

## Profit and Earnings Distribution

The Reserve Bank's earnings have two principal components – underlying earnings, broadly defined as net interest income from its portfolio, less costs; and the gains or losses which come from realised valuation changes in its portfolio. The sum of these two items is available to vary reserve holdings and for distribution to the Government.

Interest-earning assets are mainly government securities – both domestic and foreign. Offset against earnings on these assets is the interest which the Reserve Bank pays on its liabilities. The Bank does not have to pay interest on some of the items on the liabilities side of its balance sheet – most notably, the currency issue. Accumulated reserves also provide an interest-free source of funding, and Non-Callable Deposits (which are due to be removed when State-based deposit-taking institutions become subject to prudential supervision by APRA) provide another source of low (or zero) cost funding. With some three-quarters of the liabilities side of its balance sheet not requiring interest payments, the Reserve Bank routinely has net interest earnings of around \$1.8 billion, depending on the level of interest rates domestically and abroad.

Financial assets and liabilities are marked to market each week. In calculating how much of these valuation changes should be counted as earnings, the longstanding practice in central banks is that only realised valuation profits are counted as earnings available for distribution. This is consistent with the underlying economics – to pay over unrealised gains would be the equivalent of the central bank financing government deficits. For valuation losses, the convention is that these, whether realised or unrealised, should reduce earnings unless there exists a reserve fund built up from earlier valuation profits (in which case, this can be used to absorb unrealised valuation losses).

With the Reserve Bank's operating costs running at around \$200 million and non-interest income at about \$100 million, underlying earnings have, over the past five years or so, been around \$1.7 billion. Underlying earnings were a little higher in 1997/98. This reflected a number of offsetting factors. The average amount of interest-earning assets held during the year was higher than in the previous year, in part because of the sale of some of the Bank's gold holdings and its replacement in the portfolio by interest-earning foreign assets. But domestic interest rates were lower, reducing the rate of return on domestic assets.

With underlying earnings changing only slowly from year to year, realised valuation effects explain the big year-by-year swings in overall earnings. As in the previous year, earnings in the latest financial year were boosted by the proceeds of gold sales. While all the gold sales were made in 1996/97, some gold was not

delivered until September 1997, and the proceeds of these sales are included in the 1997/98 result. These gains represented the difference between the market price of gold sold and the former official price of US\$35 per ounce at which it was purchased. Sales of other domestic and foreign securities, which occur in the course of the Reserve Bank's operations, can crystallise gains or losses. The price of securities sold can differ from the purchase price, and the Australian dollar value of the proceeds of sales of foreign government securities varies with exchange rate movements. Apart from gold, realised gains on assets came to \$959 million in 1997/98, mostly from foreign exchange gains. In total, realised gains were \$1 507 million in 1997/98, down from \$1 990 million in the previous year, which were boosted by the delivery of the bulk of the gold sales, but considerably higher than the average for the past ten years.

### Sources of earnings available for distribution

(\$ million)

	Underlying earnings	Realised gains and losses*	Earnings available for distribution
1988/89	971	-554	417
1989/90	1 248	-153	1 095
1990/91	1 322	391	1 713
1991/92	1 516	1 038	2 554
1992/93	1 760	2 803	4 563
1993/94	1 556	-48	1 508
1994/95	1 649	123	1 772
1995/96	1 784	702	2 486
1996/97	1 715	1 990 **	3 705
1997/98	1 767	1 507 ***	3 274

\* Charges to earnings in 1993/94 and 1995/96 (and to provisions in the two years to 1989/90), when market values of investments and/or foreign exchange holdings fell below cost, are recorded here as capital losses.

\*\* Of which gold sales contributed \$1 637 million

\*\*\* Of which gold sales contributed \$548 million

The Reserve Bank's earnings available for distribution are paid to the Commonwealth Government after any transfers to two reserve funds maintained to deal with contingencies. Earnings available for distribution in 1997/98 were \$3 274 million. With the Treasurer's approval, the net gain on realised gold sales has been retained in the Reserve Bank Reserve Fund. With no transfers made to the Reserve for Contingencies and General Purposes, the dividend out of 1997/98 profits was a little more than \$2.7 billion, paid in August 1998.

## Reserve Bank payments to Government

(\$ million)

	Earnings available for distribution	Transfers to reserves	Balance available for Commonwealth	Final payment from previous year	Interim payment from current year	Total payment
1988/89	417	277	140	486	-	486
1989/90	1 095	520	575	140	300	440
1990/91	1 713	210	1 503	275	400	675
1991/92	2 554	200	2 354	1 103	400	1 503
1992/93	4 563	750	3 813	1 954	600	2 554
1993/94	1 508	-	1 508	3 213	-	3 213
1994/95	1 772	-	1 772	1 508	200	1 708
1995/96	2 486	150	2 336	1 572	200	1 772
1996/97	3 705	2 005	1 700	2 136	-	2 136
1997/98	3 274	548	2 726	1 700	-	1 700
1998/99				2 726		

### Accounting for Profit

Following amendment of the *Reserve Bank Act 1959*, some changes have been made in the way profit is recorded in the accounts. These changes have no effect on underlying earnings or on the amount available for distribution to the Government. The changes relate solely to the treatment of asset revaluations.

General accounting standards require revaluations of current assets to be taken directly to the Profit and Loss Account, even if the gains are unrealised. This concept of profit differs from the long-established and well-accepted view for central banks, noted above, that only *realised* valuation gains should be available for distribution to the Government. In previous years, the Auditor-General acknowledged that there was a conflict between the accounting standard and the profit distribution criteria, and accepted that, as the *Reserve Bank Act 1959* required all profits (excluding additions to reserves) to be distributed to the Government, it was legitimate to calculate profits in accordance with the central bank convention, bringing to account only *realised* valuation effects. The difference between accounting standards and the Reserve Bank's profit-distribution policy was handled by audit qualifications to the accounts. The *Reserve Bank Act 1959* has now been amended, specifically incorporating the longstanding principles regarding valuation effects as a requirement. With this requirement in place, there is no impediment to applying general accounting principles (although there will be a difference between profits – calculated according to general accounting principles – and earnings available for distribution).

Accounting profits now include all changes (both realised and unrealised) in the value of the Reserve Bank's financial assets during the year, apart from changes in the value of gold holdings, as gold is a long-term non-traded asset.

As indicated above, the *Reserve Bank Act 1959*, as amended, specifically requires that unrealised gains should not be available for distribution to the Government. Therefore, in calculating the amount available for distribution, unrealised gains are deducted from accounting profits and transferred to an unrealised profits reserve; the realised gains attributable to changes in value from earlier years are transferred out of the reserve and added to the amount available for distribution. Realised gains on gold sales have been separately transferred from an asset revaluation reserve to make them available for distribution to reserves or the Government (as noted above, these gains were retained in reserves). The outcome for 1997/98 on this basis is shown in the table below. For comparison, 1996/97 profits are shown on the new basis, and as published in last year's Annual Report.

### Accounting profits

(\$ million)

	1996/97 (Annual Report figures)	1996/97 (New basis)	1997/98
Accounting profit	3 705	2 730	4 403
Net transfers to and from unrealised profits reserve	n.a.	-662	-1 687
Realised gain on gold sales	Included in profits above	1 637	548
Realised gain on premises		-	10
Earnings available for distribution	3 705	3 705	3 274

The Reserve Bank's 1997/98 Financial Statements are presented in the following pages.