NORGES BANK

CIRCULAR NO.1/7 JANUARY 2009

The arrangement for the exchange of government securities for covered bonds

[NOT IN FORCE]

The Storting (Norwegian parliament) has authorised the Ministry of Finance to exchange government securities for covered bonds (OMF). Norges Bank will administer the arrangement on commission from the Ministry of Finance, and will conduct the assessments and operations required under the arrangement on behalf of the government.

The arrangement was previously described in Circular no.7/14 November 2008. The list of claims that may be included among the covered bonds (OMF) in the arrangement has been adjusted. It has also been decided that mortgage companies may participate under certain conditions and that the government may waive the requirement for top-up collateral. This circular replaces Circular no.7/14 November 2008.

Eligibility for participation in the swap arrangement

Banks eligible to sign up for Norges Bank's fixed-rate lending facility (F-loans) and mortgage companies owned by such banks are eligible to enter into swap agreements with the government. Participation in the arrangement is subject to an agreement between each bank or mortgage company and the government represented by the Ministry of Finance. The terms of the agreement between the parties comprise notification of invitation to tender, confirmation of allotment from Norges Bank and the agreement on the exchange of government securities for covered bonds.

Securities included in the swap arrangement

The swap arrangement will initially include Treasury bills, allotted through auctions on market terms. When market participants, the government and Norges Bank have gained some experience of the swap arrangement, the inclusion of other government securities will be considered.

The government will exchange Treasury bills for the following covered bonds (OMF) denominated in NOK:

- Covered bonds backed by Norwegian residential mortgage loans (cf. Section 2-28, first paragraph, a) of the Financial Institutions Act).
- Covered bonds backed by Norwegian commercial mortgage loans, cf. Section 2-28, first paragraph, b) of the Financial Institutions Act, if a plan for obtaining a credit rating is submitted and a high rating is anticipated.
- Covered bonds backed by Norwegian loans to, or guaranteed by, central or local government, cf. Section 2-28, first

paragraph, d) of the Financial Institutions Act, if a plan for obtaining a credit rating is submitted and a high rating is anticipated.

- Similar securities (covered bonds) issued under the rules of other EU/EEA states backed by Norwegian residential or commercial mortgage loans. Covered bonds backed by Norwegian commercial mortgage loans are eligible, provided a plan for obtaining a credit is submitted and a high rating is anticipated.

The arrangement also includes covered bonds backed by Norwegian residential or commercial mortgage loans denominated in SEK, DKK, EUR, USD, GBP or CHF.

Swap agreement structure and price

In the swap arrangement, the government will sell Treasury bills to participants from its own stock of these securities in a time-limited swap for covered bonds.

Participants entering into swap agreements may either retain the Treasury bill and receive payment from the government when the bill matures, or sell the bill in the market.

Participants can procure covered bonds either in the market or directly from a mortgage company authorised to issue covered bonds.

Swap maturities may be for up to three years. Participants may enter into several swap agreements at each auction. Agreements will mature on an IMM date, i.e. the third Wednesday in March, June, September and December.

Covered bonds must have a residual maturity that is at least 15 days longer than the swap period.

When Treasury bills mature before the end of the swap period, participants must purchase new bills from the government. This rollover structure will apply throughout the swap period.

At the end of the swap period, participants must repurchase the covered bonds from the government at the same price paid by the government for these bonds.

Under the swap arrangement, participants furnish covered bonds as collateral for the government’s claim in the repurchase operation.

In auctions, participants will submit bids at the nominal value of the Treasury bill they want to exchange for covered bonds.

Norges Bank will announce the size of the amount auctioned at each auction, but may distribute the total auction amount across the different swap periods within each auction following an assessment of all the bids received.

Interest payments related to covered bonds – fixed coupon or floating rates – are credited to participants’ accounts the same day as the payments are made, unless default occurs during the swap agreement.

A lower limit of 40 basis points has been set for the spread between the auction interest rate and the Treasury bill yield. This implies that the auction interest rate will be no lower than the Treasury bill yield received by the participant plus 40 basis points.

Participants’ payment for the swap above NIBOR (X+Y in the equation below) will remain fixed through the swap period.

Participants' borrowing cost will nonetheless be variable in that the NIBOR used in the agreement is adjusted when the Treasury bills mature.

A non-competitive bid of up to NOK 500 million per participant may be submitted in each auction. A non-competitive bid does not affect the auction price, and allotments are made at the price established in the auction. If there are no other bids with the same duration in the auction, allotments will be made to the non-competitive bid at the minimum price. A participant submitting a non-competitive bid cannot also submit a competitive bid. The total of non-competitive bids may not exceed 25 per cent of the auction amount.

Participants must submit documentation of the covered bonds to be included in the swap agreement two days before the auction. Loan agreements and securities documents (loan description) are required.

Valuation of covered bonds

At the beginning of the agreement, the Treasury bills received by participants from the government and the covered bonds received by the government from participants (adjusted for haircuts) must have the same market value.

The value of the covered bonds received by the government is determined according to the same principles as for securities pledged as collateral in favour of Norges Bank. The value is calculated based on the current value of future payments and is adjusted according to the haircut rules set out in Annex 1 to this circular.

For covered bonds without a rating at the beginning of the agreement period, but that receive a rating in the course of the agreement period, the haircut rate may be reduced *at rollover* so that a share of the covered bonds is transferred back to the participant.

Top-up collateral (two alternatives):

Alternative 1:
Participants may choose swap agreements with top-up of collateral during the swap period. The value of covered bonds is then assessed according to the valuation method laid down in the agreement on the exchange of government securities for covered bonds each time government securities mature and otherwise when deemed necessary by the government. The value of the covered bonds shall exceed the value of the government securities by a minimum safety margin, in accordance with further specified terms in the above agreement. Covered bonds will be topped up so that their value relative to the value of the government securities is the same as at the beginning of each swap.

Alternative 2:
As an alternative to a required collateral top-up during the swap period, participants may choose swap agreements with higher haircut rates, cf. Annex 1 to this circular, and without a top-up requirement. In agreements using the latter alternative, only floating-rate covered bonds are eligible.

Covered bonds in foreign currencies

For covered bonds denominated in foreign currencies, the rules on top-up of collateral and the haircuts set out in Annex 1 apply.

Price of the swap agreement

The price participants must pay to swap Treasury bills for covered bonds will be determined by Dutch auction, where all participants pay the same interest rate, equivalent to the lowest accepted interest rate in the auction. In the pricing of the swap agreement, the following definitions apply:

The auction interest rate
The auction interest rate is the interest rate bid in the auction, defined by the equation:

Auction rate = NIBOR(5) + X + Y,

where NIBOR(5) is the average NIBOR over the past five trading days and X is a premium that may be positive or negative depending on market conditions. NIBOR(5) + X is the minimum price in the auction and is set by Norges Bank before each auction. Y denotes the number of basis points bid above the minimum price. Each participant indicates the Y they are willing to pay, and Y is determined in the auction. In each auction participants may enter into several swap agreements of various durations. In each auction, the premium X is the same for all swap periods, while participant bids above the minimum price, Y, may be different for each swap period.

The Treasury bill yield
The Treasury bill yield is the rate of return on the Treasury bill that participants receive in exchange for covered bonds. The bills are a zero-coupon security and the yield on the Treasury bill is determined by the relationship between nominal and market value. The market value of the Treasury bills is estimated using the average Treasury bill yield over the past five trading days applying the highest bid price on the Oslo Stock Exchange. If fluctuations in Treasury bill yields are observed to be abnormally wide over the past five trading days, Norges Bank may adjust for this.

The price of the swap agreement
The price of the swap agreement is the difference between the auction interest rate and the Treasury bill yield. This means that during the swap period participants will receive the Treasury bill yield and pay the auction interest rate. The margin (X+Y) is fixed through the swap period, but the auction interest rate is adjusted on the basis of changes in NIBOR(5) at each rollover of the Treasury bill. In the agreement, the NIBOR with the same maturity as the Treasury bill is applied. When a new agreement is concluded, NIBOR(5) is estimated based on a weighted average of NIBOR. When a bill matures and is replaced by a new 6-month bill within the existing agreement, NIBOR(5) is estimated based on the 6-month NIBOR.

Further requirements applying in the auction are specified in the following:

- Two days before the auction, participants must deliver documentation related to the covered bond to be included in the swap agreement. Loan agreements and securities documents (loan description) are required.
- Participants must submit bids in the Treasury bill's nominal value.
- In each auction, swaps of various durations are offered. For each swap period Norges Bank ranks the bids by price (Y in the equation above). In accordance with the Dutch auction principle, allotments will be made to all participants that have bid an interest rate that is higher or equal to the accepted auction interest rate, or pro rata haircut (see following point).
- If participants' bids summed over all the swap periods exceed Norges Bank's intended total allotment, the allotment will be subject to a pro rata haircut within each swap period. The bids are thereafter ranked for each swap period by price.
- Each time a Treasury bill matures and the bills are rolled over, the following procedure applies:
  - Participants will purchase bills with a 6-month residual maturity from the government for the same amount (market value) as at the beginning of the swap agreement.
  - The amount participants will pay to the government is that determined by the auction interest rate applying through the duration of the swap agreement and the value of the bills received by participants at the time of rollover.
- At the end of the swap period, participants will repurchase the covered bonds at the same price as that paid by the government.

Auction calendar

Norges Bank will publish an auction calendar. Auctions will, in general, be conducted twice a month. Announced auctions may be cancelled at short notice. As necessary, auctions may be conducted on other dates than those set out in the auction calendar.

Invitation to tender

In the invitation to each auction Norges Bank will specify the auction window, the covered bonds eligible to be swapped for government securities, the minimum price, volume and date for the settlement of the swap transaction. Each participant may submit a maximum of three competitive bids for each swap period specified in Norges Bank's invitation to tender. The bids must be submitted by telephone. Norges Bank will publish the result on the Bank's website and through Reuters.

Bids must be submitted in whole NOK millions in the Treasury bill's nominal value. Norges Bank reserves the right to reject any bid received or all bids received.

On the day of the auction, Norges Bank will publish NIBOR(5) and the price of the Treasury bill to be swapped in the auction.

Settlement

Settlement will take place two days after the auction.

In all auctions, payments and transfers of securities in the operation will be settled in the securities settlement system (VPO). This will ensure that securities are not transferred until payment is received. The bidder must register the trade in the VPS (Central Security Depository) on the day of the auction. Norges Bank will confirm the trades in the VPS no later than the evening before the settlement day. This ensures that the transactions will be finalised in the first daily securities settlement (VPO I) on the settlement day. Mortgage companies must use an ordinary participant in the securities settlement system (VPO) in both the cash and securities settlement.

At rollover on the IMM date:

- the sale of new government securities will be settled in the securities settlement system.
- payment in connection with maturity will occur through the normal channel, i.e. the banks' clearing system (NICS).
- the interest payment must be paid into an account in Norges Bank.

At the end of the swap period, the repurchase of covered bonds will be settled in the securities settlement system.

Coupon payments related to covered bonds will be credited to participants on the maturity date. The amount will be transferred via gross settlement in NICS.

Norges Bank may choose to cancel the allotment in full or in part, or sell the Treasury bills at the bidder's cost and risk if settlement is not completed by the deadline.

Norges Bank will draw up an allotment confirmation specifying the terms and settlement conditions set out in the auction. The allotment confirmation will be sent to the bidder receiving an allotment, and must be returned signed by the bidder to Norges Bank the same day.

Annex 1

1. *Reduction in market value (haircuts) – rules for banks' swap agreements with collateral top-up*

Haircuts will be applied according to the rules for banks' loans from Norges Bank, cf. Circular no. 5/4 November 2008 "Guidelines for pledging securities as collateral for loans from Norges Bank".

2. *Reduction in market value (haircuts) – rules for mortgage companies' swap agreements with collateral top-up*

Haircut rates are one percentage point higher than the haircut rates in the guidelines for pledging securities for loans from Norges Bank with an additional one percentage point for each initiated year after the first year of the swap agreement.

3. *Reduction in market value (haircuts) – rules for banks' and mortgage companies' swap agreements without collateral top-up.*

The following haircut rates apply in addition to the haircut rates in the guidelines for pledging securities for loans from Norges Bank and the haircut rates in point 2:

- an additional haircut of 2 percentage points will be applied to covered bonds with a residual maturity of 0 - 3 years
- an additional haircut of 3 percentage points will be applied to covered bonds with a residual maturity of 3 - 7 years
- an additional haircut of 5 percentage points will be applied to covered bonds with a residual maturity of 7 years.

4. *Reduction in market value (haircuts) – rules for covered bonds denominated in foreign currencies*

An additional haircut of 10 percentage points will be applied to covered bonds denominated in foreign currencies.