

Annual Performance Statement for 2018/19

I, as the accountable authority of the Reserve Bank of Australia, present the annual performance statement of the Reserve Bank for 2018/19, prepared under paragraph 39(1)(a) of the *Public Governance, Performance and Accountability Act 2013* (PGPA Act). In my opinion, this annual performance statement accurately presents the performance of the Reserve Bank in the reporting period and complies with subsection 39(2) of the PGPA Act.

Philip Lowe
Governor, Reserve Bank of Australia
4 September 2019

Introduction

This performance statement outlines the key purposes of the Reserve Bank as set out in the 2018/19 corporate plan and provides the results of the measurement and assessment of the Bank's performance in achieving those purposes for the year ended 30 June 2019. Where necessary, additional context is provided, including an analysis of the significant factors that have contributed to the performance of the Bank in achieving its purposes in 2018/19.

As noted elsewhere in this annual report, the Reserve Bank of Australia is Australia's central bank and it conducts central banking business. The Bank has two boards, the Reserve Bank Board and the Payments System Board. The Reserve Bank Board is responsible for the Bank's monetary and banking policy and the Bank's policy on all other matters, except for payments system policy, for which the Payments System Board is responsible.

Reserve Bank of Australia – Performance Summary 2018/19

| Corporate Plan Purpose | Performance Objectives | Summary Performance Measures | Results |
|------------------------|--------------------------|---|---|
| Monetary policy | Achieve inflation target | Consumer price inflation averages between 2 and 3 per cent over the medium term | Consumer price inflation has averaged around 2½ per cent over the inflation-targeting period. Over the past four years, however, headline consumer price inflation has mostly been between 1 and 2 per cent, while measures of underlying inflation have ranged between 1½ and 2 per cent for most of this period. Consumer price inflation is forecast to increase gradually to be slightly above 2 per cent over 2021; see the Bank's quarterly <i>Statement on Monetary Policy</i> for details |

Reserve Bank of Australia – Performance Summary 2018/19

| Corporate Plan Purpose | Performance Objectives | Summary Performance Measures | Results |
|------------------------------------|--|--|--|
| Financial stability | Support overall financial stability | A stable financial system that is able to support the economy | The financial system has continued to support economic activity without disruption |
| | | Work with the Council of Financial Regulators (CFR) agencies to identify and appropriately address evolving systemic risks | The Bank has continued to work productively with the other CFR agencies |
| | | Assess and communicate risks to financial stability, including through the Bank's half-yearly <i>Financial Stability Review</i> | The Bank has continued to assess financial stability risks and communicate these through the half-yearly <i>Financial Stability Review</i> , <i>Bulletin</i> articles and speeches |
| Financial market operations | Achieve cash rate target | Overnight cash rate consistent with the target each business day | Overnight cash rate was consistent with the target each business day |
| | Manage reserves to portfolio benchmarks | Portfolio managed within small deviations around the asset and duration benchmarks | Deviations from the reserve portfolio benchmark were small and in line with pre-defined limits |
| | Intervene in foreign exchange market as appropriate | Publish data and explanations of any interventions | No foreign exchange market intervention was conducted |
| Payments and infrastructure | Support competition and efficiency in the payments system and financial system stability | Maintain and improve, where possible, the efficiency and competitiveness of the payments system, consistent with financial system stability | <p>The Bank continued to promote efficiency and competitiveness in the retail payments system through various policy initiatives and through its support for industry initiatives. There has also been continued innovation, including by the roll-out of real-time payments through the New Payments Platform (NPP)</p> <p>The Bank has continued to monitor technology-related innovations in payments and market infrastructures, including the implications of cryptocurrencies and related technologies</p> |
| | | Continue to monitor the effect of the card standards introduced in 2016–17 and encourage industry progress in providing least-cost routing functionality | The Bank consulted on a proposal to improve the clarity and operation of the net compensation requirements of the Bank's interchange standards. The variations took effect on 1 July 2019 (see <i>Payments System Board Annual Report 2019</i>). The Bank has been actively encouraging the provision of least-cost routing functionality to merchants. A number of financial institutions, including the four major banks, are now making this functionality available |

Reserve Bank of Australia – Performance Summary 2018/19

| Corporate Plan Purpose | Performance Objectives | Summary Performance Measures | Results |
|--|--|--|---|
| Payments and infrastructure (continued) | Stability in the provision of financial market infrastructure (FMI) services | Stability of FMI service provision. Assess Reserve Bank Information and Transfer System (RITS) and licensed clearing and settlement facilities (CS) against relevant standards. Establish recommendations and regulatory priorities as appropriate for each high-value payment system and CS facility based on these assessments | Assessments of RITS and all licensed clearing and settlement facilities have been completed and published. Where necessary, the Bank has set and monitored the response to regulatory priorities |
| | | Contribute to international policy work on central counterparty resilience and FMI crisis management | Bank staff actively participated in international policy development on crisis management of financial market infrastructures |
| | | Adapt domestic regulatory standards in response to international developments. Support international supervisory cooperation | No change to domestic regulatory standards was required. However, the Bank revised the guidance on its supervisory approach, introducing a more graduated framework that places greater reliance on the home regulator for overseas CS facilities |
| | RITS operational reliability | RITS availability at 99.95 per cent during core hours | RITS availability was 99.78 per cent during core hours in 2018/19, below the performance target, because of a major operational incident on 30 August 2018 |
| | | RITS Fast Settlement Service (FSS) availability at 99.995 per cent on a 24/7 basis, with most transactions processed in less than one second | FSS availability was 99.966 per cent in 2018/19, below the performance target, because of a major operational incident on 30 August 2018. The processing time for 95 per cent of FSS transactions was 103 milliseconds or less |
| | RITS cyber security | Ongoing investment and regular reviews and testing to support cyber resilience | The Bank's ongoing program of cyber resilience work helped underpin the secure operation of RITS in 2018/19 |
| Banking | Ensure central banking services remain fit for purpose | Work with key stakeholders to maintain and improve, where possible, the central banking services provided to the Commonwealth | The Bank continued to work with the Department of Finance (Finance) on its multi-stage plan to modernise Commonwealth cash management. This included the implementation of system changes that will enable Finance to make agency funding payments using the NPP from 2019/20 |
| | Satisfy financial performance benchmarks | Minimum return on capital for transactional banking business equivalent to 10-year Australian Government Security rate plus a margin for risk | The Bank's banking services achieved the minimum required return on capital in 2018/19 |

Reserve Bank of Australia – Performance Summary 2018/19

| Corporate Plan Purpose | Performance Objectives | Summary Performance Measures | Results |
|----------------------------|--|---|---|
| Banking (continued) | Progress on projects to deliver convenient, secure, reliable and cost-effective banking services to customers | Provision of high-quality, cost-effective banking services to government and other official agency customers and, in turn, the public, supported by: <ul style="list-style-type: none"> continued work on replacing the Bank's core account maintenance system continued development of NPP capabilities delivery of open and secure integration services via Application Programming Interfaces (API) for agencies | In 2018/19, the Bank: <ul style="list-style-type: none"> completed the work required to replace the Bank's core account maintenance system for implementation in July 2019 continued to work with industry to develop NPP capabilities assisted the Department of Human Services (DHS) to implement its solution to deliver urgent, crisis and disaster relief payments via the NPP from its core systems implemented its API Gateway and delivered the first service via API for the Department of Human Services |
| Banknotes | Maintain the capacity of Australian banknotes to provide a safe, secure and reliable means of payment and store of value, as follows: <ul style="list-style-type: none"> Meet banknote demand Increase security of Australian banknotes Ensure high-quality banknotes | Maintain or improve public perceptions of Australian banknotes as measured in the Reserve Bank survey <p>More than 95 per cent of banknote orders from commercial banks fulfilled by the Reserve Bank within three days of the request</p> <p>Issuance of new \$50 banknote with upgraded security features as part of Next Generation Banknote program</p> <p>Reserve Bank banknote production orders to be met by Note Printing Australia Limited within agreed quality parameters</p> <p>Maintain quality of banknotes in circulation in excess of a minimum quality standard agreed with industry</p> | Over 60 per cent of respondents expressed confidence in the system for removing counterfeits from circulation and were of the view that there was no counterfeiting problem in Australia. These figures were largely unchanged from earlier survey years. In addition, the counterfeiting rate was 11 parts per million in 2018/19, which is lower than in recent history and very low by international standards <p>100 per cent of orders were fulfilled on the day requested in 2018/19</p> <p>The new \$50 banknote was released on 18 October 2018 as planned</p> <p>97.1 per cent of orders were met by Note Printing Australia Limited on time and to the required quality standard in 2018/19</p> <p>The quality of banknotes in circulation was broadly unchanged at a high level in 2018/19</p> |

Source: RBA

Monetary Policy

Purpose

It is the duty of the Reserve Bank Board to ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia and that the powers of the Bank are exercised in a way that, in the Board's opinion, will best contribute to:

- a. the stability of the currency of Australia
- b. the maintenance of full employment in Australia
- c. the economic prosperity and welfare of the people of Australia.

In support of the above duties, the most recent *Statement on the Conduct of Monetary Policy* agreed by the Treasurer and the Governor, dated 19 September 2016, confirms the Bank's continuing commitment to keeping consumer price inflation between 2 and 3 per cent, on average, over time, consistent with its duties under the *Reserve Bank Act 1959*. Ensuring low and stable inflation preserves the value of money and facilitates strong and sustainable growth in the economy over the longer term. Low inflation assists businesses and households in making sound investment decisions, underpins the creation of jobs and protects the savings of Australians. The *Statement on the Conduct of Monetary Policy* also recognises the importance of financial stability for a stable macroeconomic environment.

Results

Assessing the conduct of monetary policy during 2018/19 involves judging whether the policy decisions taken by the Reserve Bank Board, based on the information available at the time, were consistent with achieving the inflation target and fostering sustainable economic growth in Australia. Because there are lags between

changes in the cash rate and their effect on the economy, such an assessment needs to give weight to both actual outcomes and the forecasts for inflation, output and the unemployment rate. These forecasts are published quarterly in the *Statement on Monetary Policy*.

Towards the end of 2018, the Reserve Bank Board reviewed the forecasts and monetary policy decisions it had taken over the previous year, including the reasons behind the forecast errors and what the Bank's staff had learnt about the economy as a result. The review noted that the labour market had improved at a faster rate than had earlier been anticipated. However, this had not translated into faster growth in either wages or consumer prices, suggesting that there was more spare capacity available for any given level of unemployment than had previously been thought. Consumer price inflation has remained somewhat below 2 per cent, in contrast to earlier expectations that it would increase gradually to be at or above 2 per cent throughout 2018/19. GDP growth has also been lower than expected over 2018/19, although this follows a period in early 2018 where growth was much stronger than expected.

Consumer price inflation has averaged around 2½ per cent over the inflation-targeting period. Over the past four years, however, it has mostly been between 1 per cent and 2 per cent. Measures of underlying inflation have ranged between 1½ and 2 per cent for most of this period. A range of factors has contributed to this outcome, including ongoing spare capacity in the economy and unusually slow growth in labour costs. The entry of new competitors with different business models as well as other shifts in the competitive landscape have also contributed to a step-down in the average rate of price inflation for some categories of retail spending relative to outcomes in the previous

decade. In addition, inflation in housing-related costs such as rents has been lower than expected, as has the rate of inflation for certain goods and services where prices are significantly influenced by government policies, such as childcare and some types of education. Consumer price inflation was 1.6 per cent over the year to the June quarter 2019, having been significantly affected in recent quarters by movements in fuel prices (in both directions).

GDP growth has been lower than expected in recent quarters and GDP is likely to have increased by about 2¼ per cent in 2018/19. Looking ahead, growth is expected to recover somewhat in the latter part of 2019 and to return to around 3 per cent in 2020/21. This is a little above the Bank's current estimate of the trend rate of growth in productive capacity. The unemployment rate is therefore expected to decline gradually. Consumer price inflation is expected to increase gradually to be a little above 2 per cent over 2021.

After leaving the cash rate unchanged since August 2016, the Reserve Bank Board lowered the cash rate by 25 basis points in both June and July 2019, to 1 per cent. The Board judged that this would help make further inroad into spare capacity in the economy. This will, in turn, assist with faster progress in reducing unemployment and more assured progress towards achieving the inflation target.

The Governor's statement and the minutes following the monetary policy meetings provide further details of the Reserve Bank Board's assessment of economic developments, the outlook and monetary policy decisions. A brief summary of analysis by the Reserve Bank of these issues is provided below. Further details of this analysis are provided in the Bank's quarterly *Statement on Monetary Policy*, the Governor's regular appearances before the House of

Representatives Standing Committee on Economics, and speeches by the Governor and other senior Bank officials.

Analysis

On the global economy, the incoming data and the outlook for economic growth have been significantly affected by intensifying trade and technology disputes. Interest rates have been lowered in the United States and in some other economies. Global interest rates and measures of underlying inflation remain low. Because Australia is a small open economy with a floating exchange rate, shifts in global monetary conditions can affect financial conditions in Australia.

The period of adjustment that has followed the end of the mining investment boom is close to its end. Non-mining investment has been expanding and employment growth has been stronger than growth in the working-age population. The unemployment rate had declined to around 5 per cent in the early part of 2018/19 and remained there for much of the year, although it ticked up to 5.2 per cent in the June quarter 2019.

Over the past year, the Reserve Bank Board has been considering a range of risks to the outlook and their implications for the stance of monetary policy. Escalating trade and technology disputes pose a significant risk to global growth. Other political risks would also affect global growth outcomes if they lead to tighter financial conditions. Domestic stimulus policies have helped support growth in China, but it is uncertain how the policy mix will evolve from here. For the Australian economy, the main source of uncertainty is the outlook for household income and thus consumption. Despite strong employment growth, household income growth has been slow, constrained by slow wages growth and unusually fast growth in tax payments. Further out, the risks are more

balanced; the established housing market appears to have stabilised earlier than had been expected, and the combined effect of policy measures and a brighter outlook for the resources sector could add more to growth than is currently forecast.

These risks arise against a background of ongoing low inflation that is likely to persist for some time. Inflation has remained low in a range of advanced economies, despite tight labour markets. This suggests that common factors such as technological change and globalised competition might be at work. In Australia, these more global forces have been accompanied by unusually slow wages growth. Other domestic factors have also weighed on domestic inflation, including changes in the competitive landscape in the retail industry, and the effect of the downturn in the housing market on rents and other housing-related costs. Some administered prices have also been increasing at a slower rate than usual as governments have taken steps to contain cost of living pressures. Since these factors are unlikely to unwind in the near future, they are likely to continue to weigh on domestic inflation outcomes in the period ahead.

Financial Stability

Purpose

The Reserve Bank has a responsibility for fostering overall financial stability in Australia. This stems partly from the Bank's duties to exercise its powers in a way that will best contribute to 'the maintenance of full employment in Australia' and 'the economic prosperity and welfare of the people of Australia'. Given the serious damage to employment and economic prosperity that can occur in times of financial instability, the Reserve Bank Act has long implied a mandate to pursue financial stability. This mandate has been made more explicit by successive governments. More

recently, the Treasurer and the Governor have recorded their common understanding of the Bank's longstanding responsibility for financial system stability, as part of the periodically updated *Statement on the Conduct of Monetary Policy*.

The Reserve Bank works with other regulatory bodies in Australia to foster financial stability. The Governor chairs the Council of Financial Regulators (CFR) – comprising the Reserve Bank, the Australian Prudential Regulation Authority (APRA), the Australian Securities and Investments Commission (ASIC) and the Australian Treasury – whose role is to contribute to the efficiency and effectiveness of regulation and promote the stability of the financial system. The Bank's central position in the financial system, and its position as the ultimate provider of liquidity to the system, gives it a key role in financial crisis management, in conjunction with the other members of the CFR.

The Reserve Bank's operations in domestic financial markets, discussed in the 'Financial Market Operations' section of this performance statement, and oversight and operational roles in the payments system, discussed in the 'Payments and Infrastructure' section of this performance statement, also contribute to the stability of the financial system.

Results

The financial system has remained stable and has continued to perform its function of supporting economic activity. During 2018/19, the Reserve Bank's assessment was that the Australian financial system remained resilient, although some potential sources of systemic risk were also highlighted. Details were provided in the Bank's *Financial Stability Review* in October 2018 and April 2019 and in several public speeches. Vulnerabilities related to household debt continued to be a focus during the year, as did risks related to commercial property

markets. Tighter lending standards resulting from regulatory actions by APRA and ASIC in recent years have enhanced lenders' and borrowers' resilience to risk. Operational risks, including the potential for a disruptive cyber attack on financial institutions or financial market infrastructures (FMIs), will continue to be a focus of financial institutions and regulators over coming years. None of the identified risks, on their own, appears likely to be the source of significant financial instability in the near term, given the improved resilience of banks and the financial system more broadly.

The Bank contributed to work with other CFR agencies on a range of issues during the year. Agencies continued to assess developments in the housing and mortgage markets, with a focus on credit conditions both for households and small businesses. CFR agencies also considered, and are responding to, the recommendations of recent major reviews of the Australian financial sector (including the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry (Royal Commission) and the International Monetary Fund's (IMF's) Financial Sector Assessment Program (FSAP) review). Other areas of work included: leverage and risk in the superannuation system; a resolution regime for FMIs; and cyber security.

In 2018/19, the Reserve Bank contributed to work undertaken in relation to financial stability overseen by various international regulatory bodies, including the Financial Stability Board (FSB), the Basel Committee on Banking Supervision and the Trans-Tasman Council on Banking Supervision. The Governor participated as a member of the FSB Plenary (the decision-making body of the FSB), Steering Committee and Standing Committee on Assessment of Vulnerabilities, and served as co-Chair of the FSB Regional Consultative Group for Asia. The

Governor also served as Chair of the Committee on the Global Financial System. Other Bank staff participated as members of various committees and working groups. For further information, see the chapter on 'International Financial Cooperation' in this annual report.

Analysis

Financial stability in Australia has coincided with the sustained strong financial performance of the domestic banking system. Australian banks have improved their resilience to future financial and economic shocks by increasing their capital and liquidity ratios over recent years. They have also taken steps to improve the quality of lending and raise lending standards, especially in relation to their residential mortgage business. That said, the Royal Commission highlighted deficiencies around culture and governance in the financial system. Its Final Report laid out a path for fairer financial intermediation, which will contribute to a more resilient financial system.

As noted above, the Reserve Bank, together with other CFR agencies, has continued to monitor developments in residential mortgage lending and household balance sheets. Both APRA and ASIC have taken measures to address risks in this area. As lending standards have strengthened across the industry, APRA removed the temporary benchmarks on growth in investor lending and new interest-only loans. The CFR agencies stand ready to consider further measures in the future should circumstances change. Improvements in lending standards over the past few years mean that household balance sheets will, on average, be more resilient to changes in circumstances.

The performance of the Reserve Bank in the area of financial stability can be assessed not only by its monitoring of risks and input to policy responses, but also by its contribution to ongoing improvements in the overall

regulatory structure. In this context, the Bank and other CFR agencies' work on financial stability has been informed by consideration of the recommendations from recent reviews of the resilience of the financial sector, namely the IMF's FSAP review, the Final Report of the Productivity Commission's review of competition in the financial system and the recommendations from the Royal Commission. Further relevant analysis by the Bank is provided in the *Financial Stability Review* and speeches by the Governor and other senior Bank officials.

Financial Market Operations

Purpose

The Reserve Bank has a sizeable balance sheet, which continues to be managed through financial market operations in support of the Bank's policy objectives.¹

The Reserve Bank's operations in domestic financial markets are conducted to ensure that the cash rate is consistent with the target set by the Reserve Bank Board and that there is sufficient liquidity in the domestic money market on a daily basis. This promotes the objectives of monetary policy as described in the 'Monetary Policy' section of this performance statement and the stable functioning of the financial system, in particular the payments system.

The Reserve Bank's foreign reserves are held to give the Bank the capacity to intervene in the foreign exchange market. In particular, they enable the Bank to address any apparent dysfunction in that market and/or a significant misalignment in the value of the currency, consistent with the objectives of monetary policy. Such interventions are rare. Regular transactions in the foreign exchange market

are, however, conducted to manage these reserves, to provide foreign exchange services to the Bank's clients (the largest of which is the Australian Government) and to assist in liquidity management in domestic markets.²

Results

The cash rate was consistent with the target every day during 2018/19.

The Reserve Bank manages its foreign reserves portfolio relative to a benchmark. During 2018/19, the portfolio was managed so that any deviations around the benchmarks for exchange rate and interest rate risk were small and in line with pre-defined limits.

The Reserve Bank did not intervene in foreign exchange markets during 2018/19.

Analysis

The Reserve Bank's financial markets operations continued to be influenced by monetary policy trends among the major central banks, as well as the regulatory regimes that apply to financial markets in which the Bank transacts and/or the counterparties with which it deals, both domestically and internationally. During 2018/19, the Bank continued to monitor and, where necessary, adjust to the environment where market functioning and structure are evolving significantly following a period of substantial regulatory reform and unusually low interest rates.

Payments and Infrastructure

Purpose

There are several distinct aspects to the Reserve Bank's role in the payments system, comprising those of policymaker, overseer and supervisor, and owner and operator of key national payments infrastructure.

¹ Section 8 of the Reserve Bank Corporate Plan 2018/19 covers the Bank's management of its financial position and capital.

² The 'Banking' section of this performance statement discusses the Bank's responsibility to act as banker for the Commonwealth.

In relation to the policymaking role, it is the duty of the Payments System Board to ensure that the Reserve Bank's payments system policy is directed to the greatest advantage of the people of Australia, and to ensure that the powers of the Bank under the *Payment Systems (Regulation) Act 1998* and the *Payment Systems and Netting Act 1998* are exercised in a way that, in the Board's opinion, will best contribute to:

- a. controlling risk in the financial system
- b. promoting the efficiency of the payments system
- c. promoting competition in the market for payment services, consistent with the overall stability of the financial system.

In addition, it is the Payments System Board's duty to ensure that the powers and functions of the Reserve Bank under Part 7.3 of the *Corporations Act 2001* are exercised in a way that, in the Board's opinion, will best contribute to the overall stability of the financial system. These powers and functions relate to the supervision of central counterparties and securities settlement facilities, which are key components of the central infrastructure that supports financial markets. The Bank's payments policy area also acts as overseer of Australia's high-value payment system, the Reserve Bank Information and Transfer System (RITS), which is another key part of Australia's financial market infrastructure.

The Reserve Bank's operational role in the payments system is effected through its ownership and management of RITS, which is used by banks and other approved institutions to settle their payment obligations efficiently on a real-time, gross settlement basis. This ensures that there is no build-up of settlement obligations associated with high-value transactions and thereby promotes the stability of Australia's financial system.

The Bank's work in these areas supports its other work, discussed in the 'Financial Stability' section of this performance statement, directed towards fostering overall financial stability.

Results

Developments in the Australian payments system are discussed further in the *Payments System Board Annual Report 2019*. The retail payments market continues to offer safe and secure payments and there is significant innovation, in particular involving real-time payments using the New Payments Platform (NPP).

The Bank has continued to monitor the regulatory framework for card payments and the evolution of the market following the comprehensive review completed in June 2016. In February, the Bank consulted on a proposal to improve the clarity and operation of the net compensation requirements of the Bank's interchange standards. The variations have been approved and took effect on 1 July 2019. More broadly, the Bank's standards for interchange and surcharging are helping to contain payment costs in the economy. Average merchant service fees for all debit and credit card payments are now lower than at the time of the conclusion to the comprehensive review.

The Bank has continued to encourage industry progress on providing merchants with the ability to route contactless dual-network debit card transactions to their lowest-cost processing network, known as least-cost routing (LCR). A number of financial institutions, including all of the major banks, are now making this functionality available. The Bank will continue to monitor progress in cases where institutions are not yet making this available to their entire customer base. The introduction of LCR has increased competitive pressure in the debit card market, which is helping to reduce payment costs in the economy.

In support of the Payments System Board's responsibility to promote efficiency in the payments system, the Bank has continued to contribute to the industry project to deliver the NPP, which was publicly launched in February 2018. The NPP is a major enhancement to Australia's retail payments infrastructure and facilitates real-time, data-rich, easily addressed payments on a 24/7 basis for households, businesses and government entities. Transaction volumes through the NPP have continued to grow each month. The Bank's Payments Policy Department has recently completed a consultation, together with the Australian Competition and Consumer Commission, on NPP access and functionality. The report's overall conclusion was that the NPP is enabling payments functionality that largely addresses the gaps identified in the Reserve Bank's 2012 Strategic Review of Innovation. However, it highlighted that the slow and uneven roll-out of NPP services by the major banks has been disappointing and that this has likely slowed the development of new functionality and contributed to stakeholder concerns about access to the NPP. Therefore, the report included a number of recommendations aimed at promoting the timely roll-out of NPP services and development of new functionality. In addition, it made a number of recommendations for NPP Australia Limited to take action in relation to its participation requirements, the required capital contribution for participation and the governance arrangements for assessing the suitability of new participants.

The Reserve Bank published annual assessments of each of the licensed clearing and settlement facilities as part of its ongoing oversight of these facilities. Assessments were published of the ASX clearing and settlement facilities in September 2018, of LCH.Clearnet Limited's SwapClear service in December 2018 and of Chicago Mercantile

Exchange Inc. (CME) in March 2019. In these assessments, the Bank judged that all the entities had conducted their affairs in a way that causes or promotes overall stability in the Australian financial system, or had made progress against regulatory priorities set by the Bank. The Bank also set out a series of regulatory priorities for each of the facilities for the subsequent year. The Bank's 2019 assessment of RITS against the *Principles for Financial Market Infrastructures*, which was published in May 2019, concluded that RITS observed all relevant principles other than Operational Risk, which RITS broadly observed. The Bank also provided advice in respect of CME's application to vary its licence to permit clearing of commodity derivatives, energy derivatives and environmental derivatives traded on the market operated by FEX Global Pty Ltd.

In support of the Reserve Bank's oversight approach and of its policy framework, Bank staff also actively participated in international policy development on crisis management of FMI and monitoring the implementation of international standards. No change was required to domestic regulatory standards in 2018/19 as a result of international developments. However, in June the Bank revised the guidance on its supervisory approach, introducing a more graduated framework to prioritise its supervisory efforts and place greater reliance on the home regulator for overseas clearing and settlement facilities where they are adequately supervised. The Bank also issued guidance on its supervision and oversight of systemically important payment systems.

The Bank, working with other domestic financial regulators, continued to make progress on the detailed design of a resolution regime for FMIs.

As the owner and operator of RITS, the Reserve Bank seeks to ensure that this system operates with extremely high levels of reliability and security, while also adapting to the needs of

a 24/7 payments world. For RITS, the system availability target is 99.95 per cent during core system hours, while for the Fast Settlement Service (FSS), the system availability target is 99.995 per cent on a 24/7 basis. Neither system met its system availability target in 2018 because of a major operational incident on 30 August 2018, which affected both RITS and FSS. An incorrectly executed process during a routine test of fire controls resulted in the sudden loss of power to most of the Reserve Bank's IT systems that were running in one of its two data centres. The established automated and manual processes used for failover to backup systems were complicated by a number of factors and it took several hours to complete the orderly recovery of systems. RITS operating hours were extended to allow members to complete settlement of their day's transactions. Largely as a result of this incident, RITS availability was 99.78 per cent during core system hours in 2018/19 and FSS availability was 99.966 per cent over the same period. FSS met its target to complete settlement of transactions in less than one second, with 95 per cent of FSS transactions processed in 103 milliseconds or less.

The Reserve Bank is committed to ensuring that RITS is well protected from cyber attack and has an ongoing program of work to maintain high levels of cyber resilience. The Bank made its second compliance attestation under the new SWIFT Customer Security Controls Framework in December 2018 and, in July 2018, the Bank's payment settlement systems received certification under the International Organization for Standardization (ISO) 27001 standard for Information Security Management.

Analysis

The Reserve Bank's work in the payments area in 2018/19 occurred in an environment that was continuing to change rapidly, with higher

expectations of users and the industry concerning the speed of payments and the capacity to combine information with payments. Use of cash and cheques is declining relative to other payment instruments, while use of cards and other electronic forms of payment continues to grow strongly. New technologies, including distributed ledger technology, and other forms of financial technology (fintech), have the potential to change the payments landscape and the operation of FMIs significantly. Bank staff liaise actively with the private sector to better understand trends in these areas and their implications and have participated in a range of domestic and international working groups with other regulators.

Banking

Purpose

Insofar as the Commonwealth requires it to do so, the Reserve Bank must act as banker for the Commonwealth. The Reserve Bank's banking services fall into two components – those services provided in its capacity as the central bank and those transactional banking services it provides, in competition with other commercial financial institutions, to Australian Government agencies. In common with many other central banks, the Bank also provides banking and custody services to a number of overseas central banks and official institutions. The banking services offered to the Commonwealth and other central banks include payments and collections as well as general account maintenance and reporting.

Results

The Reserve Bank must compete with other organisations to provide banking services to Australian Government agencies. The Bank must cost and price these services separately from its other activities. In addition, the return on providing these services must meet an externally

prescribed minimum rate of return on capital over a business cycle. At present, this measure, equivalent to the 10-year yield on Australian Government Securities plus a margin for risk, is the Bank's principal measure of financial performance for its transactional banking business. In 2018/19, the Bank met the prescribed rate. Pro forma accounts for the transactional banking business are published in a separate chapter of this annual report.

As the provider of the Commonwealth's Official Public Account, the Reserve Bank works closely with both the Department of Finance (Finance) and the Australian Office of Financial Management to ensure the central banking services it provides remain fit for purpose. The Bank continued to work with Finance on its multi-stage plan to modernise Commonwealth cash management. The Bank made a number of systems changes that will enable Finance to make agency funding payments using the NPP from 2019/20.

During 2018/19, the Reserve Bank completed the renovation of the account maintenance system and banking systems used to process government payments and collections with new functionality scheduled for implementation in July 2019. The Bank also implemented its new Application Programming Interface (API) Gateway, which will facilitate fast, secure and automated communications between the Bank and its customers. The first service via API was delivered in June for the Department of Human Services (DHS).

The Reserve Bank assisted DHS to roll out its solution for generating NPP payments from its core systems in late 2018. Since then, over 140,000 payments have been made relating to urgent, crisis and disaster relief payments. The Bank has also continued to participate in the ongoing industry work on further developing NPP capabilities. In addition, responding to

the community's increased use of 'wallets' as a payment method, the Bank has been actively working to expand the options available to government agency customers for collecting online payments.

Analysis

The banking and payments landscape has continued to evolve, particularly in the area of payment services. The ongoing development of NPP capabilities will allow the community to embrace this new functionality through the delivery of real-time digital services. Reflecting this demand, government agencies continue to push ahead with their own initiatives to improve service delivery and achieve productivity gains. Those initiatives that will affect the Reserve Bank include: the DHS's Welfare Payment Infrastructure Transformation Program; collections and payments programs for the Australian Taxation Office; and Finance's project to modernise Commonwealth cash management. During 2018/19, the Bank continued to ensure that it remained in a position to respond appropriately with convenient, secure, reliable and cost-effective services as the provider of both central banking and transactional banking services to the Australian Government.

Banknotes

Purpose

The Reserve Bank is responsible for the issue, reissue and cancellation of Australian banknotes. Its primary purpose in carrying out this role is to maintain the capacity of Australian banknotes to provide a safe, secure and reliable means of payment and store of value. The Bank works with its wholly owned subsidiary, Note Printing Australia Limited (NPA), to design and produce banknotes. The Bank distributes banknotes to financial institutions, monitors and maintains

banknote quality in circulation and withdraws unfit banknotes from circulation. It also monitors and analyses counterfeiting trends and conducts research into banknote security technology.

Results

Public confidence in Australian banknotes is measured directly by a Reserve Bank survey on perceptions of Australian banknotes conducted every two years. The most recent survey was conducted in early 2019 and showed that the majority of respondents had confidence in the system for removing counterfeits from circulation, and did not think that there was a counterfeiting problem in Australia.

Fulfilment of banknote orders from commercial banks provides an indication that the public's demand for banknotes is being met. The Reserve Bank aims to fulfil 95 per cent of banknote orders within three days of the request; during 2018/19, 100 per cent of orders were fulfilled on the day requested.

The Reserve Bank's key initiative to enhance banknote security is the release of the new banknote series with upgraded security features. Work on the Next Generation Banknote program continued during 2018/19, with the new \$50 banknote entering circulation on 18 October 2018 as planned. The Bank implemented a targeted communication strategy to assist with public recognition of the new banknotes. The new \$20 banknote is scheduled to enter circulation in October 2019.

A couple of months after the new \$50 banknote was released into general circulation, it was noticed that there was a spelling error in the microprint. Despite the misspelling, these banknotes remain legal tender and can continue to be used. The error was corrected in the print run that commenced in mid 2019 and the Reserve Bank and NPA have reviewed processes

to reduce the likelihood of such an error occurring in the future.

The Reserve Bank continued to monitor Australian banknote counterfeiting rates, which remained low by international standards. The estimated counterfeiting rate continued to fall to 11 parts per million in 2018/19, after having peaked at around 30 parts per million in 2014/15. The Bank also continued to monitor international developments in counterfeiting. This was assisted by engagement with other central banks and international organisations.

NPA met 97.1 per cent of the Reserve Bank's orders for new series banknotes, to the required quality standard and as per the agreed delivery schedule. The shortfall of 2.9 per cent in \$5 banknotes will be delivered in the 2019/20 banknote order.

The quality of banknotes in circulation, as measured by the Reserve Bank in agreement with commercial banks, was broadly unchanged at a high level in 2018/19.

Analysis

While the proportion of payments made using banknotes is declining relative to electronic payments, the number and value of banknotes on issue continues to rise, highlighting their continued importance as a store of value as well as a payment mechanism. The Reserve Bank has continued to meet demand for banknotes by ensuring orders are fulfilled. The release of the new series of banknotes with upgraded security features is expected to maintain public confidence in banknotes. Australia's level of counterfeiting remains low by international standards.