NORGES BANK
ANNUAL REPORT

/2018

Annual Report of the Executive Board

Norges Bank's mission is to promote economic stability and manage substantial assets on behalf of the Norwegian people. The Bank conducts monetary policy, monitors financial system stability and promotes robust and efficient payment systems and financial markets. Norges Bank manages the Bank's foreign exchange reserves and the Government Pension Fund Global (GPFG) on behalf of the government. The investment strategy of the GPFG is designed to obtain the highest possible return over time within the framework of the investment mandate.

2018 was an eventful year for Norges Bank. On 2 March, the Government laid down a new regulation on monetary policy with a new inflation target. The operational target is now annual consumer price inflation of close to 2% over time.

On 19 October, the Government submitted a white paper on a new central bank act. This was an important step in clarifying key questions regarding Norges Bank's mandate, responsibilities and organisation. The Government proposes that the GPFG should remain within Norges Bank and that an expert committee should be established to strengthen the work on monetary policy and financial stability. The Storting endorsed the white paper in February 2019.

In September, Norges Bank raised its policy rate for the first time in seven years. If the economy develops as was then envisaged by the Bank, this will be the start of a gradual interest rate normalisation. There has been solid economic growth in recent years and the labour market has been improving. The upturn among Norway's trading partners has contributed to lifting growth in Norway.

At the same time, financial system vulnerabilities in Norway are assessed as having increased over the past year, primarily owing to rising commercial property prices. On 13 December 2018, Norges Bank advised the Ministry of Finance to increase the countercyclical capital buffer from 2.0% to 2.5%, effective from 31 December 2019. The Ministry of Finance decided to follow the Bank's advice.

The GPFG's return before management costs was -6.1% measured in the fund's currency basket in 2018. Measured over the period 1998–2018 as a whole, the annual return on the GPFG was 5.5%. The annual net real return, after deductions for inflation and management costs, was 3.6% in this period.

Monetary policy

The Government laid down a new monetary policy regulation on 2 March 2018. The operational target is now annual consumer price inflation of close to 2% over time. Inflation targeting shall be forward-looking and flexible so that it can contribute to high and stable output and employment and to counteracting the build-up of financial imbalances. The new regulation clarifies the monetary policy mandate and underpins the Bank's flexible approach to inflation targeting.

Economic growth was solid among Norway's trading partners in 2018, but slowed somewhat in the course of autumn. The slowdown partly reflected tighter financial conditions and heightened uncertainty owing to trade tensions. Unemployment continued to fall in many countries and wage growth picked up somewhat. Inflation also picked up, mainly as a result of higher energy prices. Core inflation among most of Norway's trading partners remained relatively stable in 2018 and was somewhat below target.

The global interest rate level remained low, but policy rates in the US, the UK and Sweden were raised in the course of 2018. The European Central Bank (ECB) discontinued its net asset purchases at the end of the year. Forward rates among Norway's main trading partners fell somewhat overall through 2018 and at the end of the year indicated a very gradual global interest rate rise ahead.

Norwegian money market rates rose in 2018, partly owing to the policy rate increase in September and higher money market premiums. Residential mortgage rates were raised after Norges Bank increased the policy rate in September.

The policy rate was raised to 0.75% in September

Oil prices fluctuated widely through 2018, rising from below USD 70 per barrel at the start of the year to above USD 85 per barrel in the course of autumn. Thereafter, oil prices declined to below USD 55 per barrel at the end of the year. Price developments were particularly affected by supply-side factors in the oil market. Towards the end of 2018, uncertainty about global economic prospects contributed to the fall in oil prices. Oil futures prices were slightly higher at the time of the December 2018 *Monetary Policy Report* than one year earlier.

The krone, as measured by the import-weighted index I-44, appreciated from the beginning of 2018 and through autumn. The krone depreciated towards the end of the year, in parallel with the fall in oil prices and increased uncertainty in global financial markets.

The upturn in the Norwegian economy that began in 2016 continued through 2018. Economic growth was supported by petroleum investment, which started to rise in 2018 after falling sharply for several years, and a pick-up in oil service exports. Housing investment declined markedly in 2018 after rising rapidly for several years. Higher inflation curbed growth in household disposable income, and growth in household consumption was slightly lower than in 2017

Capacity utilisation in the Norwegian economy appeared to be somewhat below a normal level at the beginning of 2018. During the year, spare capacity gradually diminished, and at the end of 2018 capacity utilisation appeared to be close to a normal level. The labour market improved and employment rose. Unemployment showed little change in the same period, partly owing to labour force expansion as a result of an increase in new entrants to the labour market.

Wage growth picked up further in 2018, partly owing to a tighter labour market, but remained moderate.

Consumer price inflation rose through 2018. A substantial increase in electricity prices contributed to the rise. Underlying inflation also accelerated, driven in part by a pick-up in wage growth. The year-on-year rise in the consumer price index (CPI) was 2.7% in 2018. Adjusted for tax changes and excluding energy products (CPI-ATE), inflation was 1.6%.

Through 2018, the Bank's monetary policy assessments emphasised that the upturn in the Norwegian economy appeared to be continuing and that capacity utilisation was approaching a normal level. Underlying inflation was low, but picked up and was close to target towards the end of the year. The Executive Board's assessment was that a policy rate that remained unchanged for a long period could contribute to accelerating price and wage inflation and a build-up of financial imbalances. The risk of a sharp economic downturn further out would then increase.

On the other hand, the Executive Board also gave weight to the outlook and the balance of risks, which implied that the policy rate should be raised gradually. A rapid rate rise could stifle the upturn, resulting in higher unemployment and below-target inflation. The long period of low interest rates and rising debt ratios has generated increased uncertainty surrounding the effects of higher interest rates. This suggested a cautious approach to policy rate setting.

The policy rate was kept at 0.5% until September 2018, when it was raised to 0.75%. The rate was thereafter kept unchanged for the remainder of the year.

The forecast for the policy rate was revised up in the first half of 2018 and thereafter revised down somewhat in the second half of the year. The forecasts published in the December 2018 *Monetary Policy Report* implied a policy rate that would be raised gradually, to 2% at the end of 2021. In the coming years, capacity utilisation was expected to rise and remain above a normal level, while underlying inflation was expected to remain close to 2%.

Financial stability

It is important that the financial system is stable and well-functioning and capable of executing payments, channelling funding and distributing risk efficiently. Norges Bank has a particular responsibility for promoting robust and efficient financial markets and payment systems.

In the 2018 *Financial Stability Report,* financial system vulnerabilities in Norway are assessed as having increased somewhat since the 2017 *Report*, primarily owing to rising commercial property prices. At the same time, banks have become more resilient, and measures implemented by the authorities have limited borrowing by vulnerable households. On balance, the financial stability outlook was broadly unchanged in 2018.

Household debt ratios are high and are an important source of vulnerability for the Norwegian economy. Household debt growth fell somewhat in 2018, but is still higher than income growth. House prices have risen for many years, fuelling household debt accumulation. After falling in 2017, house prices rose in the first half of 2018. In the second half of 2018, house prices levelled off. Even though house price inflation has slowed, the high level of house prices still implies vulnerability.

In June 2018, the Ministry of Finance decided to retain the regulation on requirements for new residential mortgage loans. The requirements in the regulation and gradually higher interest rates will have a dampening effect on debt growth and, over time, on household vulnerability to shocks.

In the commercial real estate market, estimated selling prices for prime office space in Oslo have continued to rise rapidly. This increases financial system vulnerability. Commercial property prices can fall sharply if there is a marked rise in long-term rates or risk premiums or if the economy enters a downturn resulting in falling rental prices. Experience shows that in the event of such developments, commercial real estate loans can be a source of substantial bank losses.

All Norwegian banks fulfil the capital requirements, and the Common Equity Tier 1 (CET1) ratios of the large banks exceed their long-term capital targets. The banks satisfy liquidity requirements and have had ample access to funding through 2018. The stress test in the 2018 *Financial Stability Report* shows that banks would have to draw down their entire countercyclical capital buffer and some of the other buffers in order to maintain credit supply in the event of a pronounced downturn in the Norwegian economy.

Norges Bank prepares the decision basis for and advises the Ministry of Finance on the level of the countercyclical capital buffer for banks on a quarterly basis. The countercyclical capital buffer is part of the total CET1 capital requirement applied to banks. Banks should build and hold a countercyclical capital buffer when financial imbalances are building up or have built up. Norges Bank's assessment of financial imbalances is based on developments in credit, property prices and bank funding. The countercyclical capital buffer rate was 2.0% through 2018. In December 2018, Norges Bank issued advice to increase the buffer rate from 2.0% to 2.5%, effective from 31 December 2019. The Ministry of Finance decided to follow the Bank's advice.

In December, Norges Bank issued advice to increase the buffer rate to 2.5%, effective from 31 December 2019

EU regulations that require less capital to achieve the same risk-weighted capital ratio will likely be implemented in the course of 2019. This means that banks will be able to withstand an increase in the buffer rate without having to make substantial adjustments.

New deposit guarantee rules and bank recovery and resolution rules entered into force on

1 January 2019. Under the new rules, investors in bank bonds and short-term paper will have to be prepared to contribute towards a bank´s recapitalisation if a bank experiences a sharp decline in capital adequacy and requires fresh equity. Finanstilsynet (Financial Supervisory Authority of Norway) will draw up recovery plans for banks deemed too important to be allowed to fail.

DNB and Kommunalbanken have been designated as systemically important financial institutions, which have higher capital requirements than other banks. Finanstilsynet has proposed changes to the rules for identifying systemically important banks to give weight to market share for corporate loans in different regions. Under the proposal, the largest regional banks will also be designated as systemically important. In Norges Bank's opinion, it should be considered whether large regional banks deemed too important to be allowed to fail under the bank recovery and resolution framework should also be subject to the same capital requirements as systemically important banks, as proposed by Finanstilsynet.

Management of the Government Pension Fund Global

At end-2018, the market value of the GPFG was NOK 8 256bn, a decline of NOK 233bn since the beginning of the year. The return on the GPFG was equivalent to NOK -485bn, while transfers to the GPFG came to NOK 34bn. 2018 was the first year with net transfers to the GPFG since 2015. Changes in the krone exchange rate increased the GPFG's value by NOK 224bn, although this has no effect on the GPFG's international purchasing power.

The return before management costs was -6.1% measured in the GPFG currency basket in 2018. Equities returned -9.5%, bonds 0.6% and unlisted real estate 7.5%. Management costs amounted to 0.05% of the GPFG's capital.

The GPFG's overall return in 2018 was the second lowest since 1998. Equity allocation has increased over time and equity returns are therefore now more important for the GPFG's overall performance than in previous years. The return on equity investments in 2018 was the fourth lowest since 1998, after returns of -40.7% in 2008, -24.4% in 2002 and -14.6% in 2001. The GPFG had a long-term investment horizon. The Executive Board is prepared for substantial return variation from one year to the next and emphasises that performance must be assessed over time.

Measured over the period 1998–2018 as a whole, the annual return on the GPFG was 5.5%. The annual return, adjusted for inflation and net of management costs (net real return), was 3.6% in this period.

Norges Bank manages the GPFG with a view to achieving the highest possible return over time in the mandate laid down by the Ministry of Finance. The Bank pursues a range of investment strategies. For the period 2013–2018, these strategies can be grouped into three main categories: allocation, security selection and asset management. The different strategies are complementary. The aim is that in combination they will yield a higher return than the benchmark index over time.

In 2018, the return before management costs was 0.3 percentage point lower than for the benchmark index. The contributions from the various investment strategies show that

Broad media coverage of the Governor's annual address in 2018

allocation, security selection and asset management all contributed to a lower return than the return on the benchmark index. The contributions from equity, fixed income and real estate investments show that equity investments contributed to the GPFG's negative relative return in 2018.

Real estate investments are financed by selling equities and bonds, and the results are reported as a sub-strategy of allocation. In 2018, the return on unlisted real estate was higher than the return on the equities and bonds sold to finance them.

The Executive Board emphasises the importance of assessing performance over time. Viewed over the six-year period 2013–2018, the investment strategies achieved an annual excess return before management costs of 0.18 percentage point. In this period, allocation made a negative contribution to the excess return, while both security selection and asset management made positive contributions.

Over the period 1998–2018 as a whole, the return on the GPFG before management costs was 0.25 percentage point higher than the return on the benchmark index set by the Ministry of Finance.

The objective of the highest possible return is to be achieved within the limits of acceptable risk. Risk is measured, analysed and followed up using a broad set of measures and different types of analyses. One key provision in the mandate from the Ministry of Finance requires Norges Bank to manage the GPFG with the aim that expected relative volatility (tracking error) does not exceed 1.25 percentage points. In 2018, it was below 0.4 percentage point.

The Executive Board attaches importance to cost-effective management to support the objective of the highest possible return. In the period 2013–2018, annual management costs averaged 0.06% of the market value of the GPFG. In 2018, management costs totalled NOK 4.5bn compared with NOK 4.7bn in 2017.

An important part of Norges Bank's role as manager of the GPFG is to advise on the further development of the GPFG's management. In 2018, the Executive Board provided advice and input on the rule for rebalancing the equity share, the guidelines for exclusion and observation, the environment-related mandates and investments in unlisted renewable energy infrastructure.

At end-2018, the market value of the GPFG was NOK 8 256bn

The GPFG's performance and the Executive Board's assessment are presented in an annual report on the management of the GPFG, in line with the mandate.

The Executive Board is satisfied that returns have been good over time and higher than the return on the benchmark index, against which the return is measured.

Foreign exchange reserves

The foreign exchange reserves are the Bank's contingency funds in international currencies and are to be available for use in foreign exchange market transactions as part of the conduct of monetary policy, to promote financial stability and to meet Norges Bank's international commitments. The importance of investing the reserves in liquid assets is therefore given considerable weight. Within these limits, the aim of foreign exchange reserve management is to be cost-effective and provide a positive excess return.

The foreign exchange reserves are divided between a fixed income portfolio and an equity portfolio. In addition, the foreign exchange reserves include a petroleum buffer portfolio. The purpose of the petroleum buffer portfolio is to provide for an appropriate management of the government's need for converting between foreign currency and NOK, as well as to conduct transfers to and from the GPFG.

The foreign exchange reserves cannot be invested in securities that have been excluded from the GPFG's investment universe in line with the ethical guidelines. Management of both portfolios is subject to an index-tracking requirement whereby expected tracking error does not exceed 0.5 percentage point.

In accordance with the Executive Board's principles, rebalancing is to take place if the equity share deviates more than four percentage points from the strategic equity share. Following strong growth in the value of the equity portfolio, such a rebalancing was implemented at the end of September by transferring NOK 21bn from the equity portfolio to the fixed income portfolio.

Over the past ten years, a number of changes have been made to the foreign exchange reserves strategy. The investment universe has been gradually changed in the direction of narrower benchmark indexes to reduce complexity and increase the liquidity of the reserves. Based on the annual review of the foreign exchange reserves strategy, the Executive Board decided in November to reduce the strategic equity share from 35% to 20%. The change was implemented during the first half of December through a further transfer of NOK 65bn from the equity portfolio to the fixed income portfolio.

The market value of the foreign exchange reserves was NOK 511.8bn at the end of 2018, with NOK 97.5bn in the equity portfolio, NOK 408.8bn in the fixed income portfolio and NOK 5.5bn in the petroleum buffer portfolio. The size of the foreign exchange reserves is approximately unchanged since the end of 2017. A positive return measured in NOK was offset by a net outflow of NOK 18.5bn, primarily from the petroleum buffer portfolio.

In international currency terms, the return on the foreign exchange reserves, excluding the petroleum buffer portfolio, was -0.8% in 2018. Equity investments returned -7.0%. Equity prices fell in many parts of the world in 2018, with a substantial fall in US equity prices towards the end of the year. Fixed income investments returned 1.0% in 2018, primarily owing to current returns.

Over the past ten years, the foreign exchange reserves have earned an annual return of 6.8%. In the Executive Board's assessment, reserve management performance in 2018 and over the past ten years has been positive.

Payment system
Under Section 1 of the Norges Bank Act, Norges Bank shall "promote an efficient payment system domestically as well as vis-à-vis other countries".

Norges Bank settles interbank payments in banks' accounts at Norges Bank and supplies society with banknotes and coins in a manner that promotes payment system efficiency. Norges Bank also oversees the payment system, with the main emphasis on clearing and settlement systems.

The financial infrastructure in Norway is efficient, which means that payments can be executed swiftly, securely, at low cost and tailored to users' needs. In 2018, there were few disruptions in the systems, and the systems generally comply with international principles. There are, however, some remaining vulnerabilities.

The payment system's reliance on IT makes it vulnerable to operational failure and cyber-crime. Norges Bank monitors the interbank systems subject to supervision to ensure that their defence mechanisms are satisfactory. An important element is system owners' responsibility for ensuring that critical IT providers have established robust contingency solutions and that these are tested regularly. Norges Bank will also continue to strengthen contingency arrangements to protect the settlement system in Norges Bank.

The technical operation of the payment system has been largely outsourced. The system owners' responsibility is the same, irrespective of whether all or only parts of the technical operation are outsourced. This requires system owners to have sufficient resources and expertise to follow up providers. The failure of a key IT provider in the payment system could impact large parts of the payment system. Norges Bank follows up system owners' monitoring of outsourced operations.

The operation of Norges Bank's settlement system was stable through 2018. The settlement system handled a daily average of approximately NOK 248bn in payment transactions. At the end of 2018, banks' sight deposits and reserves on deposit with Norges Bank totalled NOK 35.1bn.

In 2017, Finance Norway and Norges Bank launched a project to introduce an improved solution for real-time payments with manageable risk for banks. This work was put on hold in February 2018 when seven Nordic banks announced their intention to explore the possibility of a common Nordic payment infrastructure (called P27). As it was assumed that it would take more time than originally planned to clarify the premises for P27, and as the banking industry was also considering possible Norwegian solutions for faster real-time payments, in October 2018, Norges Bank called upon Norwegian banks to resume the work to introduce an improved infrastructure for real-time payments in NOK. This work is now underway in the banking industry, and Norges Bank will carry out the necessary adjustments to its settlement system to enable settlement of real-time payments with manageable risk for banks.

A list of factors that should be given weight in an assessment of whether Norges Bank should issue a central bank digital currency (CBDC) was presented by a Norges Bank working group in May. Phase 2 of the assessment is now in progress. The working group is focusing on the purposes of a CBDC, the solutions that best serve these purposes and their impact. The working group's report will be published in spring 2019. This is a long-term process and it is too early to draw any conclusions. A premise underlying the work is that a CBDC must not impair the ability of banks and other financial institutions to provide credit.

Work on the new Norwegian banknote series, Series VIII, is on schedule. The 50-krone and 500-krone notes were put into circulation on 18 October 2018. The first two denominations in the series, the 100-krone and 200-krone notes, were put into circulation in May 2017. The 1000-krone note is scheduled to be issued in 2019 Q4.

Corporate social responsibility

The Executive Board has laid down ethical principles for employees, under which the Bank is committed to maintaining high ethical standards, respecting human rights and acting in a socially responsible manner in all its activities. Norges Bank does not accept any form of discrimination or corruption. In 2018, the Executive Board updated the ethical principles for employees and amended the ethical principles for external members of Norges Bank's Executive Board. The amendments apply in particular to the rules on personal trading.

The fulfilment of Norges Bank's role depends on confidence and an understanding of the Bank's use of instruments. The Bank therefore pursues a policy of transparency and continuously seeks to improve its communication.

Responsible investment is an integral part of the GPFG's investment strategy, designed to support the objective of securing the highest possible return over time within the framework of the investment mandate. Long-term returns depend on sustainable development and well-functioning markets.

In its management, the Bank seeks to mitigate financial risks associated with the social and environmental practices of investee companies. This is achieved by assessing corporate governance and sustainability issues that could impact the GPFG's performance over time. These issues are integrated into the work on standard-setting, the long-term exercise of ownership rights and responsible investment.

Press conference following publication of the March 2018 interest rate decision and Monetary Policy Report

The Ministry of Finance has laid down guidelines for observation and exclusion of companies, and Norges Bank's Executive Board is responsible for making such decisions based on recommendations from the Council on Ethics.

In the course of 2018, the Executive Board published its decisions to exclude 13 companies. The exclusions were based on the product-based coal criterion, production of key components for nuclear weapons, unacceptable risk of gross corruption, risk of severe environmental damage and serious or systematic human rights violations. Four companies were placed under observation in connection with a recommendation based on the product-based coal criterion and the danger of an unacceptable risk of human rights violations. In one case, the Executive Board chose to exercise the Bank's ownership rights based on the Council on Ethics' recommendation to place the company under observation. The exercise of ownership rights was chosen to support the company's efforts to prevent the use of child labour in its operations for a period of five years.

Norges Bank decided on an environmental strategy for the Bank's operations in November 2018. The strategy includes a combination of specific short-term measures and long-term research. The Bank also became a member of the Network for Greening the Financial System (NGFS) in December 2018. NGFS is a network for central banks and supervisory authorities to exchange experiences and share best practices to contribute to the development of systems for environmental and climate risk management in the financial industry.

Personnel
Norges Bank aims to recruit from leading institutions and works systematically to strengthen and maintain its reputation. Norges Bank ranks high in annual independent surveys on Norway's most attractive workplaces. Marketing the Bank as an employer is conducted regularly on social media and at various career events.

The Bank works continuously on professional development for its managers and employees. Through internal training initiatives and by facilitating internal mobility, internships abroad, secondments and other in-house training, the Bank invests in maintaining a robust professional organisation. The Bank provides for good working conditions for employees and promotes gender balance and diversity in the workplace.

The Executive Board has set a minimum target of 40% for female employees as an overall long-term goal. Strategic work and action plans are based on this objective and are given weight in the planning and implementation of recruitment processes. The share of women on the permanent staff of Norges Bank at the end of 2018 was 33%. It is challenging to increase the share of female employees in certain job categories. Prioritised gender equality initiatives are in place for the period 2017–2019. The three main priority areas in the current strategy period are recruitment and reputation management, career development, and an inclusive working environment.

The Bank's management has close and regular contact with trade unions. The cooperation is constructive and helps the Bank to develop and adapt in pace with requirements for companies in general and for the Bank in particular. In spring 2018, the Bank and the trade unions agreed on a new salary and promotion system for all the Bank's employees. The main wage settlement for 2018 was conducted in line with prevailing agreements. The Bank engages in negotiations and discussions to create the basis for a well-functioning workplace.

Norges Bank's priority is protecting the lives and health of all those who work in the Bank. In 2018, three incidents/injuries directly relating to work conducted at Norges Bank's office premises or conference and holiday facilities were reported. None of the workplace accidents or injuries was serious and no occupational injuries were reported to the Norwegian Labour Inspection Authority in 2018. Sickness absence remained stable in 2018 at a low level of 2.0%.

Corporate governance, risk management and internal control
Norges Bank's governance framework is to be in line with best practice. The Executive Board follows up the Bank's operations through periodic reporting on performance and performance measurement, action plans, budgets, financial and operational risk and compliance.

Norges Bank's use of resources is to be cost-efficient and prudent, with a cost level that is reasonable compared with that of similar organisations. The Executive Board uses external comparisons of the Bank's use of resources with that of other similar organisations, "benchmarking", as a corporate governance tool. During 2018, several cost comparisons were completed: for expenses related to the management of the GPFG, the use of resources in NBCBO and the management costs for unlisted real estate. The Executive Board is satisfied with the Bank's favourable results in these comparisons. In 2018, the Executive Board focused in particular on cost-efficiency. The Executive Board followed up the budgeting process closely, and planning and the budget for 2019 were discussed at several Executive Board meetings in the second half of 2018.

Norges Bank complies with the regulation on risk management and internal control at Norges Bank issued by the Ministry of Finance. In addition, the Ministry of Finance lays down a number of guidelines for the management of the GPFG, which include asset allocation and a benchmark index. The Executive Board sets similar limits for the management of the foreign exchange reserves. There were no breaches of the limits for the management of the GPFG or the foreign exchange reserves in 2018.

In the area of investment management, the Executive Board has also focused on the methodology and procedures for the valuation of the investment portfolio. Detailed information is also published on real estate investments and performance and risk, among other areas. The calculation of the GPFG's performance results is also verified by an independent third party in compliance with the Global Investment Performance Standards (GIPS). The GIPS verification report confirmed that Norges Bank Investment Management (NBIM) is in compliance with the GIPS standards.

The reporting and follow-up of incidents constitute an important part of the measures to improve operation and internal control. For NBIM, the Executive Board has decided that over a twelve-month period the probability that operational risk factors will result in a gross loss of NOK 750m or more must not exceed 20%. This limit is referred to as the Board's risk tolerance. In 2018, operational risk exposure was within the Board's risk tolerance. For NBCBO, key risks are followed up through regular reporting to the Executive Board and risk management measures.

Norges Bank's operations are IT- and information-intensive. The transaction processes on which financial reporting is based are highly automated. The Bank's IT systems are largely standard systems adapted to the Bank's needs and are supplied and operated by third parties. The portfolio of IT systems for investment management has been consolidated and simplified in recent years, and a number of tasks have been insourced to increase the efficiency of the operational model.

As it is important to ensure that Norges Bank's IT systems support secure and cost-efficient operations at the Bank, there is a major focus on strategic IT sourcing and IT security in both operational areas.

The Executive Board maintains a high level of IT and information security awareness, including monitoring outsourced IT functions. The Bank's IT systems are continuously updated and improved to ensure they are operationally reliable and protected against cybercrime. In 2018, for example, the core systems for Norges Bank' settlement system (NBO) were upgraded.

The Executive Board continuously monitors operational and financial risk related to the use of IT systems through its assessment of operational risk and internal control.

Based on reporting by the administration and Internal Audit, the Executive Board submits an annual assessment of the risk situation to the Supervisory Council. Under the Norges Bank Act, the Bank's financial statements are required to be audited by an external auditor. The auditor's report is included in the financial statements.

No material deficiencies in the risk management and control regime were identified in 2018, and the Executive Board assesses the control environment and control systems at Norges Bank as satisfactory.

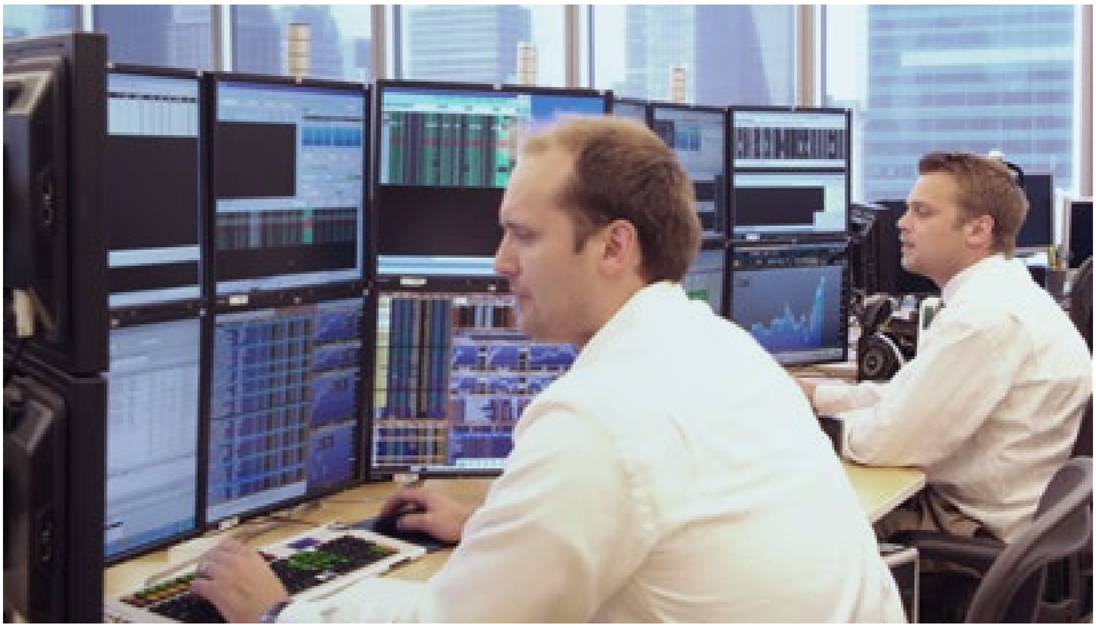
Balance sheet composition and financial risk

Norges Bank's balance sheet total at the end of 2018 amounted to NOK 8 851bn, of which the investment portfolio of the GPFG accounted for NOK 8 256bn. Accrued management costs were NOK 4.5bn.

The Ministry of Finance places funds for investment by the GPFG in the form of a (Norwegian krone) deposit with Norges Bank (the GPFG's krone account). The Bank reinvests these funds, in its own name, in the krone account of an investment portfolio composed of equities, fixed income investments and real estate investments, in accordance with a management mandate from the Ministry of Finance. The net value of the investment portfolio is presented on a separate line as an asset in Norges Bank's balance sheet, and the GPFG's krone account is presented as a liability in the same amount to the Ministry of Finance. The value of the krone account will always equal the value of the investment portfolio. Detailed financial reporting for the investment portfolio of the GPFG is presented in Note 20 to the financial statements. In addition, an annual report on the management of the GPFG is produced, which includes the financial statements of the investment portfolio. Norges Bank, in its role as asset manager, bears no financial risk associated with the management of the GPFG.

Excluding the GPFG, the Bank's foreign exchange reserves are the largest balance sheet asset. The foreign exchange reserves are primarily invested in equities, fixed income instruments and cash. Net foreign exchange reserves amounted to NOK 511.8bn at the end of 2018 compared with NOK 512.4bn at the end of 2017. See the relevant sections in this *Report* for more details on the management of the GPFG and the foreign exchange reserves.

Excluding the GPFG's krone account, the largest balance sheet liability is deposits from the government. At 31 December 2018, this liability item amounted to NOK 187.7bn, compared with NOK 162.4bn in 2017. This item fluctuates considerably through the year owing to substantial incoming and outgoing payments over the government's accounts. Banknotes and coins in circulation are a liability item for Norges Bank. As a result of lower demand for cash, this liability item has gradually declined somewhat in recent years. At year-end 2018, banknotes and coins in circulation amounted to NOK 44.8bn, compared with NOK 48.4bn at year-end 2017. Deposits from banks, which comprise sight deposits, reserve deposits and F-deposits, are managed by Norges Bank through its liquidity management policy. At 31 December 2018, these deposits amounted to NOK 40.4bn, compared with NOK 64.0bn at year-end 2017. Norges Bank administers Norway's financial obligations and rights ensuing from participation in the International Monetary Fund (IMF). Norges Bank therefore



NBIM's offices in New York

has both claims on and liabilities to the IMF. See Note 17 in the notes to the financial statements for more details. At year-end 2018, net positions with the IMF amounted to a claim of NOK 9.3bn, compared with NOK 8.7bn at the end of 2017.

This balance sheet composition will normally generate an expected positive return over time, disregarding foreign currency effects, as returns on the Bank's investments in equities and fixed income instruments are expected to exceed the cost of the Bank's liabilities. The Bank's assets are primarily invested in foreign currency, whereas its liabilities are primarily in NOK. Future increases in the value of the GPFG will be affected by, among other things, transfers to the fund. The level of the transfers ahead is uncertain, partly owing to oil price volatility. Movements in the krone exchange rate can also have a substantial impact on the value of the foreign exchange reserves and of the GPFG in NOK terms.

Norges Bank attaches considerable weight to managing and controlling financial risk. The Executive Board has issued principles for risk management, which are further defined in rules and guidelines for the operational areas.

Investment risk includes market risk, credit risk and counterparty risk. The Bank employs several measurement techniques, processes and systems to control investment risk. Robust and widely accepted risk management systems and processes are complemented by internally developed measurement techniques and processes. Valuations, performance measurement, management and control of risk in investment management are required to comply with internationally recognised standards and techniques. See the notes to the financial statements for more details.

INCOME STATEMENT

Norges Bank's total comprehensive income for 2018 shows a profit of NOK 15.9bn, compared with a profit of NOK 27.7bn in 2017. Net income from financial instruments was NOK 16.8bn in 2018, compared with NOK 28.7bn in 2017. Equity investments posted a loss of NOK 4.3bn, while fixed income investments posted a gain of NOK 3.4bn. Net income from financial instruments includes a gain of NOK 19.2bn as a result of foreign currency effects. Foreign currency effects in 2017 resulted in a loss of NOK 1.5bn.

The GPFG's total comprehensive income shows a loss of NOK 266.1bn, consisting of a loss on the portfolio of NOK 261.6bn net of management costs of NOK 4.5bn. Total comprehensive income was recognised against the GPFG's krone account at 31 December 2018. The return on the portfolio, after management costs reimbursed to Norges Bank have been deducted, is transferred in its entirety to the krone account and thus does not affect Norges Bank's total comprehensive income or equity.

In accordance with the GPFG's management mandate, Norges Bank is reimbursed by the Ministry of Finance for its expenses related to the management of the GPFG within an upper limit. The Bank was reimbursed in the amount of NOK 4.5bn in 2018, compared with NOK 4.7bn in 2017. Norges Bank also earns income from services provided to banks and the government and rent from external tenants. Income other than the reimbursement for the management of the GPFG totalled NOK 125m in 2018, compared with NOK 124m in 2017.

Operating expenses amounted to NOK 5.7bn in 2018, compared with NOK 5.9bn in 2017. The decrease in expenses is primarily the result of a NOK 282m reduction in fees for external managers owing to a lower excess return on the GPFG and a lower share of external managers. Personnel expenses were reduced by NOK 108m, primarily owing to lower performance-based pay. An increase in other wage expenses was offset by a reversal of financial tax. In addition, expenses associated with the procurement of banknotes were reduced by NOK 69m. Furthermore, increased use of consultant services, primarily in connection with the introduction of a new model for the delivery of IT services and maintenance and development of the system portfolio offset increased use of contract labour and higher depreciation and amortisation. NOK 4.5bn of the expenses is related to management of the GPFG, including labour costs, custody and settlement services, IT expenses, analytical research services and fees for external managers. The internal operating expenses (excluding fees for external managers) for the management of the GPFG are in accordance with Norges Bank's maximum target for internal operating expenses of five basis points. The Executive Board attaches importance to high standards and low costs in the Bank's performance of its responsibilities. Changes in the threat landscape with rising cyber risk may lead to higher operating expenses in the period ahead.

Norges Bank's equity capital at 31 December 2018 was NOK 239.1bn, compared with NOK 238.0bn at 31 December 2017. The Adjustment Fund and the Transfer Fund comprise the Bank's equity capital. At the end of 2018, the Adjustment Fund stood at NOK 209.5bn and the Transfer Fund at NOK 29.6bn. Norges Bank's equity capital was 39.9% of the balance sheet total, excluding the GPFG, the same as in 2017.

Distribution of total comprehensive income

The distribution of Norges Bank's total comprehensive income follows guidelines laid down by Royal Decree of 6 December 2002. The guidelines state that total comprehensive income must be allocated to the Adjustment Fund until the Fund has reached 40% of the Bank's net foreign exchange reserves. Any surplus is allocated to the Transfer Fund. A third of the Transfer Fund is transferred annually to the Treasury.

In accordance with the guidelines, the following transfers and allocations will be made: Norges Bank's total comprehensive income of NOK 15.9bn is to be transferred as follows: NOK 156m to the Adjustment Fund and NOK 15.7bn to the Transfer Fund. NOK 14.8bn will be transferred from the Transfer Fund to the Treasury.

Oslo, 6 February 2019

Øystein Olsen
Governor/Chair

Jon Nicolaisen
First Deputy Chair

Egil Matsen
Second Deputy Chair

Kristine Ryssdal

Kjetil Storesletten

Karen Helene Ulltveit-Moe

Kathryn M. Baker

Steinar Juel

Arne Hyttnes
First alternate

Kristine Landmark
Second alternate

Mona Helen Sørensen
Employee representative

Kjersti-Gro Lindquist
Employee representative

Governor Øystein Olsen

Income statement

Amounts in NOK millions	Note	2018	2017
NET INCOME/EXPENSE FROM FINANCIAL INSTRUMENTS			
Net income/expense from:			
-Equities	3	-4 310	29 063
-Bonds	3	3 437	1 618
-Financial derivatives		62	-92
-Secured lending	9,10	257	163
Interest income and expense from deposits and short-term borrowing		33	5
Interest income from lending to banks	18	81	14
Interest expense on deposits from banks and the Treasury	18	-1 918	-496
Net interest income from the IMF	17	68	33
Tax expenses	3	-64	-71
Other financial income/expenses		-25	-10
Net income from financial instruments before foreign exchange gains/losses		**-2 379**	**30 227**
Foreign exchange gains/losses	8	19 182	-1 488
Net income/expense from financial instruments		**16 803**	**28 739**
MANAGEMENT OF THE GOVERNMENT PENSION FUND GLOBAL (GPFG)			
Total comprehensive income, GPFG	20	-266 126	1 037 764
Withdrawn from/Transferred to the krone account of the GPFG	20	266 126	-1 037 764
Of which management fee, GPFG	13	4 544	4 728
Management of the Government Pension Fund Global		**4 544**	**4 728**
OTHER OPERATING INCOME			
Other operating income	**15**	**125**	**124**
OPERATING EXPENSES			
Personnel expenses	12	-1 799	-1 908
Other operating expenses	15	-3 612	-3 792
Depreciation, amortisation and impairment losses	14	-285	-235
Total operating expenses		**-5 696**	**-5 935**
Profit/loss for the period		**15 776**	**27 656**
STATEMENT OF COMPREHENSIVE INCOME			
Profit/loss for the period		15 776	27 656
Change in actuarial gains/losses	11	110	-2
Total comprehensive income		**15 886**	**27 654**

Balance sheet

Amounts in NOK millions	Note	31 Dec. 2018	31 Dec. 2017
ASSETS			
Financial assets			
Deposits in banks		23 894	8 533
Secured lending	9,10	5 984	25 559
Unsettled trades		796	2 046
Equities	4	91 127	173 403
Equities lent	4,9,10	7 292	10 584
Bonds	4	394 995	299 357
Financial derivatives		-	2
Claims on the IMF	17	68 015	67 965
Lending to banks	18	-	250
Other financial assets	13	5 030	5 707
Total financial assets		**597 133**	**593 406**
Net value, GPFG			
Net value, GPFG	**20**	**8 251 401**	**8 483 727**
Non-financial assets			
Pensions	11	141	-
Non-financial assets	14	2 420	2 563
Total non-financial assets		**2 561**	**2 563**
TOTAL ASSETS		**8 851 095**	**9 079 696**

Amounts in NOK millions	Note	31 Dec. 2018	31 Dec. 2017
LIABILITIES AND EQUITY			
Financial liabilities			
Short-term borrowing		685	-
Secured borrowing	9,10	201	286
Unsettled trades	9,10	10 034	6 617
Financial derivatives		20	10
Other financial liabilities		2 645	1 916
Liabilities to the IMF	17	58 713	59 221
Deposits from banks	18	40 434	63 968
Deposits from the Treasury	18	187 653	162 386
Notes and coins in circulation	16	44 803	48 420
Total financial liabilities		**345 188**	**342 824**
Deposits in krone account, GPFG			
Deposits in krone account, GPFG	**20**	**8 251 401**	**8 483 727**
Other liabilities			
Pensions	11	-	59
Other liabilities	19	15 419	15 087
Total other liabilities		**15 419**	**15 146**
Total liabilities		**8 612 008**	**8 841 697**
Equity		**239 087**	**237 999**
TOTAL LIABILITIES AND EQUITY		**8 851 095**	**9 079 696**

Oslo, 6 February 2019

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(Employee representative)

Statement of cash flows

Amounts in NOK millions, inflows (+)/outflows (-)	2018	2017
Operating activities		
Receipts of dividend from equities	4 295	4 169
Receipts of interest from bonds	4 698	4 981
Net receipts of interest and fee from secured lending and borrowing	299	211
Receipts of dividend, interest and fee from holdings of equities and bonds	*9 292*	*9 361*
Net cash flow from purchase and sale of equities	80 727	16 858
Net cash flow from purchase and sale of bonds	-77 673	-30 898
Net cash flow financial derivatives	250	-227
Net cash flow related to deposits in banks	94	-5 210
Net cash flow secured lending and borrowing	19 464	-8 656
Net cash flow related to other expenses, other assets and other liabilities	-11 245	-9 385
Net cash flow related to other financial assets and other financial liabilities	-22 325	13 307
Net cash flow from the Treasury	25 267	15 194
Of which cash flows between the GPFG and the Treasury	*-32 520*	*60 837*
Management fee received from the GPFG	4 728	3 731
Net cash inflow/outflow from operating activities	**28 579**	**4 075**
Investing activities		
Net cash flow related to non-financial assets and liabilities	-144	-237
Net cash inflow/outflow from investing activities	**-144**	**-237**
Financing activities		
Cash flow to the Treasury from the Transfer Fund	-14 333	-17 726
Net cash inflow/outflow from financing activities	**-14 333**	**-17 726**
Net change in cash		
Deposits in banks at 1 January	8 533	22 728
Net increase/decrease of cash in the period	14 104	-13 888
Net foreign exchange gains and losses on cash	574	-307
Deposits in banks and short-term borrowing at 31 December	**23 209**	**8 533**

Statement of changes in equity

Amounts in NOK millions	Adjustment Fund	Transfer Fund	Total equity
1 January 2017	189 227	35 452	224 679
Total comprehensive income	20 107	7 547	27 654
Transferred to Other liabilities	-	-14 334	-14 334
31 December 2017	**209 334**	**28 665**	**237 999**
1 January 2018	209 334	28 665	237 999
Total comprehensive income	156	15 730	15 886
Transferred to Other liabilities	-	-14 798	-14 798
31 December 2018	**209 490**	**29 597**	**239 087**

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