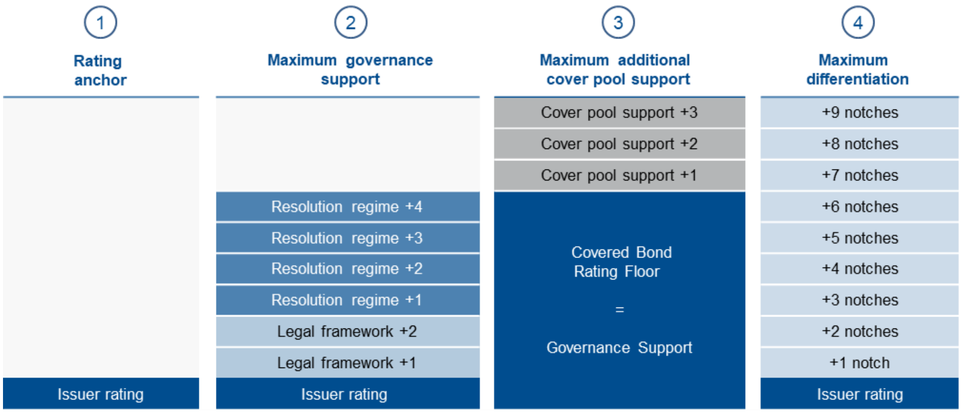
Legal framework analysis: Norway

Obligasjoner med fortrinnsrett/OMF

Norway's covered bond framework is strong and robust. Our positive assessment remains unchanged following full alignment with the European Covered Bond Directive on 8 July 2022. This report provides Scope's view of the governance support factors common to Norway's covered bonds and their issuers.

Norwegian covered bonds can achieve the maximum six notch governance support uplift allowable under our covered bond methodology. Governance support provides a floor to how much a covered bond can be rated above its issuer's rating and constitutes an anchor for additional credit differentiation based on cover-pool support.

Figure 1: Maximum rating differentiation for Norwegian covered bonds



Source: Scope; credit differentiation is expressed as a rating notch above the issuer's rating.

Our positive view of the strength of the Norwegian legal framework generally translates into the maximum two-notch uplift. The assessment remains unchanged following the updated legislation that came into force on 8 July 2022. The update transposed the European Covered Bond Directive (CBD) into local law. This ensures that mortgage covered bonds can use the "European Covered bonds (Premium)" label. The update provided only limited changes to the framework e.g. the introduction of a cover pool liquidity buffer requirement as well as a mandatory requirement to provide regular investor information.

Our resolution regime assessment for Norwegian covered bonds remains unchanged and may allow for an additional uplift of up to four notches. This is based on our analysis of how regulators would maintain the issuer and its covered bonds upon regulatory intervention, the preferential status of covered bonds in a resolution scenario as well as their systemic importance.

We classify Norwegian mortgage covered bonds as a systemic refinancing product. Public-sector covered bonds are a niche product accounting for only 2% of total outstandings hence we assign them moderately systemic relevance. The likelihood of a covered bond issuer remaining a going concern is mainly driven by its size and funding activity. We also differentiate between parent-owned banks and structures with multiple bank owners.

Additional cover-pool support can lift ratings up to nine notches above the issuer rating. The cover-pool support uplift is a function of the interplay between the complexity of a covered bond programme, the transparency provided to investors by the issuer, and the credit and market risk profile of the cover pool and covered bonds.

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Related Methodology/Research

Covered Bond Rating Methodology
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Covered Bond Quarterly: strong issuance volumes as cracks appear in house-price rally
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Norwegian banks: adoption of EU Creditor. Hierarchy Directive facilitates MREL issuance
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Legal framework assessment

Covered bond framework

We consider the Norwegian covered bond framework to be strong. It fully meets our investor protection expectations. We assign Norwegian covered bonds the highest credit uplift of two notches.

EU directive transposed in national law – credit neutral

The Norwegian legal covered bond framework is mainly based on the relevant section in the country's Financial Institutions Act (Lov om finansforetak og finanskonsern) and related regulation on mortgage companies (I forskrift 9. desember 2016 nr. 1502 om finansforetak og finanskonsern (finansforetaksforskriften)). Both were introduced in 2007. The Act was amended to transpose the European CBD and came into force 8 July 2022, in parallel with the application date in the EU. The Act provides the general structure of the main framework and references to regulations provided by the Ministry of Finance (Finanstilsynet). The Norwegian regulation on capital requirements and national adaptation of CRR/CRD IV provides further details on the requirements for Norwegian covered bonds and issuers.

Under this framework, issuance is permitted through specialist covered bond issuers (Kredittforetak, or mortgage companies). Most issuers of covered bonds (generally called Boligkreditt,) are subsidiaries that rely on loans originated by their respective parent bank(s). Parent banks generally also provide most of the services for these subsidiaries, allowing the latter to keep staff numbers low.

With the update to the covered bond legislation, the requirement to maintain different covered bond issuers has been lifted. We consider this credit neutral.

Segregation of cover pool

Assets legally segregated

The Norwegian legislation gives covered bondholders preferential claims over the cover pool if the issuer is placed under public administration. The term "covered bonds", (in Norwegian "obligasjoner med fortrinnsrett" or "OMF") is protected by law. The assets in the pool remain with the estate if the issuer is placed under public administration but bondholders and derivatives counterparties have exclusive, equal and proportionate preferential claims over the cover pool, and the administrator is committed to assuring timely payments, provided the pool provides full cover to claims.

The issuer maintains a register of issued covered bonds and of the cover assets assigned to them, including derivatives agreements.

Ability to continue payments following issuer insolvency

Public administrator ensures management and timely payments

Under the Norwegian legislation, owners of covered bonds and derivatives counterparties have a direct claim to timely payments with funds covered by preferential rights. Only if timely payment is not possible i.e. after maturity extension is triggered and no distressed liquidity situation emerges[1], can payments on the covered bonds be suspended. Covered bonds will not, however, be subject to automatic acceleration in the event of special administration or liquidation under public administration of the credit institution.

The administrator's is to ensure proper management of the cover pool and that holders of covered bonds and derivatives counterparties receive agreed and timely payments. Assets can be sold, and new covered bonds can be issued. The administrator can also enter new derivatives contracts or change existing contracts. The entire collateral can only be sold if this provides full coverage of all senior costs as well as the costs incurred by covered bond investors (including any deferred or accrued interest and costs).

[1] Decision to be made by the Ministry of Finance according to "Crisis management and crisis measures" of the Financial Undertakings Act

Liquidity and other risk management guidelines

Maturity extensions and liquidity buffer mitigate liquidity risks…

The credit institution shall ensure that payment flows from the cover pool enable the institution to honour its payment obligations towards holders of covered bonds and derivatives counterparties. It shall establish a liquidity reserve to be included in the cover pool as substitute assets in addition to carrying out stress tests periodically to ensure satisfactory liquidity management.

Liquidity risk

The covered bond issuer may in the terms and conditions of the bond stipulate that the term may be extended when specified events occur. The updated regulation now clearly defines the criteria for a 12-month extension: a) the expectation that an issuer will be affected by a crisis[2] in the near future and there is no reasonable prospect that other measures will prevent the institution from being affected by a crisis, or b) a decision made by the Ministry of Finance. The determination of a "crisis" will be made by Finanstilsynet, the Financial Supervisory Authority (FSA), while the Ministry of Finance and resolution authority will be most likely involved into this process as well.

….but liquidity buffers will rarely be present in practice

In addition, a covered bond issuer must always have a liquidity buffer forming part of the cover assets that at least corresponds to the net liquidity outflow in the OMF programme over 180 days. However, the regulation specifies that the basis of the liquidity calculation can be the extended maturity (if applicable). The ability to extend by 12 months effectively means that in general institutions that issue soft-bullet covered bonds do not need to provide additional collateral for the liquidity buffer.

For those institutions that have hard-bullets outstanding and might become subject to the rules, the liquidity buffer must consist of assets that qualify as level 1, level 2A or level 2B in accordance with the Capital Requirements Regulation article 460. In addition, short-term exposures to credit institutions in risk class 1 or 2 and short-term deposits in credit institutions that qualify for risk class 1, 2 or 3 do qualify. Assets in default cannot be counted in the liquidity buffer.

Interest rate risk

Formalised interest stresses…

A covered bond issuer shall not assume greater than prudent risk at all times. It must establish a limit on the interest-rate risk in relation to its own funds and potential losses. This shall be based on a parallel shift of one percentage point in all interest-rate curves as well as non-parallel shifts in the same curves. The interest-rate curves shall be divided into time intervals. Value changes for each time interval shall be limited to a prudent portion of the overall limit on interest rate-risk that is set for the institution.

Foreign currency risk

…but no FX considerations

Neither the Act nor the regulations foresee dedicated foreign-currency stresses or the obligation to hedge – issuers need to limit risks. Market risk including interest-rate risk and currency risk must be reported at least quarterly and shared on the issuer's website.

We take comfort from existing market practices where most internationally-active issuers typically mitigate all market risk. Issuers are exposed to interest and foreign-exchange risk. Norwegian mortgages are denominated in NOK and have floating rates whereas their covered bonds are denominated in EUR and USD and issued as fixed-rate bonds. Such positions are typically hedged, however.

[2] As defined in the Financial institutions act section 20-15

Derivatives

Market risks can be hedged, no must

Norwegian issuers can use derivatives to limit or fully remove FX and interest-rate risk. If a derivatives agreement has a positive mark-to-market value, the contract is part of the cover pool. If the value is negative, the derivatives counterparty has a preferential claim on the pool and ranks pari passu with covered bonds. Derivatives must not terminate during special administration (incl. maturity extension) or liquidation. They can be actively managed and new contracts can be entered into during special administration or liquidation. The regulation stipulates details on qualified counterparties, the contract's format, and valuation requirements.

Cover asset valuation

Valuation updates mandatory

The Act specifies valuation requirements for the mortgage portfolio. The value of the property securing the mortgage claim shall be "reasonable" and not higher than its market value. The valuation must be carried out according to recognised principles by a competent and independent person but can be based on statistical models. It must be monitored and renewed as necessary.

The use of Eiendomsverdi as an AVM (automated valuation model) provider is market practice for most covered-bond issuers. This provider estimates market values of residential real estate based on a valuation model and is performed on a property-by-property basis. The model is used both at origination, as a benchmark for physical valuations, and for updating market values on banks' mortgage portfolios. Eiendomsverdi benefits from the very high transparency of the Norwegian market. For example, most of residential properties are put up for sale on a public marketplace called finn.no. Such properties are sold via open auction.

Even though~~,~~ the law is relatively vague on the specifications of asset valuations, we value the market practice of issuers and high transparency in the market.

Programme enhancements remain available

Minimum OC at 5%

The public administrator must ensure proper management of assets securing covered bonds and that the provisions on composition of collateral, liquidity, currency and interest-rate risk are continuously complied with.

According to the law, the value of the assets must at all times cover the value of the covered bonds. Any excess collateralisation, yielding more than is necessary to cover bondholders' or derivatives counterparties' claims, may constitute a general bankruptcy claim. While this may limit the preferential position of covered bond investors, it is up to the special administrator to judge if available over-collateralisation (OC) is excessive. We do not expect that any special administrator would release assets as long as it has to ensure timely and full payment of covered bonds according to the law.

The law further specifies a concentration limit of 5% for individual exposures.

The regulation specifies minimum over-collateralisation levels that are dependent on the collateral type. Norwegian mortgage covered bonds benefit from nominal over-collateralisation that has increased to 5% (from 2% earlier). Domestic public-sector covered bond programmes are only required to maintain 2% minimum OC. Export Credit Agencies or internationally-backed public-sector covered bond programmes must provide 10% minimum OC.

The cover pool's interest yield must at all times be higher than the sum of the costs associated with covered bond funding including derivatives.

Asset criteria in line with CRR art. 129 raising max LTV to 80%

The collateral requirements allow for loans secured by housing association shares, mortgage loans, or loans secured by pledges in other real property assets. Mortgage collateral must be located within European Economic Area (EEA). Additionally, assets can consist of assets guaranteed by a state or public body, claims against credit institutions or receivables from derivatives agreements.

According to the regulation, the collateral pool securing a European Covered Bond (Premium) can only consist of claims that meet the requirements of article 129 of the Capital Requirements Regulation. This restricts funding coverage for mortgage covered bonds to the asset's loan-to-value threshold of 80% (from 75% earlier) for residential mortgages and 60% for commercial mortgages. The regulation further specifies that mortgages on holiday properties qualify only up to a loan-to-value of 60%. The amount of substitute assets is restricted according to their credit quality step category.

Covered bond oversight

FSA supervises and is supported by independent monitor

Norwegian issuers are subject to a supervisory regime involving both an independent monitor (cover pool monitor) and the Norway's national supervisor, Finanstilsynet – the Financial Supervisory Authority (FSA).

The FSA must approve new covered bond issuance programmes and can reject issuance in case of solvency doubts. The cover-pool monitor must be a State-authorised auditor and be different from the firm auditing the parent or the covered bond issuer.

At least quarterly, the monitor checks that the requirements for collateral, OC, liquidity, registration and investor information are met and reports at least annually to the FSA. If the monitor has reason to believe that the requirements have not been met, it must notify the FSA as soon as possible.

Transparency

Regular cover-pool reporting according to minimum standards

The Norwegian framework now stipulates mandatory cover-pool disclosures that have to be published on the issuer's website at least on a quarterly basis. The required information meets the minimum requirement under the EU's Capital Requirements Regulation (CRR).

In practice, most Norwegian issuers already provide such information using the ECBC's Harmonised Transparency Template which goes beyond minimum requirements thus is credit positive.

Other legal framework considerations

As a credit positive for issuers, Norwegian covered bonds fully comply with the provisions of the CRR and can be used for LCR purposes by investors.

There are no rating-relevant aspects that materially differ between covered bond types that are relevant for assessing differentiation in the legal framework. Generally, all Norwegian covered bond types receive the full legal framework rating uplift.

Resolution regime assessment

Translation of BRRD into national law

Covered bonds exempt from bail-in

Norwegian covered bonds are explicitly excluded from bail-in, both as a consequence of the transposition into national law of the EU Bank Recovery and Resolution Directive (2014/58/EU – BRRD) and, very explicitly, section 11-6 of the Financial Institutions Act.

Norway is in the EAA but is not part of the EU. Relevant EU rules are normally incorporated into the EEA Agreement before being enacted into Norwegian law. This includes the BRRD as well as the European CBD.

The main legal Act applicable to Norwegian banks is the Act on Financial Undertakings and Financial Groups (Financial Undertakings Act) which has been in effect since 1 January 2016. This Act consolidates the main financial regulations and implements (among others) the Capital Requirements Regulation (575/2013) (CRR), Capital Requirements Directive (2013/36/EU) (CRD IV) and the Bank Recovery and Resolution Directive (2014/59/EU) (BRRD).

Ability of regulators to maintain the issuer and its covered bonds as going concern

Resolvability of an issuer remains a bespoke analysis

The issuer's business model, systemic importance, liability and capital structure can incentivise regulators to use available resolution tools. We assess on an issuer-specific basis the likelihood that a covered bond programme will be maintained as an actively-managed going-concern funding programme.

Going concern most likely for systemically important banks…

The Norwegian banking market is dominated by the two largest banks/mortgage companies. As of June 2021, they account for 37% of private customers and 46% of corporate loans. Resolution for such systemically important banks is highly likely.

…while less likely for small banks

For smaller, typically regional saving banks with wholly-owned covered bond issuers, low-to-moderate covered bond issuing activities and market share translates into low to moderate systemic importance. Such banks generally only issue into the domestic market, which reduces negative repercussions on other issuers in the event of a failure. The most likely resolution scenario would be a transfer or takeover by another bank. An orderly wind-down of the covered bond issuer is another plausible scenario.

As seen throughout Norway, banking alliances play an important role in sustaining individual small banks' efficiencies and business franchises. This includes shared ownership of companies offering a range of financial products, such as insurance, leasing and securities services as well as covered bond funding. The number of participating banks and their size in relation to the whole market act as a guide for us to determine their systemic importance.

Systemic relevance of covered bonds in Norway

Norwegian mortgage covered bonds with high systemic relevance

We classify Norwegian residential mortgage covered bonds as a systemic important refinancing product. Public sector or pure commercial real estate-backed covered bonds are niche products which we believe are less relevant.

In Norway, 24 specialised covered bond issuers are active, issuing residential, commercial and public sector-backed covered bonds. Since the introduction of covered bonds in 2007, covered bonds have become a key pillar in each bank's funding toolkit. They allow banks to better match longer-dated mortgage financing with stable and also longer-dated wholesale funding, which they are also able to source in the euro market or in USD.

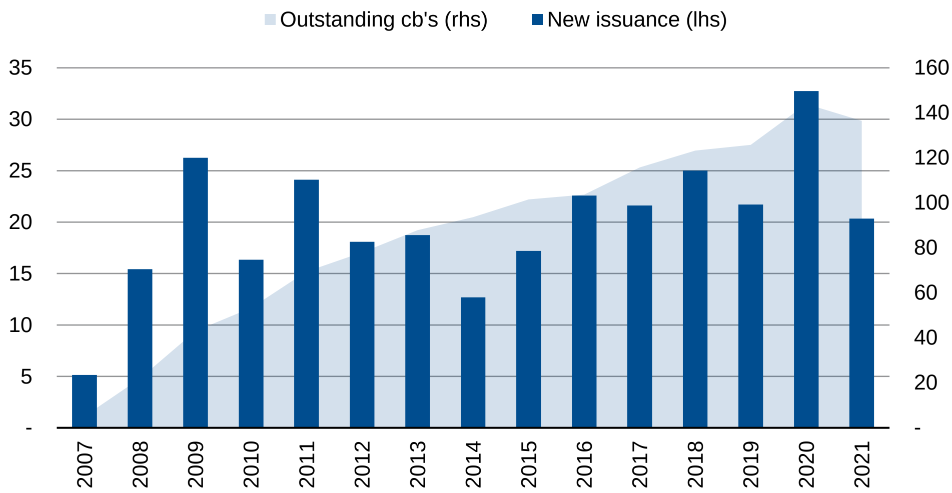
Since 2007, covered bonds outstanding have soared to EUR 136bn or NOK 1.36trn at the end of 2021. Outstanding covered bonds to GDP has doubled to more than 40% at the end of 2020 compared to 2010. Annual issuance regularly hovers around EUR 25bn.

Covered bonds have repeatedly provided Norwegian banks with funding stability when capital markets-based wholesale funding has been challenging. Ongoing access to investors as well as ability to use covered bonds as collateral with the central bank prompted peak issuance volumes shortly after the Global Financial Crisis in 2008 (EUR 26bn) as well as during the pandemic crisis (EUR 32.8bn).

Globally, Norway was the eighth largest issuing country in 2021 and it ranks 10th by total outstanding covered bonds. The majority of issuance is still domestic and in NOK (about 60%) with the residual mostly in EUR (35%-40% in normal years).

Figure 2: Covered bonds increasing as a refinancing tool

Figures in EUR bn



Source: ECBC. Scope Ratings

Public-sector covered bonds a niche with moderate systemic importance

Mortgage covered bonds make up around 98% (or around EUR 134bn) of the total. Most are secured by residential mortgages. Public-sector covered bonds are a niche, accounting for 2% of total issuance. We do not see the latter as an essential part of banks' funding mix, which is why we distinguish between the systemic importance of covered bonds secured by mortgage and public-sector assets.

Stakeholder support

Very active stakeholders and proactive regulator support Norwegian covered bonds

The country's covered bond issuers actively co-operate under the umbrella of the Norwegian Covered Bond Council to promote the product and initiate any changes to the framework, such as the March 2017 increase in minimum OC to 2% to avoid potential challenges for cover-pool derivatives due to the European Market Infrastructure Regulation.

Domestic covered-bond investors such as banks and insurers actively use covered bonds not only as a substitute for long-dated and rare NOK-denominated government debt but also to manage liquidity. Norway's central bank has demonstrated its support for covered bonds by using them in its repo operations and running a covered bond-to-government debt swap programme between 2008 and 2014. Norway's FSA also has an active interest given the widespread use of covered bonds to refinance residential mortgage lending.

Norway was also first out of the blocks to align its covered bond framework with the CBD and met the European deadline to transpose the directive into national law. These are further signs for the high systemic importance of the product and the activity of the local community.

For shared ownership companies, documented support expected

For shared ownership companies, we further analyse the implicit and explicit support documented in the companies' service agreements. The cohesion between the owners can be weaker if compared to a 100%-owned covered bond company. As a consequence, we expect to see strong documented shareholder support with regard to liquidity, over-collateralisation and operations (servicing in regard to the treatment of non-performing loans) to strengthen the coherence of the involved parties.

Appendix I: Key characteristics of the Norwegian covered bond framework

Issuer	Mortgage companies with a special licence to issue covered bonds. Most issuers of covered bonds (generally called Boligkreditt) are subsidiaries that rely on loans originated by their respective parent banks. Core tasks can be outsourced to the parent company. Issuers can add cover pool assets originated by other banks via a true-sale of assets. Where the issuer keeps 'off-balance-sheet' mortgages that are typically still serviced by the parent bank or a bank that has an ownership in a jointly-owned covered bond entity, significant additional disclosure is required.
Cover assets	Mortgage assets (residential and commercial assets) within the EEA, Switzerland and the United Kingdom. Underlying properties must be adequately insured against physical damage and the insurance must be part of the cover pool. Exposures to public-sector entities or public-sector-guaranteed entities in the EEA, Switzerland and the United Kingdom. Substitute and liquid assets can comprise exposure to eligible public-sector issuers, financial institutions, deposits and cash. Other 'high-quality' assets, given that these are credit claims with appropriate collateral. Derivatives but only to hedge risks – no specific restrictions on volumes.
Loan-to-value restrictions	Residential mortgages are eligible up to 80% of the properties' market or mortgage value; commercial mortgages and holiday homes are eligible up to 60%; of the properties' market value. The full loan amount is part of the cover-pool register while the portion up to the threshold determines maximum funding potential. Covered bond investors have a preferential claim on cover assets, including recovery proceeds from non-eligible loan parts above the LTV threshold. The value of the property securing the mortgage claim shall be "reasonable" and not higher than its market value. The valuation must be carried out following recognised principles by a competent and independent person but can be based on statistical models. It must be monitored and renewed if necessary. Derivatives are valued according to regulations.
Market and liquidity risk guidelines	Minimum 180 days of liquidity coverage, including interest and principal payments. In addition, the framework allows soft-bullet structures of up to 12 months. Extension criteria must be in line with the provisions in the directive. Issuers must establish prudent processes and risk management systems to identify, assess and control risks including interest-rate and foreign-exchange risks. Interest rates are stressed by parallel and non-parallel shifts of the interest-rate curve.
Coverage principle/minimum OC	5% over-collateralisation on a nominal basis for mortgage-backed covered bonds; 2% for domestic; 10% international public-sector-backed covered bonds.

Treatment upon insolvency	The assets in the pool remain with the estate in case the issuer is placed under public administration, but bondholders and derivative counterparties have exclusive, equal and proportionate preferential claims over the cover pool. The administrator is required to assure timely payment, provided the pool gives full cover to the claims. A public administration will decide which measures are appropriate to resolve the bank.
Mandatory transparency	Yes; information must be provided on a quarterly basis .
UCITS/CRR compliance	Norwegian covered bond types generally fully comply with UCITS and Capital Requirements Regulation.
Trustee/special supervision	Independent monitor (auditor), appointed by the issuer, and the Norwegian FSA.

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