

# Earnings, Distribution and Capital

In 2021/22, the Bank recorded an accounting loss of \$36.7 billion. While underlying earnings were positive, large unrealised valuation losses were recorded on the bonds purchased as part of the Bank's economic support package during the pandemic. The large accounting loss means there will be no dividend paid to the Australian Government this year. Of the \$36.7 billion loss, \$15.9 billion has been absorbed by the unrealised profits reserve (UPR) and the Reserve Bank Reserve Fund (RBRF). The remainder (\$20.8 billion) is being recorded as 'accumulated losses' on the Bank's balance sheet. These accumulated losses exceed the Bank's other reserves, so that the Bank was in a negative equity position of \$12.4 billion as at 30 June 2022.

The Reserve Bank Board's judgement is that negative equity does not affect the Bank's ability to operate effectively or perform its policy functions, but that it is important that the Bank's equity is restored over time. This restoration can be achieved through the Bank retaining its profits over the years ahead. Accordingly, the Board has communicated its strong expectation to the Australian Government that future distributable earnings would be applied, in full, to offsetting the accumulated losses and restoring the balance of the RBRF to the Board's target. In response, the Treasurer has endorsed the Board's general approach to restoring the equity position over time, while noting any retention of earnings remains at the discretion of the Treasurer in terms of the Reserve Bank Act 1959. The Treasurer also supported the Board's judgement that the Bank will be able to continue to operate effectively, even in the event of further losses over the coming few years. Given that there is a credible path to restoring the Bank's capital, the Board has not sought a capital injection from the government.

## The Reserve Bank's earnings and distribution

The Reserve Bank's earnings come from two sources: (i) underlying earnings, including net interest and fee income, less operating costs; and (ii) valuation gains or losses on its holdings of government bonds and foreign exchange.

Net interest income usually arises from the Bank earning interest on almost all of its assets, albeit currently at low rates, while paying no interest on a large portion of its liabilities – namely, banknotes on issue.

Moreover, Exchange Settlement (ES) balances, which have grown significantly as a result of the Bank's policy actions, were, until recently, paid a zero interest rate.

Valuation gains and losses arise from fluctuations in the value of the Reserve Bank's assets due to movements in exchange rates or changes in the market yields on securities held outright. Over the past year, the valuation gains from exchange rate movements were relatively small. By contrast, there were large valuation losses on the holdings of domestic government bonds owing to the rise in bond yields. The Bank purchased significant quantities of bonds at low yields during the pandemic to support the economic recovery. As that recovery gathered pace, yields rose, and the Bank recorded significant valuation losses on these bonds.

### Accounting for domestic bonds

Consistent with Australian Accounting Standards, the Reserve Bank's longstanding policy has been to account for its domestic bonds held on an outright basis at 'fair value through profit and loss'. This treatment reflects that the Bank's domestic bonds are held to implement monetary policy and may be sold or lent in pursuit of those policy objectives. By contrast, many other central banks use amortised cost to value their domestic bond holdings, as permitted by their respective accounting frameworks, with the result that there is less volatility in their reported profits.

Under amortised cost, the return on the Bank's domestic bonds would be calculated as the sum of coupon (interest) income received less any premiums paid to acquire those securities (reflecting that bonds under the Bank's bond purchase program were generally purchased at prices higher than the face value of those bonds, owing to their coupon rates being greater than market yields at the time). In the event bonds are purchased at a price below their face value, the 'discount' would be added to coupon income. Each of these components is accrued on a straight line basis over the remaining term of the bond. During 2021/22, the return on an amortised cost basis is estimated to have been about \$3 billion.

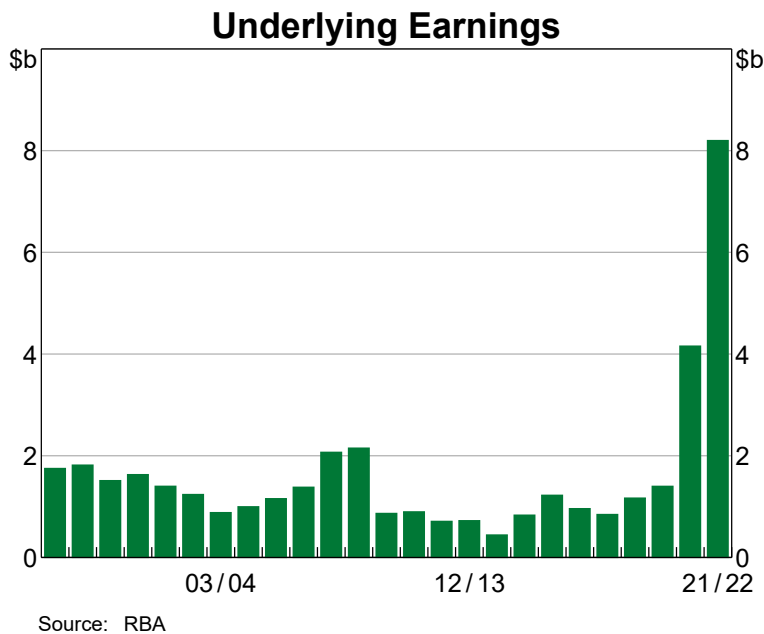
By contrast, fair value accounting, as applied in the Bank's financial statements, also includes valuation gains or losses from movements in market yields. In 2021/22, these valuation changes resulted in very large unrealised losses being recorded. When combined with other components of earnings, a net loss of \$37.7 billion was reported on the Bank's domestic bond holdings. Given the intention to hold these bonds to maturity, any valuation losses that occur as yields increase will be offset at the time that the bonds mature at their face value. This means that fluctuations in yields alter the timing of any valuation gain or loss over time, but do not change the ultimate return the Bank will earn on its domestic bonds. This would not be the case if the bonds were sold prior to maturity.

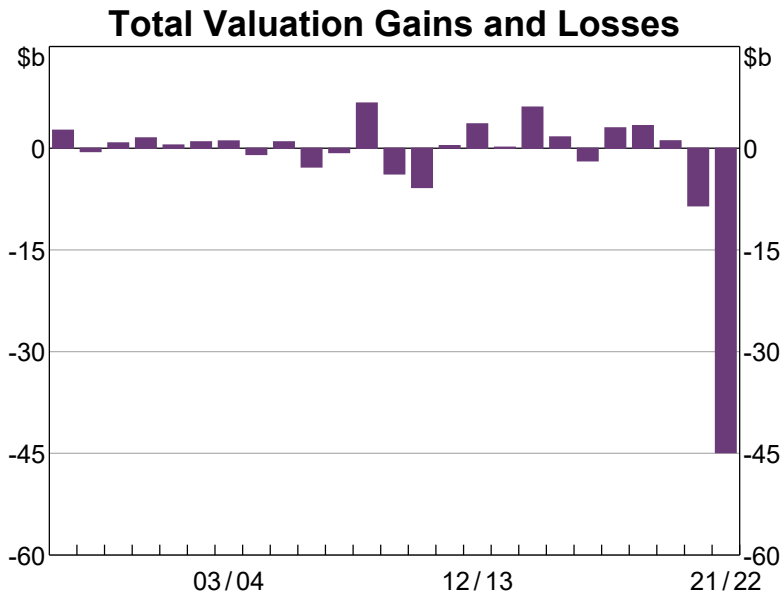
In 2021/22, the Bank's accounting loss of \$36.7 billion was comprised of the following:

- Underlying earnings of \$8.2 billion, compared with \$4.2 billion in 2020/21. This increase reflects interest earnings through the year on the larger portfolio of Australian Government bonds purchased under the bond purchase program.
- Unrealised valuation losses of \$44.5 billion, from:
  - a rise in bond yields in Australia (\$40.3 billion loss) and overseas (\$0.5 billion loss)

- the unwinding of premiums on domestic government bonds (\$5.2 billion loss); these premiums are unwound on a straight-line basis and recorded as unrealised valuation losses each day, and realised upon sale or maturity of the bond
- partially offset by the depreciation, on average, of the Australian dollar over the year (\$1.5 billion gain).
- Realised valuation losses of \$0.4 billion.

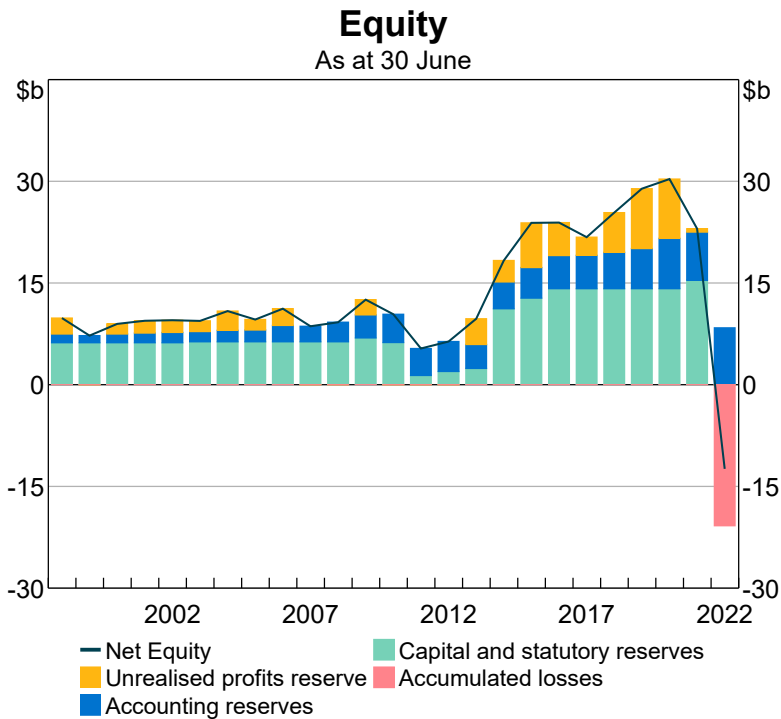
In accordance with the Reserve Bank Act, unrealised valuation losses were initially absorbed by the UPR, and then against other sources of income (namely, underlying earnings). A further \$15.4 billion was charged against the RBRF, bringing the balance of this reserve to nil. The remainder, \$20.8 billion, is reported as accumulated losses on the Bank's balance sheet.





## Capital and reserves

The Reserve Bank Board views it as important that the Bank's capital is restored over time. It also recognises that by virtue of their unique nature, central banks can operate for a period of time with negative equity. Indeed, a number of central banks in other countries have operated for some time with negative equity; several other central banks are, or are likely to be, in a similar position over coming years. Unlike a normal business, there are no going concern issues with a central bank in a country like Australia. The negative equity position will not affect the ability of the Reserve Bank to do its job.



Source: RBA

For a number of years, the Board has maintained a formal framework for determining the target balance in the RBRF, which is the Bank's main reserve and essentially its capital. Under that framework, capital was assigned to market risk arising from the Bank's portfolio of foreign and domestic securities. A small amount of capital was also assigned to credit risk arising from the very small exposures to commercial banks that are not collateralised. The target balance in the RBRF is not a minimum level of capital that needs to be maintained at all times, but rather a benchmark for the Board to consider when providing advice to the Treasurer regarding the Bank's capital and dividends.

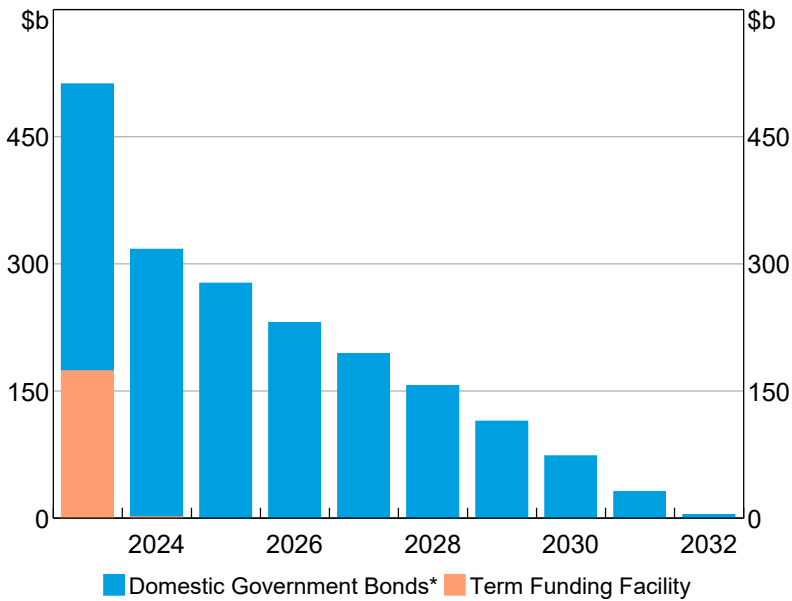
As at 30 June 2022, the target for the RBRF stood at \$20.8 billion, compared with an actual balance of nil (and accumulated losses recorded elsewhere on the balance sheet of \$20.8 billion).

Given this shortfall, at its July 2022 meeting the Board considered the case for a capital injection by the Australian Government. It concluded that a capital injection was not necessary, as the Bank's capital can be restored over time through the retention of future earnings. This path to capital restoration requires that all distributable earnings are retained by the Bank, perhaps for many years.

The majority of the Bank's domestic bonds are now carried on the balance sheet at a discount to their face value, so that capital gains are expected to be realised as these bonds mature. This will add to the Bank's distributable earnings in future periods. Nevertheless, the Bank's future earnings remain highly uncertain, due to the mismatch between the fixed returns on the majority of its assets and the variable rate paid on a large portion of its liabilities, especially ES balances. This is especially so in the next two financial years before the bonds purchased to support the three-year yield target mature and funds lent under the Term Funding Facility are repaid.

## Domestic Fixed Interest Assets

As at 30 June



\* Total face value held, assuming all domestic government bonds are held to maturity.

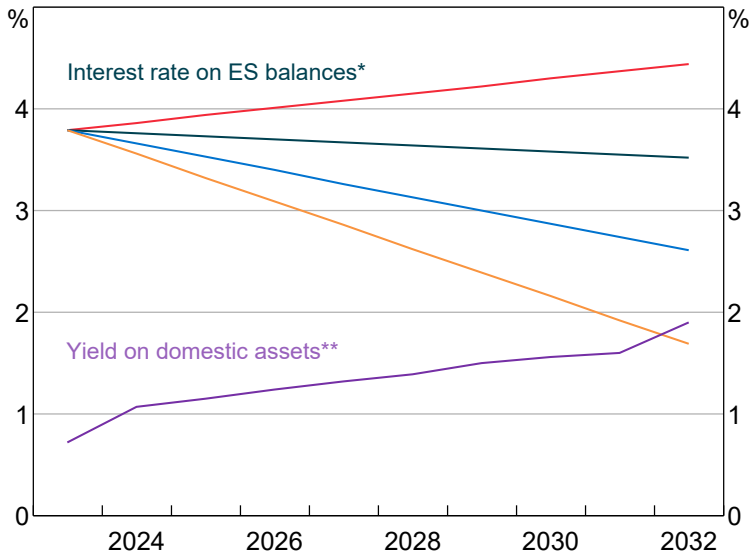
Source: RBA

Below are four scenarios to illustrate how the Bank's future earnings and net equity position could vary with different assumed paths for policy rates. For all scenarios, the cash rate is projected to evolve in line with the market expectations to June 2023 (using overnight index swap rates as at 31 August), with the margin between the cash rate target and the ES rate assumed to remain constant at its current level of 10 basis points. The projections beyond 2023 assume the ES rate converges to either 1½ per cent, 2½ per cent, 3½ per cent or 4½ per cent.

Under all four scenarios, losses are forecast in the next few years, as the interest rate on ES balances would be higher than interest income on the Bank's assets (especially funds lent under the Term Funding Facility). Thereafter, the abovementioned valuation gains on the Bank's domestic bonds are projected to more than offset negative underlying earnings, underpinning an expected improvement in the Bank's financial results and equity position. These projections are highly dependent on the future path of the cash rate and broader movements in bond yields and the Australian dollar exchange rate.

## Domestic Interest Rates

As at 30 June

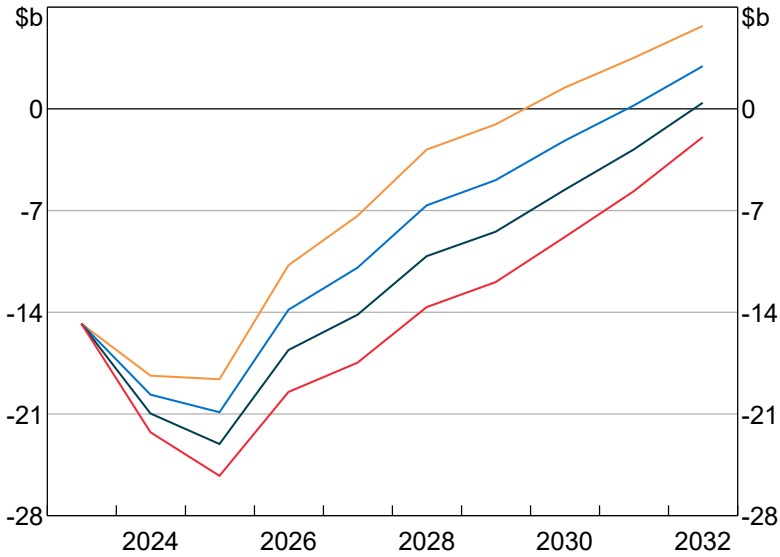


\* The path of interest rate on ES balances up to 30 June 2023 is based on the cash rate path implied by overnight index swap rates as at 31 August 2022; the projections beyond June 2023 assume the ES rate converges to either 1½ per cent, 2½ per cent, 3½ per cent or 4½ per cent.

\*\* Weighted average yield to maturity of outstanding domestic government bonds and interest rate on Term Funding Facility reverse repos.

Sources: Bloomberg; RBA

### Projections of Net Equity\* As at 30 June



\* Assuming future distributable earnings will first be applied to offsetting accumulated losses and then to restoring the RBRF to target. In accordance with the Reserve Bank Act, such transfers are to be formally determined by the Treasurer each year.

Source: RBA

The Board views it as important that there is a credible path to restoring the Bank’s capital over time. Accordingly, the Board’s strong expectation is that future distributable earnings will first be applied to offsetting accumulated losses and then to restoring the RBRF to target, before paying any dividends to the Australian Government. Following consultation with the Governor, on behalf of the Board, the Treasurer has endorsed the Board’s general approach to restoring its equity position. Consistent with the Reserve Bank Act, any transfers from the Bank’s earnings in the future will be formally determined by the Treasurer after consulting the Board each year.

Details of the composition and distribution of the Reserve Bank’s profits are contained in the table below. ↗



## Composition and Distribution of Reserve Bank Profits

\$ million

Financial Year	Composition of profits <sup>(a)</sup>				Distribution of profits				
	Underlying earnings	Realised gains or losses <sup>(b)</sup>	Unrealised gains or losses <sup>(c)</sup>	Accounting profit or loss <sup>(-)</sup>	Unrealised profits reserves	Asset revaluation reserves	Reserve Bank Reserve Fund	Dividend payable	Accumulated losses
1997/98	1,750	966	1,687	4,403	1,687	-558	548	2,726	-
1998/99	1,816	2,283	-2,773	1,326	-2,349	-1	-	3,676	-
1999/00	1,511	-708	1,489	2,292	1,489	-	-	803	-
2000/01	1,629	1,200	320	3,149	320	-5	-	2,834	-
2001/02	1,400	479	-11	1,868	-11	-10	-	1,889	-
2002/03	1,238	1,157	-222	2,173	-222	-2	133	2,264	-
2003/04	882	-188	1,261	1,955	1,261	-	-	694	-
2004/05	997	366	-1,289	74	-1,289	-	-	1,363	-
2005/06	1,156	4	933	2,093	933	-17	-	1,177	-
2006/07	1,381	72	-2,846	-1,393	-2,475	-3	-	1,085	-
2007/08	2,068	614	-1,252	1,430	27	-	-	1,403	-
2008/09	2,150	4,404	2,252	8,806	2,252	-	577	5,977	-
2009/10	866	-128	-3,666	-2,928	-2,248	-	-680	-	-
2010/11	897	-1,135	-4,651	-4,889	-23	-	-4,866	-	-
2011/12	710	405	-39	1,076	-20	-	596	500	-
2012/13	723	-135	3,725	4,313	3,725	-	588	-	-
2013/14	9,242 <sup>(c)</sup>	790	-640	9,392	-640	-3	8,800	1,235	-
2014/15	832	2,622	3,434	6,888	3,434	-	1,570	1,884	-
2015/16	1,223	3,389	-1,729	2,883	-1,729	-	1,390	3,222	-
2016/17	960	322	-2,179	-897	-2,179	-4	-	1,286	-

Financial Year	Composition of profits <sup>(a)</sup>				Distribution of profits				
	Underlying earnings	Realised gains or losses <sup>(b)</sup>	Unrealised gains or losses <sup>(-)</sup>	Accounting profit or loss <sup>(-)</sup>	Unrealised profits reserves	Asset revaluation reserves	Reserve Bank Reserve Fund	Dividend payable	Accumulated losses
2017/18	845	-176	3,178	3,847	3,178	-	-	669	-
2018/19	1,167	412	2,970	4,549	2,970	-106	-	1,685	-
2019/20	1,399	1,168	-79	2,488	-79	-	-	2,567	-
2020/21	4,157	-240	-8,249	-4,332	-8,249	-1	1,247	2,671	-
2021/22	8,198	-353	-44,545	-36,700	-502	4	-15,366	-	-20,836

(a) As originally published.

(b) Excludes gains or losses realised from the sale of fixed assets that had been held in asset revaluation reserves.

(c) Includes the Commonwealth grant of \$8,800 million.

Source: RBA