounts with CSDs and cash accounts with central banks, but the accounts with central banks and CSDs participating in T2S are linked. Settlement in securities accounts and central bank accounts takes place on a transaction by transaction basis, with securities and cash being transferred simultaneously. If CSDs have accounts with each other, two banks will be able to settle securities trades with one another directly even if they are not members of the same CSD.

of banks participate in VPO indirectly through one of these direct participants.

Trading in fixed-income instruments and in equities is sent to VPS by the securities firms. VPS checks that the information on purchases and sales matches in terms of price, volume and other terms. If the trade is in equities, a CCP will normally become the counterparty in the securities settlement in VPS (see Section 3.4 *Central counterparties*).

VPO is a multilateral net settlement. VPS calculates a net position for each bank based on the agreed securities transactions. Norges Bank executes the cash leg of the settlement and VPS enters the securities transactions in the participants' securities accounts (the securities leg of the settlement). This solution ensures that securities only change owner after the buyer has paid and the seller has delivered (delivery versus payment). CCPs participate in securities settlement but generally have a net position close to zero, because they act as 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 that have sold securities and

debit the investors who have purchased securities. This can also be done prior to settlement. For Norwegian investors, Norwegian equities are registered on a VPS account in the name of the investor. Otherwise, equities may be registered in the investor's bank (nominee registration), where only the name of the nominee and not the name of the beneficial owner appears in VPS. There are currently about 1.3 million VPS accounts.

### 3.4 CENTRAL COUNTERPARTIES

A central counterparty (CCP) 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 CCP and one between the seller and the CCP. The parties to the transaction will not be exposed to each other, but to the CCP instead (Chart 3.13). The CCP guarantees completion of the transactions that are cleared through it (clearing) and is responsible for payment of any margin requirements. Margin requirements are either in the form of cash or securities and are intended to ensure that the CCP does not incur a loss in the event of counterparty default.

#### 3.4.1 Use of central counterparties

The global financial crisis in 2008 revealed that margin requirements for bilateral trading in derivatives (OTC

Chart 3.13 Central counterparty (CCP)

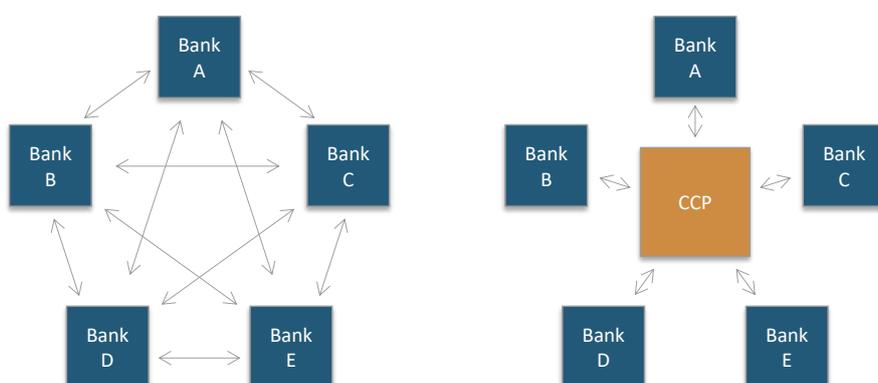
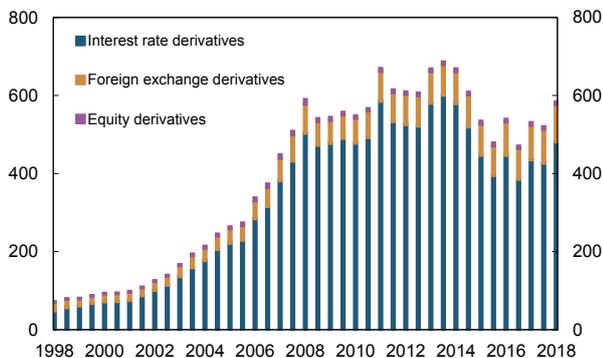


Chart 3.14 Global OTC derivatives market. Notional amounts outstanding. In trillions of USD. 30 June 1998 – 30 June 2018



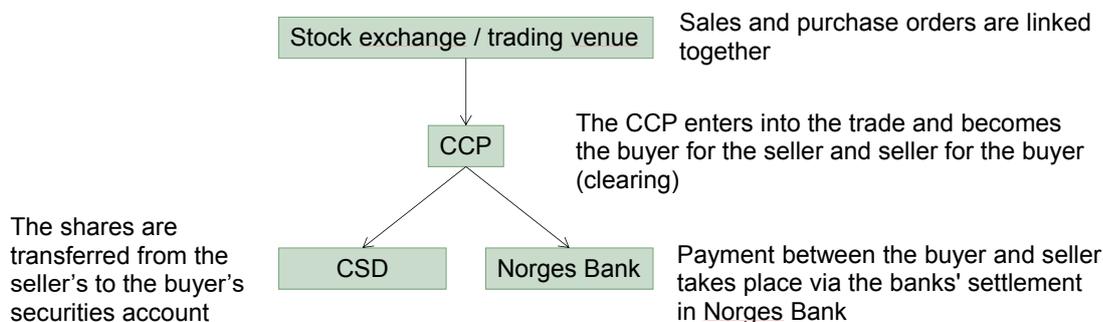
Source: BIS

derivatives) were not adequate. In addition, the authorities were unaware of the scale and type of exposures between market participants. Drawing on the experience gained during the financial crisis, the G20 leaders agreed to strengthen the regulation of derivatives markets. Importantly, it was agreed that OTC derivatives should to a greater extent be settled via CCPs. This has been followed up in the US by means of the Dodd-Frank Act and in Europe through the European Market Infrastructure Regulation (EMIR), see box: **European legislation on securities and derivatives**.

EMIR was implemented in Norway on 1 July 2017. Under EMIR, standard interest rate derivatives, which are by far the most widely traded derivatives, will be subject to clearing (Chart 3.14). For example, banks use interest rate derivatives in connection with foreign currency borrowing in bond markets (see box: **Norwegian Banks' and mortgage companies' bond funding abroad** in Section 1). Today, Norwegian banks settle interest rate derivatives bilaterally and through SwapClear, which is part of the UK central counterparty LCH.Clearnet (LCH). DNB Bank ASA participates directly in SwapClear, as do a number of other Nordic banks.

Clearing through a CCP has also increased because many trading venues have made it a requirement. 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 3.15). Some CCPs are active on one or more trading venues. Since this means that they have positions that need to be settled in the Norwegian securities settlement system, the CCPs take part in the cash leg at Norges Bank, either directly or through another bank.

Chart 3.15 Trading, clearing and settlement of equities in NOK<sup>1</sup>



<sup>1</sup> This chart has been simplified for clarity

Source: Norges Bank

### 3.4.2 Central counterparties and financial stability

In principle, a CCP has a balanced position (a “matched book”). Any fluctuations in the prices of the equities or derivatives that it clears will not therefore involve a risk of losses for the CCP. It is still, however, exposed to a conditional market risk. If either party fails to fulfil its obligations under the trade, the CCP is obliged to honour the terms of the original trade with the party that has not defaulted. In this situation, the CCP’s position will no longer be balanced. The CCP will then close out the position, ie it will enter into a new contract to buy or sell an opposite position. To limit risk, the CCP will try to close out the position quickly once a participant has defaulted.

To manage the risk they take on, CCPs require CCP members to deposit margins and pay contributions to a default fund. If a member defaults, losses must initially be covered by the margin and default fund contribution paid in by the defaulting member. If the losses exceed the margin and the default fund contribution, the CCP’s own equity is used. Any losses beyond that must be covered by other participants’ default fund contributions (Chart 3.16).

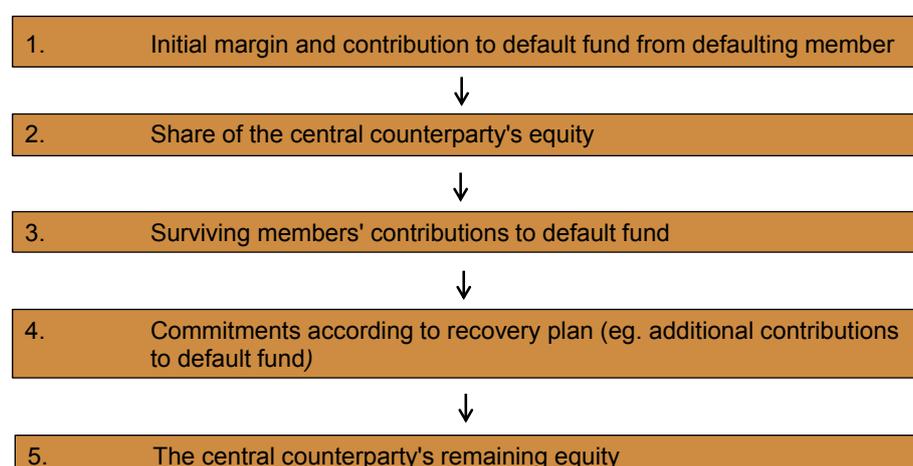
Most direct participants in a CCP are large banks. If a CCP’s losses are so large that it has to exhaust the default fund to close out the position, the CCP may require members (including Norwegian banks) to pay in an additional contribution to the default fund. The size of these contributions depends on the contracts the CCPs have with members.

### 3.4.3 Central counterparties and systemic risk

CCPs should have clear and pre-defined procedures for the management of a clearing member default. With clear procedures, margin requirements and required default fund contributions, problems are less likely to arise compared with bilateral settlement. Since trading venues introduced the obligation to use a CCP, market participants’ exposures have been concentrated in a small number of CCPs. This means that the consequences could be considerable if a CCP’s risk management procedures are inadequate.

CCPs often operate in more than one country. To ensure that CCPs 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 groups (colleges) responsible for the supervision and oversight of three CCPs active in the Norwegian securities market.

Chart 3.16 Illustration of the central counterparty default waterfall



## EUROPEAN LEGISLATION ON SECURITIES AND DERIVATIVES

The EU is working to create a single securities market in the EU with more efficient competition and enhanced transparency in securities and derivatives trading. To achieve this, the EU has introduced a number of directives and regulations in recent years on trading and settlement of financial instruments. Important 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 restrictions on the information that can be provided to customers and on the types of product that can be offered to different kinds of customer. The Directive also requires the best bid and offer prices to be quoted ahead of the trade, with subsequent publication of the price, volume and timing of a trade. MiFID I was introduced in Norway in 2007.
- MiFID II is an extension of MiFID I in response to a number of trends in the market. For example, MiFID II introduces requirements 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. MiFID II was introduced in Norway through the regulation of 1 January 2018.
- EMIR requires suitable OTC derivatives to be cleared through a central counterparty and all derivatives trades 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 above a certain volume. EMIR was introduced in Norway on 1 July 2017.
- CSDR standardises national legislation on central securities depositories (CSDs) and aims to promote competition between CSDs in different countries. The Regulation provides for links between CSDs, allowing investors and issuers 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. A new Central Securities Depository Act, which will implement CSDR in Norway, has been passed by the Storting, but has not yet entered into force.<sup>1</sup>

A common feature of these regulations 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/EEA (known as the "single passport"). Non-EU service providers 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, where for example ESMA participates.

<sup>1</sup> The new Central Securities Depository Act (in Norwegian only) [<https://lovdata.no/dokument/NL/lov/2019-03-15-6>]

# Appendix 1: Regulation of financial markets and trading venues

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In financial markets, savings are channelled to investments, and risk is allocated according to investors' willingness to bear risk. Moreover, many markets generate prices that are communicated to market participants 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, securities trading will be associated with risk beyond the risk of the individual security. This will make it more expensive for businesses to raise capital in securities markets.

Various kinds of market failure can give rise to a loss of confidence. For example, information asymmetry can provide an opportunity for unlawful insider trading and price manipulation. Protecting investors is the responsibility of the authorities, and there are various measures in place to reduce the risk associated with financial market activities, including regulation and supervision. The *Securities Trading Act* regulates 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 at this stage of a trade. The *Act relating to regulated markets (Stock Exchange Act)* and the *Securities Register Act* (in Norwegian only) regulates the securities market infrastructure. In markets where consumers (non-professional investors) participate, consumer information and protection are key objectives of the legislation.

To ensure that all investors in Norwegian securities traded in regulated markets are provided, as far as possible, with the same information, the Securities Trading Act contains the following provisions:

- Requirements with regard to ongoing and periodic information.
- A requirement for close associates of a company who therefore have particular knowledge of its

financial position (primary insiders) to give notification of the purchase or sale of shares.

- A disclosure requirement for large shareholders when their holdings exceed or fall below specified thresholds in either direction. For holdings of up to 25%, there is a disclosure requirement for every five percentage points.
- A requirement for extensive publicly available information in connection with an initial public offering or offers to subscribe for shares or other securities in a regulated market.

Finanstilsynet monitors compliance with the legislation and the information requirements. See *Finanstilsynet's website* for information about prospectuses (in Norwegian only).

Norway participates in the EU single market in financial services under the EEA Agreement. 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, authorisation requirements for regulated markets, reporting obligations to prevent market manipulation, notification obligations relating to transactions in shares and provisions on admission of financial instruments to quotation on regulated markets. The Directive has been implemented in Norway through the Securities Trading Act. MiFID I was introduced in Norway in 2007 and MiFID II in January 2018.

Over the past decades, various forms of derivatives (see box: **Derivatives** in Section 1) have become an increasingly important element in financial markets. Derivatives trading has been largely unregulated or lightly regulated. The financial crisis showed that when market participants are unaware of the risk associated with given financial instruments and moreover have no knowledge of who owns which instruments, the result can be a loss of mutual trust. In the wake of the financial crisis, this has led to increased regulation of derivatives markets, including mandatory clearing for certain standard interest rate

derivatives. In the EU, over-the-counter (OTC) derivatives, central counterparties and transaction registers are regulated by the *European Market Infrastructure Regulation (EMIR)*. EMIR was introduced in Norway on 1 July 2017.

The CSDR (Central Securities Depository Regulation) standardises the legislation relating to central securities depositories (CSDs) and is intended to promote competition between CSDs in different countries (see Norges Bank's 2018 *Financial Infrastructure Report*). 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, trust is largely assured by participants' self-regulation and by the fact that participants (ie banks and other financial institutions) are regulated. However, as there have been a number of examples of misuse of information and attempts to manipulate key prices in several unregulated markets in recent years, a number of initiatives have been taken to regulate previously unregulated activities and market participants.

# Appendix 2: Bank capital regulation

The losses a bank is able to absorb depend on how much risk-bearing capital, also referred to as regulatory capital, the bank holds relative to assets. Risk-bearing capital is primarily equity capital, but can also be different types of subordinated debt. Capital requirements are among the oldest and most important requirements set for banks by the authorities. Problems in the banking sector 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, efforts have been made over several decades to establish a common set of rules governing banks' capital adequacy.

## THE INTERNATIONAL BASEL FRAMEWORK

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. Revisions have been made to Basel III and the Basel Committee announced the proposed revisions at the end of 2017. Market participants usually refer to these proposed changes as "Basel IV". The Committee has no supranational authority, but members have committed to implementing the rules.

The Basel Committee had its first meeting in 1975, and Basel I was issued in 1988. 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 in 1991. Basel I introduced minimum requirements for capital as a percentage of banks' risk-weighted assets.

It became apparent over time 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 associated with banks' assets and banks' risk management. Banks were given the option of choosing between using standardised risk weights for their assets and using risk weights based on their own internal models (the internal ratings-

based (IRB) approach). The internal models are based on historical data for defaults and losses on various types of loan. Most large banks use IRB models to calculate the risk in their loan portfolios. Risk weights are intended to reflect the risk of unexpected losses. Expected losses should be reflected in lending margins and covered by current earnings.

Nevertheless, the intention was that Basel II should not result in a decline in regulatory capital in the global banking system. However, in practice, 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 an additional requirement that can be imposed on an individual bank based on the supervisory authority's assessment of the bank's risk. Pillar 3 contains reporting and disclosure requirements aimed at strengthening market discipline. These pillars are retained in Basel III. Basel III introduced several buffer requirements as an addition to the minimum capital requirements. A leverage ratio requirement has also been introduced in the Basel standard as a supplement to the risk-weighted capital requirements. A leverage ratio requirement has already been introduced in the EU. The revised version of Basel III contains a new standardised approach for credit risk to enhance the risk sensitivity of the capital requirements. In addition, stricter rules have been introduced for the IRB approach, while a new floor for the IRB banks will be less binding than the former transitional rule. The Basel Committee proposes that the rules be phased in between 2022 and 2027.

## CAPITAL ADEQUACY REQUIREMENTS FOR NORWEGIAN BANKS

The equity ratio, which is defined as equity capital as a percentage of total assets, is the traditional solvency measure for businesses. Banks and other financial institutions are required to have sufficient solvency in the form of capital adequacy. The capital adequacy

requirement 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 the financial institution fails, hybrid capital and then Tier 2 capital absorb losses after equity. Assets that cannot be used to absorb losses, including intangible assets, are deducted from equity before the capital ratio is calculated (regulatory deductions). Risk-weighting of assets means weighting different 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 (additional Tier 1 capital, AT1)
- Regulatory capital = Tier 1 capital + subordinated debt capital (Tier 2)

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

$$RWA = \sum_{i=1}^n \text{Asset}_i * \text{Risk weight}$$

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.

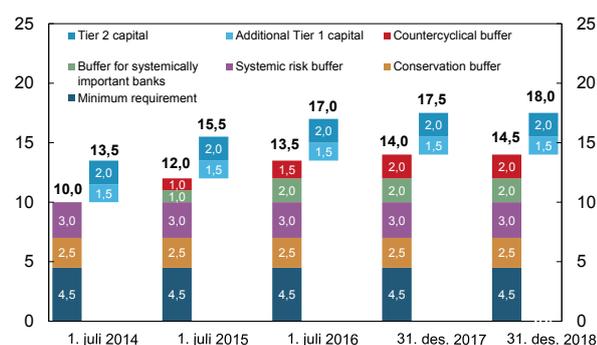
The minimum requirement for banks' CET1 capital ratio is 4.5%. In addition, banks face a number of soft requirements, so-called buffer requirements, which must also consist of CET1 capital. Banks in breach of the buffer requirements are required to prepare a plan to strengthen their capital adequacy, and Finanstilsynet can impose various restrictions such as a prohibition on paying dividend or bonuses. If a bank is on the verge of breaching the minimum requirement, specific crisis management rules will apply (see Section 2.2.8 *Crisis management in the banking sector* in the banking sector). 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 1).

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. According to EU rules, the size of the buffer is to be assessed at least 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 global systemically important and domestic systemically important banks. The reason for this buffer requirement is that problems in systemically important banks can lead to more severe consequences for society than problems in other banks. Finanstilsynet is required to advise the Ministry of Finance as to which financial institutions in Norway should be designated as systemically important by the end of the first quarter each year. 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 should, as a rule, be designated as systemically important. DNB ASA and Kommunalbanken AS were the domestic systemically important

Chart 1 Phase-in of Pillar 1 capital requirements in Norway.<sup>1</sup> Percent of risk-weighted assets. 1 July 2014 – 31 December 2018



1) The minimum requirement and buffer requirements in the columns to the left 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

banks in 2018. No Norwegian financial institutions have been identified as global systemically important institutions.

The **countercyclical capital buffer** aims to ensure that 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 for 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. The minimum requirement for Tier 1 capital and total capital before buffers is 6% and 8%, respectively, of risk-weighted assets.

The requirements mentioned above are what are called Pillar 1 requirements. In addition, there are Pillar 2 CET1 capital requirements intended to cover risks that are not, or are only partly, covered by Pillar 1 requirements. Pillar 2 requirements are individual and depend on Finanstilsynet's assessments of the risks of the relevant bank. Pillar 2 requirements consist of a formal requirement set as an individual decision and a "management" buffer, of which Finanstilsynet notifies the bank. The latter is not a formal requirement and is not made public by Finanstilsynet.

The Ministry of Finance has set a **leverage ratio requirement**. The minimum requirement is 3% for banks and other financial institutions not part of an insurance group. In addition, all banks are required to hold a leverage ratio buffer of at least 2%, and systemically important banks are required to hold an additional buffer of at least 1%. For the Norwegian banking sector as a whole, the leverage ratio was just over 7% at end-2018.





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Norway's financial system

