RESERVE BANK OF AUSTRALIA ANNUAL REPORT 2003

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GOVERNOR'S FOREWORD

The financial year just completed was a disappointing one for the world economy. It started promisingly, but the good growth that had occurred in the first half of 2002 faded. Although the world economy did not relapse into recession, its growth was sluggish throughout most of the year and underlying inflation continued to edge down from its already low starting point. In the first half of 2003, the world economy received further disruption from the short-lived Iraq War and the fear that the outbreak of Severe Acute Respiratory Syndrome would turn into a major epidemic.

Throughout the year, the Australian economy performed well, although there was a clear difference in tone between the beginning and the end of the year. With the outlook for the world economy still seeming strong in the early part of the financial year, and with Australian inflation heading up, it looked for a time that further monetary policy tightening might be needed (it having been tightened in May and June 2002). But as the year progressed, bad news on the world economy and a more benign outlook for Australian inflation changed the picture. Indeed, by the end of the year, with further falls in world interest rates and talk of possible deflation abroad, both of which were leading to a strongly rising Australian dollar, the choice the Reserve Bank Board faced was whether to leave interest rates where they were or lower them. In the event, the former alternative was chosen, which meant that there were no changes in official interest rates in 2002/03. More details on the rationale behind the conduct of monetary policy can be found in the quarterly *Statements on Monetary Policy*, the testimonies to the House of Representatives Standing Committee on Economics, Finance and Public Administration, and in various speeches made during the year.

Although there were no changes in monetary policy, the RBA's operations in financial markets were at least as active as in other years. On the domestic side, in addition to the normal daily liquidity management transactions, we had to adjust to the introduction of the continuous linked settlement system for settling foreign exchange transactions between banks. This involved not only the provision of a new intra-day liquidity facility, but also the extension of the settlement session time to as late as 9.00 pm during Australian eastern daylight saving time. On the foreign side, a major activity during the year was the steady replenishment of the international reserves that had been used in earlier years to limit the fall in the Australian dollar. The fact that the Australian dollar appreciated by 20 per cent against the US dollar over the course of the year made this exercise relatively easy.

International economic relations with the major groupings such as the Bank for International Settlements, the Financial Stability Forum and the Group of 20 again involved active participation by senior management. At the regional level, our major involvement is through EMEAP (the Executives' Meeting of East Asian and Pacific central banks). A significant concrete achievement of this body during the year was the establishment of the Asian Bond Fund, through which central banks in the region can invest some of their international reserves in US-dollar denominated debt issued by Asian governments. Although the initial offering of

US$1 billion is quite small (as is Australia's share of US$50 million), it is a promising start which will lead on to bigger volumes and in time, it is hoped, to the inclusion of debt issued in local currencies.

The Australian financial system experienced a relatively uneventful year despite quite divergent movements in asset prices, with share prices falling moderately and residential property prices continuing to rise strongly. Credit growth was again rapid, with the vast majority of loans being directed to the already overheated residential property market.

In response to a recommendation of the HIH Royal Commission, the Government announced a major change to the Australian Prudential Regulation Authority (APRA), whereby its Board would be replaced by an executive group of three members. Dr John Laker, formerly Assistant Governor (Financial System), was appointed to head APRA on 1 July 2003.

Reforms to credit card schemes in Australia, designed to enhance competition and the efficiency of Australia's payment systems, were announced by the RBA in August 2002. Some changes came into effect on 1 January 2003, while others will be implemented in October 2003. The two international credit card schemes – Visa and MasterCard – have challenged the reforms in the Federal Court. After a six-week hearing, a decision is expected in the coming month. Reform to the pricing of EFTPOS and ATM networks is proceeding, with the industry playing a major role and the RBA a supporting one.

The project to bring in-house the computer system supporting Australia's real-time gross settlement system (RTGS) was completed on schedule on 21 October 2002. This had formerly been outsourced, but bringing it in-house means we have greater control, not only over its day-to-day operation, but over its future evolution.

The Head Office consolidation project, whereby four floors previously occupied by the RBA were renovated and made available for rent, was completed ahead of schedule and within budget in December 2002. So far, long-term leases have been signed for more than a third of the available space and tenanted by legal groups. The Adelaide building was sold in February 2003, and the Adelaide Regional Office opened shortly thereafter. We now have a complete suite of Regional Offices located in Adelaide, Brisbane (also serving the Northern Territory), Melbourne (also serving Tasmania) and Perth.

As mentioned in the most recent Annual Reports, the size of the RBA, as measured by staff numbers, is levelling out at around 820 people. It took nearly two decades to reduce numbers from a peak of 3 200 in 1983 and, at times, it seemed the shrinkage would continue inexorably. However, there is reason now to believe that a new equilibrium has been found, both in terms of numbers and Australia-wide structure. I am confident that this major transformation has not in any way reduced the functional interaction between the RBA and the Australian community; indeed, there are a number of ways in which it has been improved.

FINANCIAL SYSTEM STABILITY

Although the RBA no longer has responsibility for supervision of individual financial institutions, it retains a mandate for the overall stability of the Australian financial system. In addition, the RBA is responsible for the soundness of the payments system, and is itself an important participant in the wholesale payments system. As a result, in the event of a serious threat to financial stability, the RBA could be required to take action. Such arrangements are common to other countries where the central bank is not the prudential regulator of banks.

In pursuing its mandate for financial stability, the RBA monitors the health of the Australian financial system through a range of "macroprudential" or financial soundness indicators. These include measures of the financial condition of major groups of borrowers (the household and business sectors); aggregate prudential data on the strength of financial institutions; market-based information on credit spreads and credit ratings; and readings on the key markets in which financial institutions operate. These indicators, taken together with information which the RBA receives in the course of its normal market and settlement activities, should provide pointers to potential vulnerabilities facing the financial system.

While the global financial system was spared shocks of the severity experienced in the previous year – which included the largest ever corporate and sovereign defaults – 2002/03 was, nonetheless, not an easy year from a financial stability perspective. Uncertainty about the trajectory of world economic growth and greater caution on the part of investors unsettled financial markets, while geopolitical uncertainties over Iraq and the Korean peninsula at times weighed heavily on market confidence. The Australian financial system is not quarantined from global developments but, in the RBA's assessment, it remains in a strong condition, supported by the continued expansion of the Australian economy. However, the substantial build-up in household debt may create strains for any financial institutions that have lowered their guard, if Australia's economic circumstances were to deteriorate.

The Stability of the Australian Financial System

The International Environment

Over the first three quarters of 2002/03, and as tensions in Iraq built, uncertainties about prospects for growth in the major economies and a retreat by investors from risk-taking combined to generate various signs of stress in the global financial system. Credit spreads in the corporate bond market reached historical highs in many countries, though they later fell substantially as investors switched from equities to fixed-interest markets; equity markets fell sharply; and the balance sheets of financial institutions came under pressure in a number of countries. The quick resolution of the Iraq conflict gave a lift to market sentiment and encouraged a return to equity markets, but confidence that global growth will regain momentum is not yet securely founded.

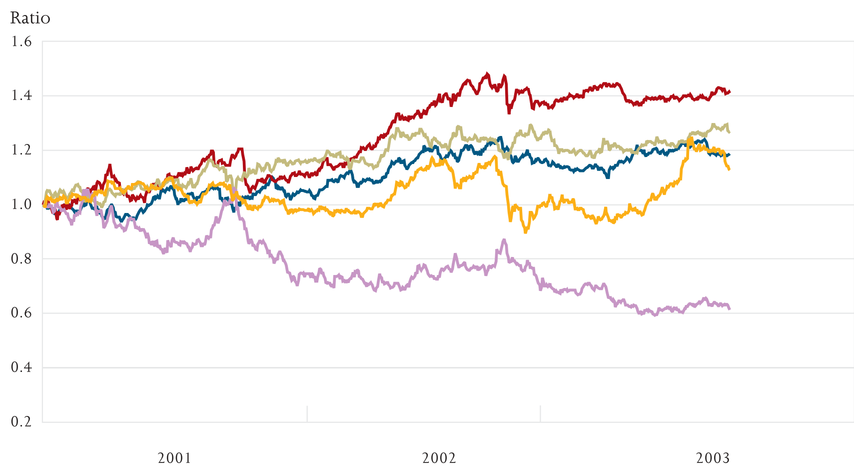
The robustness of the global financial system through recent upheavals owes much to the resilience of banking systems in most of the major industrial countries. Banks with strong retail franchises have performed reasonably well. The US banking system, in particular, has been characterised by healthy levels of capital and low levels of non-performing assets notwithstanding the sluggish US economy. Improvements in the management of credit risk and operating costs and a positively sloped yield curve have helped the US banking index to out-perform the broader US equity market for some time. A similar story is evident in the United Kingdom and a number of other European countries.

Nonetheless, clear areas of weakness have emerged. Banks that rely heavily on wholesale business have come under considerable pressure. Seven of the ten largest international banks have had their long-term rating downgraded by at least one of the major credit-rating agencies since early 2001. Markets dealt severely with international banks that mismanaged major credit exposures or suffered reputational losses and legal liabilities from dubious business practices.

In addition, the banking systems of two of the major industrial countries have been under stress. In Japan, banks continue to grapple with deflation, the unwinding of Japan's earlier asset price bubble and persistent impaired asset problems. Progress in dealing with impaired assets has been slow; recent official estimates suggest that some 9 per cent of the total loans of Japanese banks are non-performing and private-sector estimates are much higher. In May, the Japanese Government agreed to inject public funds into Resona Holdings, the country's fifth largest bank, to stave off its collapse. In Germany, a highly fragmented banking system has struggled with a sizeable non-performing loan burden, low levels of profitability and a significant exposure to equity markets. Since early 2002, German supervisory authorities have felt the need to issue statements of support for German banks. More recently, sentiment towards the German banking sector has improved considerably, partly reflecting restructuring initiatives and the increasing value of their direct holdings of shares.

During 2002/03, the insurance sector remained a source of concern in many countries. This sector plays a critical role in absorbing risk in the financial system – including, increasingly, as buyers of credit

GRAPH 1 | **BANKS' SHARE PRICES** Relative to equity market



Australia Germany Japan UK US

Source: Bloomberg

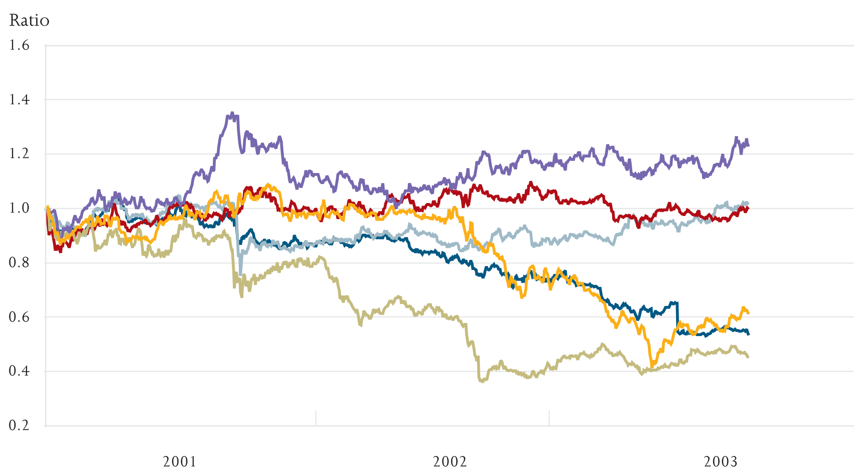
risk from banks through credit derivatives. For this reason, the financial condition of the sector and its future appetite for risk have become a major focus of international policy makers. The main difficulty confronting insurance companies is a weak flow of investment income. This problem is especially acute for life insurance companies in countries such as Germany, Switzerland and the UK, where the profitability of annuity products depends heavily on equity and fixed-interest returns exceeding guaranteed rates of return on policies. The impact of this problem has been felt in the Australian market through the UK operations of AMP. Insurance companies have responded to losses on their investment portfolios by raising capital and reducing their equity holdings. In some cases, supervisory authorities have relaxed equity valuation rules to reduce pressure on insurers to sell their equities into declining markets.

External Vulnerabilities

Global economic and financial conditions impinge upon the Australian economy and Australian financial markets in various ways and these are monitored closely by the RBA in the setting of monetary policy. From a financial stability perspective, the key issues are the exposure of Australian financial institutions to global developments, through both their lending and funding activities.

On the assets side of the balance sheet, Australian banks' offshore exposures have remained broadly constant over the last decade or so – at a little under one third of total assets – but their geographic composition has changed somewhat. Lending to Japanese borrowers has diminished significantly in importance while lending to borrowers in New Zealand has risen to become the single largest country exposure, a little above the UK. The risks facing Australian banks in their New Zealand and UK operations – where strong growth in mortgage lending has fuelled house price appreciation – bear close similarities with their exposures to Australian borrowers.

GRAPH 2 | **INSURERS' SHARE PRICES** Relative to equity market



Australia Australia (excluding AMP) Germany Japan UK US

Source: Bloomberg

Australian Banks' Lending to Overseas Economies
Per cent of total assets

	1990	1996	2002
New Zealand	3.7	8.3	8.6
United Kingdom	8.3	7.1	8.0
Euro area	2.8	2.5	4.4
United States	5.5	3.9	3.9
Japan	5.0	2.7	0.6
Other	4.6	5.1	5.3
Total	30.0	29.6	30.8

Source: APRA

On the liabilities side, Australian banks have turned increasingly to offshore markets as a source of funding to supplement their domestic deposit base. The major banks now source around one quarter of their liabilities offshore, up from about 10 per cent at the start of the 1990s. A significant part of these liabilities has been raised in Australian dollars, through banks issuing in offshore markets where there is strong demand for Australian dollar assets. So-called "uridashi" issues to retail investors in Japan, in particular, have been popular in the past two years or so. Nevertheless, about 65 per cent of banks' offshore liabilities are denominated in foreign currencies. On international comparisons, Australian banks appear to have much higher levels of net foreign currency liabilities than is the case in most other industrialised countries.

Some have seen this structure of liabilities as a potential source of external vulnerability for the Australian financial system. One aspect of such concerns is the belief that the banks are exposed to significant foreign exchange risk. As the RBA has explained in its *Bulletin* (August 2000 and August 2002), this is, in fact, not the case. In aggregate, the large net foreign currency liabilities which appear on banks' balance sheets (and in the national statistics based on those balance sheet figures) are offset by off-balance sheet derivatives positions. Taking the on-balance sheet and off-balance sheet exposures together, survey data in 2001 showed that Australian banks actually had small net foreign currency assets. More recent information shows that banks' foreign currency exposure remains at relatively low levels.

Banks' Foreign Currency Exposure

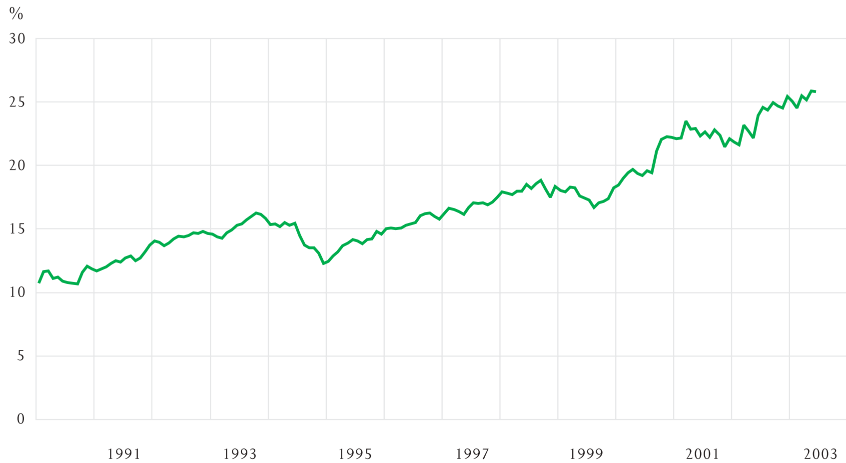
June 2001	$b
Net FX position on debt	-117
Foreign equity assets	31
Net position on FX derivatives	109
Overall position	23

Source: ABS

Banks' foreign currency borrowings have been undertaken as one element in a strategy which involves the matching use of off-balance sheet cross-currency swaps to convert the foreign currency exposure into an Australian dollar exposure. The result is that the banks are able to obtain Australian-dollar funding at a lower cost than they could achieve by borrowing directly in the Australian market. Since the borrowings and swaps are matched, the banks face negligible foreign exchange risk through this strategy. When the exchange rate moves, gains or losses on the original foreign currency borrowings are offset by corresponding losses or gains on the swaps.

A second concern raised about banks' use of offshore funding is that they are exposed to greater refunding risk (the inability to renew a borrowing facility when it matures). This concern rests on the view that offshore markets are more prone to flight than domestic markets. This could happen if, for example, foreign investors lost confidence in the economic fundamentals and policy settings of Australia or, at the level of the individual borrower, if a credit-rating downgrade raised doubts about that borrower's asset quality and ability to repay borrowings. In either case, international capital markets would likely demand more favourable terms for any funding through a lower exchange rate and higher interest rates. Australian banks would then

GRAPH 3 | **AUSTRALIAN BANKS' FOREIGN LIABILITIES** On balance sheet (domestic book), per cent of total



Source: APRA

find the pricing of offshore funding unattractive and would unwind their overseas borrowings and the associated swap facilities in parallel. Funding would be switched to onshore markets. This would put some pressure on domestic security yields as the Australian banks increased their call on local wholesale markets but, given that the funding would mainly be at the short end of the yield curve, which is largely fixed by the RBA, the rise in yields would be only at the margin. In summary, the RBA's assessment is that Australia's banking sector would not be unduly impaired by sudden changes in the exchange rate or in global funding markets, even though banks are active users of these markets.

This conclusion extends more broadly to other aspects of Australia's external position. In recent years, there has been an increase in interest in measuring the external vulnerability of countries. Much of the impetus has come from the Asian and other financial crises of 1997-98 and has therefore focussed on issues of particular relevance to emerging market economies. It was in this context that the International Monetary Fund (IMF) identified in 2000 a group of key debt-related and reserve-related indicators which it has since used as a basis for discussions with country authorities. But there has also been heightened interest in the study of external vulnerability, and financial fragility more generally, in industrialised countries. Emerging and industrialised countries have pledged to undertake reviews of these matters as part of the Financial Sector Assessment Program, under the auspices of the IMF and World Bank.

In this context, and despite significant reservations about applying to industrialised countries concepts intended for use in emerging market economies, the RBA has studied the potential for the IMF's indicators to be used to draw conclusions about financial vulnerability in Australia. The central focus in this work has been on understanding the reasons for Australia's overall high level of net foreign liabilities (and the Australian banking system's high level of foreign currency liabilities, discussed above).

Australia does have a high level of net external liabilities. That level rose from about 25 per cent of GDP in 1983 to about 55 per cent of GDP in 1993, and has since remained relatively steady. However, most of Australia's gross external liabilities – about 60 per cent – are denominated in Australian dollars, while almost all of our gross external assets are in foreign currencies. As a result, Australia's net foreign currency position is one of surplus – the country has net foreign currency assets equivalent to about 10 per cent of GDP. When off-balance sheet positions (such as swaps undertaken by the banking sector) are taken into account, Australia's net foreign currency asset position is even larger, at about 20 per cent of GDP. This net foreign currency asset position means that Australia as a whole is not vulnerable to any significant degree to currency valuations associated with even large falls in the exchange rate.

Australia also has a low level of foreign reserves, especially – as is often done in analyses of external vulnerabilities – when compared to the high level of short-term, on-balance sheet debt. For several reasons, however, this does not indicate a high degree of vulnerability. First, foreign reserves are a more relevant indicator for countries with fixed or managed exchange rate systems than for countries with a floating exchange rate, such as Australia. Secondly, most of Australia's on-balance sheet debt is denominated in Australian dollars and, of the remainder, about half has been hedged back to Australian dollars using derivatives. Thirdly, Australian borrowers are likely to have continuing access to global funding markets even in otherwise difficult circumstances, as proved to be the case during the Asian and other financial crises of 1997-98.

The RBA's judgment that Australia's low ratio of foreign reserves to short-term debt does not pose a significant economic risk is also borne out by the assessments of financial markets themselves, as reflected in credit ratings by the major ratings agencies. A relatively low ratio of foreign reserves to short-term debt is also common across many medium-sized industrialised countries which have floating exchange rates, and which share with Australia a relatively high credit rating. On the other hand, many countries with high levels of international reserves have lower credit ratings.

Ratio of Reserves to Short-term Debt and Credit Ratings

	Reserves/debt	Credit rating
Switzerland	0.2	AAA
Sweden	0.2	AA+
Australia	0.2	AAA
Canada	0.3	AAA
New Zealand	0.4	AA+
Brazil	1.2	B+
Mexico	1.7	BBB-
Indonesia	2.1	B-
Korea	2.6	A-
Thailand	3.5	BBB-
Malaysia	3.6	BBB+

Domestic Developments

The main feature of domestic developments in 2002/03 was the exceptionally fast pace in growth of credit extended by Australian financial institutions to the household sector, particularly for housing. Growth in credit to business, which had picked up around mid year, was more subdued over the latter months, but growth in total credit, at around 12 3/4 per cent, was above its recent average.

These developments have continued the trend evident over the past decade or so which has seen a shift in the proportion of lending by financial institutions away from the business sector and towards lending to households. Lending to the latter group now accounts for about 56 per cent of total credit, compared with less than 40 per cent in 1990. The switch in emphasis is due, in part, to the strength of corporate profits and positive share market sentiment over much of the period, which have enabled businesses to make greater use of internal funding and equity raisings for expansion. Growth in the corporate bond market has played a role as well. The switch is also due to strategic decisions by some major financial institutions to favour lending to households in the wake of their corporate loan loss experiences in the early 1990s. The divergent credit trends have led to a shift in the structure of assets held by financial institutions towards lower-risk loans and, as a consequence, average credit quality has improved.

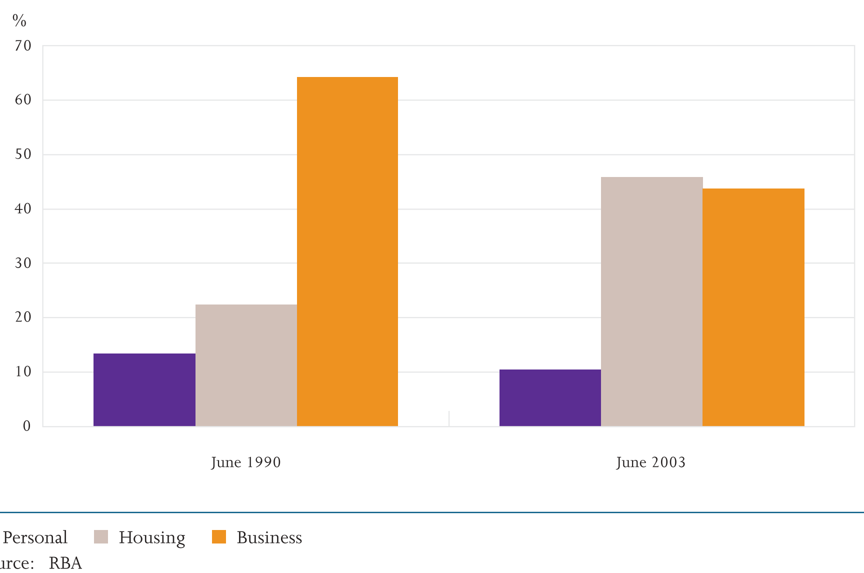
Lending to the household sector – about four-fifths of which is secured against housing – has been growing at double-digit annual rates for some time now. This has been associated with substantial and widespread increases in house prices and, in the past few years, with increased purchases by investors. Consequently, household debt is now equivalent to 129 per cent of annual household disposable income, at the high end of the range of other comparable countries.

These developments have raised the financial risks facing that proportion of households (around 30 per cent) which have housing debt, a concern to which the RBA has drawn attention on a number of occasions recently. At this juncture, however, there are no obvious signs of financial stress in the household sector. Interest rates remain at historically low levels and the aggregate interest burden – interest paid as a share of income – is below its peak in the late 1980s/early 1990s, although it is trending upwards as the average size of housing loans rises. Many households have a significant cushion from repaying debt ahead of schedule (though others are topping up their debt through redraw facilities), and late payments (past-due) on housing and other personal loans are close to cyclical lows. Growth in employment and wages has tended to support household incomes and debt-servicing capacity.

Latest readings confirm that the financial position of the business sector is sound and, with ample funding for investment plans available from internal sources, the sector had only limited additional recourse to the banking system in 2002/03. Corporate profitability remains high, and although the drought has had an impact on rural producers, the profitability of other unincorporated enterprises is generally favourable compared with recent years. Debt ratios are well below their peak of the late 1980s and interest burdens are around historically low levels. Credit spreads for both low- and high-grade corporate debt have declined to relatively low levels.

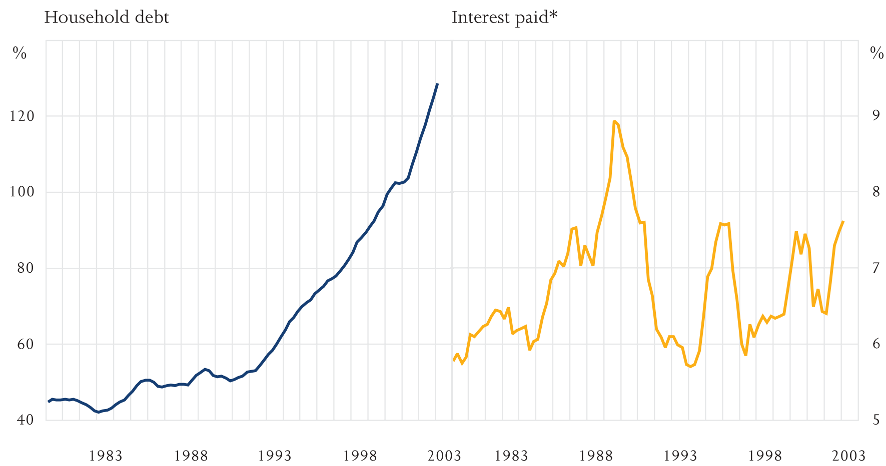
Within business lending, two sectors have been under somewhat closer scrutiny. The first is the rural sector, which has been weakened by drought.

GRAPH 4 | **CREDIT BY SECTOR** Per cent of total



Source: RBA

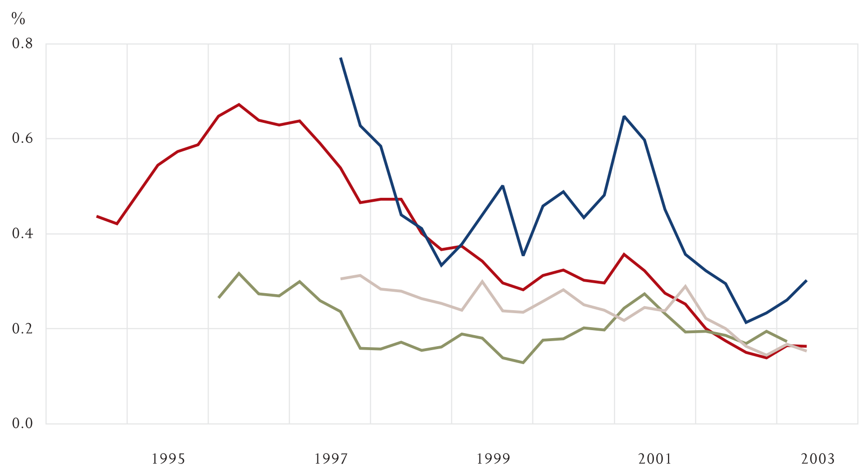
GRAPH 5 **HOUSEHOLD DEBT AND INTEREST** Per cent of household disposable income



* Gross of financial intermediation service charge; RBA estimates from December 2000

Sources: ABS; RBA

GRAPH 6 **HOUSING LOANS PAST DUE** Per cent of total value of housing loans



Banks Building societies Credit unions Securitised lending – prime

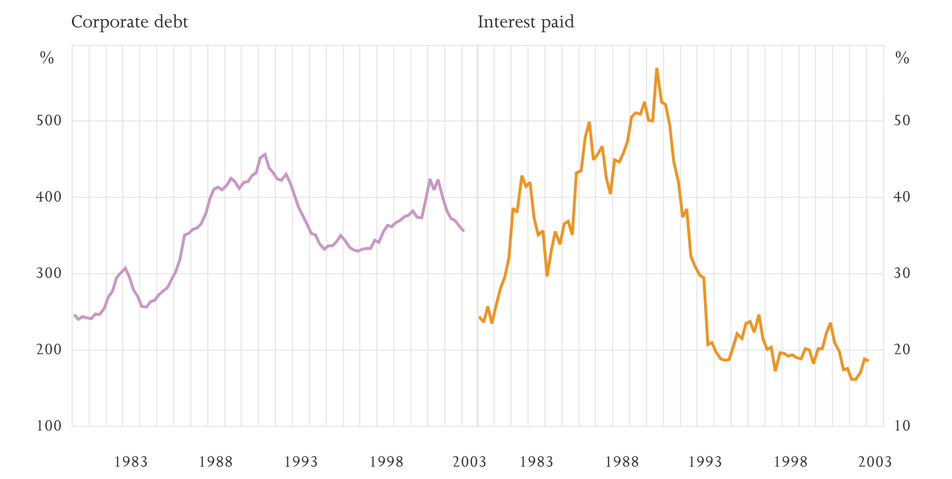
Sources: APRA; Standard & Poor's

Notwithstanding sharp falls in production and the impact on some rural communities, the drought and its consequences are unlikely to threaten financial stability. Lending to the rural sector accounts for less than five per cent of total credit provided by banks. The interest burden of the rural sector is low both in historical terms and relative to other industries, and declines in revenue seem manageable in light of tax-effective saving instruments (such as Farm Management Deposits) and the previous run of good rural profits.

The other sector under scrutiny is office property, where earlier episodes of over-investment have been the source of stress on the financial system. Conditions in the office property market have softened a little recently, but have generally held up well considering the bursting of the "high tech" bubble and financial sector downsizing which pushed up vacancy rates in some areas. Nonetheless, current conditions seem more sustainable than those in the late 1980s: price rises over recent years have been far more muted and the build-up in supply of office accommodation has been much less pronounced. Banks have considerably reduced their exposures to office property to around three per cent of total bank credit (and to commercial property in general to around 13 per cent) and have strengthened their risk management procedures in this area.

Reflecting the general health of the household and business sectors, the overall financial condition of authorised deposit-taking institutions in Australia remains strong. The financial soundness indicators which the RBA monitors – including asset quality, capitalisation, profitability and market valuation – continue to provide reassuring readings. Asset quality remains robust. For banks, the ratio of impaired assets to total assets was 0.5 per cent at year-end, around the very low levels established during the course of the current economic expansion. "Distressed" assets, a broader measure which includes loans on which payments are late, were 0.7 per cent of total assets. Impaired asset ratios for building societies and credit unions are also around cyclical lows. These measures of asset quality are, of course, backward-looking and more forward-looking indicators strike a note of caution. A number of banks have noted potential for

GRAPH 7 | **CORPORATE DEBT AND INTEREST** Per cent of gross operating surplus



Sources: ABS; RBA

increased loan delinquencies in parts of their household and business exposures, and some have tightened lending standards accordingly. In particular, on new investment loans – particularly for apartments in some inner-city suburbs – major banks have lowered the maximum proportion of the purchase price that can be borrowed.

Financial intermediaries have strong lines of defence against any deterioration in credit quality. Banks hold general provisions of around 0.5 per cent of total assets against the possibility of future losses not attributable to particular assets. The ratio of specific provisions (written against assets already identified as impaired) to total assets is lower, reflecting the sustained improvement in asset quality over recent years. Banks maintain aggregate capital ratios of around 10 per cent of risk-weighted assets, well above minimum required levels. The comparable ratios for building societies and credit unions are around 14-15 per cent.

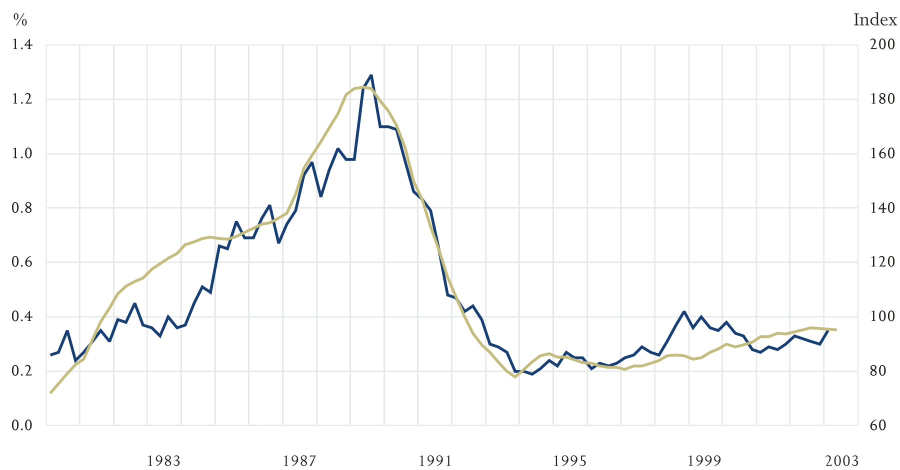
Notwithstanding the compression of interest margins over recent years, banks in particular have been able to maintain high levels of profitability by enlarging their asset base, containing costs and diversifying income sources. For the major banks, non-interest income now accounts for almost half of total income, a proportion boosted by recent acquisitions of funds management businesses. Declining equity markets have been taking their toll on funds management activities, but retail banking franchises remain very profitable.

Market indicators continue to signal a generally positive view of the credit quality of Australian banks. Despite a retraction in the first part of 2002/03, since reversed, bank share prices have out-performed the broader market over a long period. Average spreads on long-term US dollar bonds issued offshore by Australian banks have regularly been lower and less volatile than the average spreads on comparable debt of their overseas counterparts.

Outlook for Financial Stability

Looking ahead, the main potential source of risk to financial stability would be a substantial correction in the housing market, impacting on the balance sheets of authorised deposit-taking institutions through mortgage defaults. At this point, there are

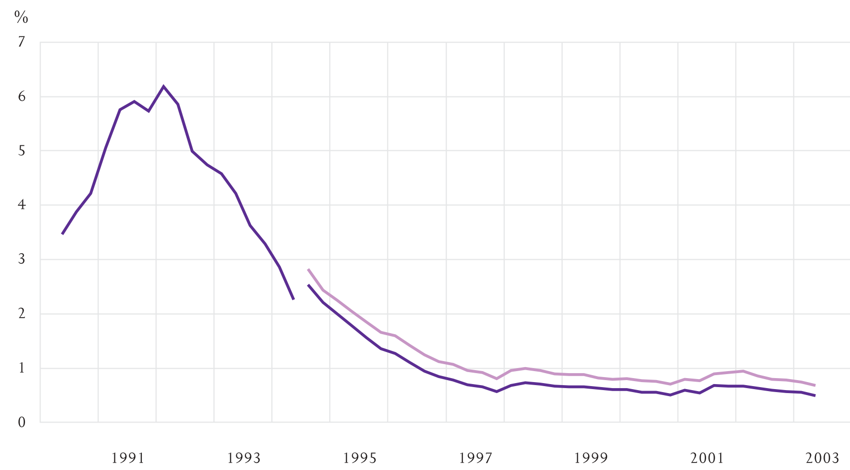
GRAPH 8 | **OFFICE PROPERTY INDICATORS**



Office construction as a per cent of nominal GDP   Real office property prices – index June 1992 = 100

Sources: ABS; Jones Lang LaSalle; RBA

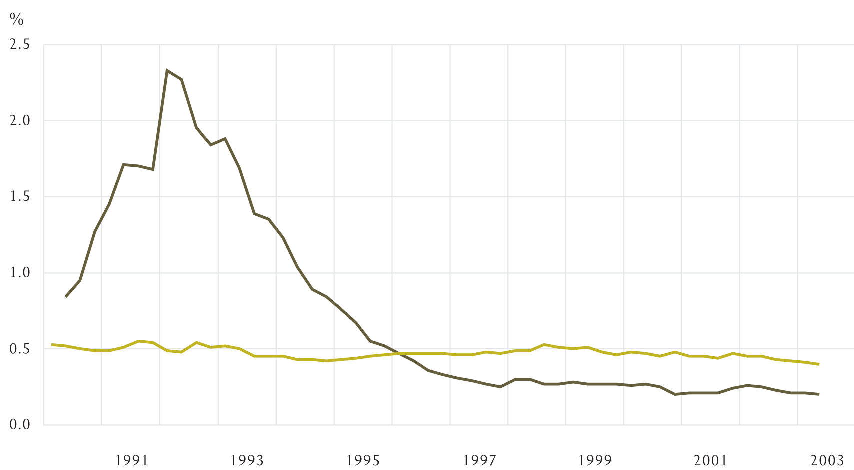
GRAPH 9 | **DISTRESSED ASSETS OF BANKS** Per cent of on-balance sheet assets



Impaired assets   Distressed assets – includes impaired assets and past-due items

Source: APRA

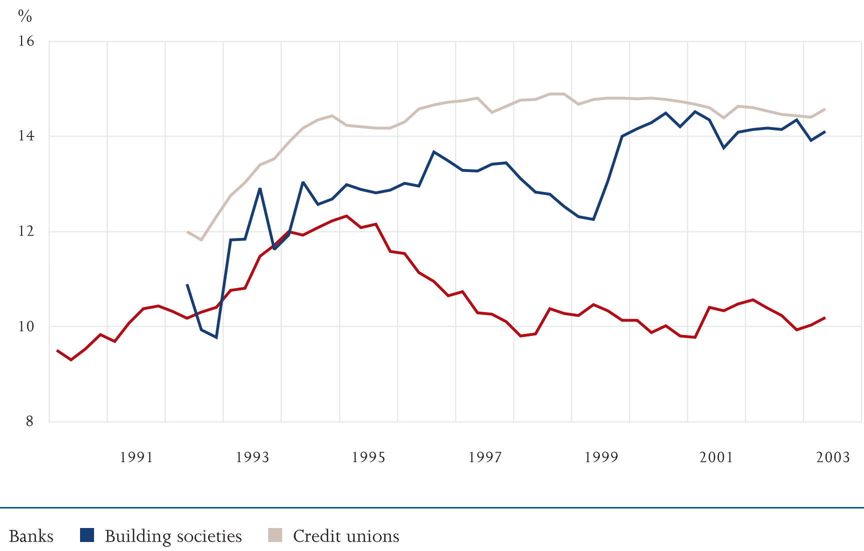
GRAPH 10 | **PROVISIONS FOR BAD AND DOUBTFUL DEBTS OF BANKS** Per cent of on-balance sheet assets



General   Specific

Source: APRA

GRAPH 11 **RISK-WEIGHTED CAPITAL RATIOS**



Source: APRA

only limited signs of an easing in pressure in the housing market. A flattening or modest reversal of house price increases would not in itself be a cause for concern. The concern would be a sharp jump in mortgage default rates which triggered a more substantial market correction – a scenario more likely to be associated with a deterioration in employment conditions or sharp rise in interest rates.

The rapid increase in lending for housing, particularly for property investment, may harm borrowers carrying substantial exposures to an already over-extended apartment market. From a financial stability perspective, however, the current assessment is that the rise in household debt to date does not pose a significant danger of a financial crisis, such as occurred in the early 1990s after the build-up in corporate debt. This assessment is underpinned by the general strength and profitability of authorised deposit-taking institutions in Australia over a sustained period. It also takes into account developments that are specific to lending for housing. The first is the risk management procedures followed by these institutions and the "internal buffers" on which they may draw. The second is the extent to which risks on lending for housing are being transferred to other risk-takers.

To guard against the risk of a significant increase in mortgage delinquencies, authorised deposit-taking institutions apply various "stress tests" to their housing loan portfolio, typically looking at the impact of higher interest rates, rising unemployment and falling house prices on expected default rates and losses. A key benchmark in loan application processes is the capacity of the borrower to service increases in interest rates, normally taken to be two percentage points. For lending to investors, institutions generally allow for falling rental yields by discounting the expected rental income for probable intervals of vacancy. Recently, APRA has supplemented these screening exercises with rigorous tests of its own; it has also found cause to voice concerns about slippages in property lending processes.

If default rates were to rise, lenders have two internal buffers on which to draw: the value of equity supporting the housing loan – commonly measured as the loan-to-valuation ratio (LVR) – and the excess repayments that borrowers have made at their discretion. Low LVRs and high excess repayments both increase the assurance that a lender's exposure at default will be covered by the expected proceeds from the sale of property held as underlying security. LVRs on new housing loans appear to average 65-70 per cent across lending portfolios. Evidence suggests that around two thirds of households with mortgage debt repay their housing loans ahead of schedule. On the other hand, an increasing number of households are now taking advantage of new lending products – such as home equity loans and redraw facilities – to top up their mortgages, ensuring that their debt levels remain higher for longer.

For housing loans with LVRs above 80 per cent, authorised deposit-taking institutions generally have protection in the form of mortgage insurance. In the event of default on an insured loan, the lender receives from the mortgage insurer any shortfall between the proceeds from the sale of the underlying security and the amount of the loan outstanding. Use of mortgage insurance is governed by APRA's prudential guidelines. To qualify for the concessional risk-weight applied to housing loans for capital adequacy purposes, loans which have an LVR above 80 per cent must be covered by mortgage insurance. If this cover is to be relied upon in hard times, mortgage insurers themselves need to be in a strong financial position, and APRA requires that they be at least A-rated. In determining credit ratings, ratings agencies require mortgage insurers to hold capital sufficient to cover a number of "worst-case scenarios", including a prolonged downturn in the economy and substantial falls in house prices. To achieve the highest rating, a mortgage insurer would need to be able to withstand an increase in insurance claims many times worse than its most serious historical claims experience.

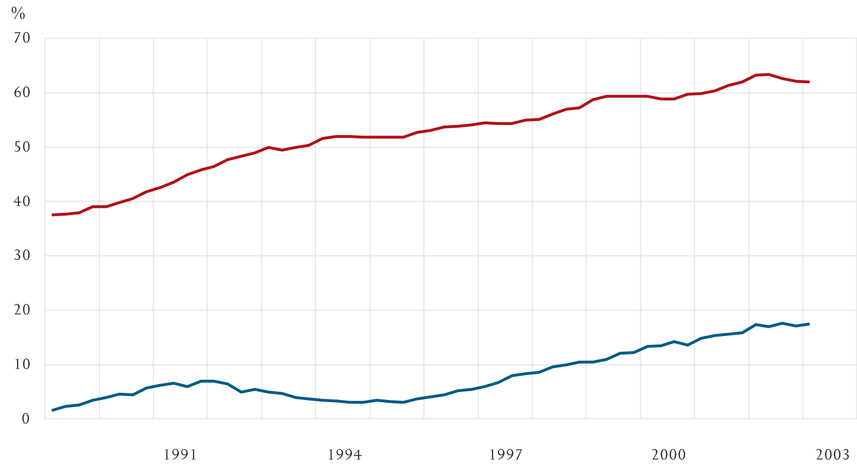
Authorised deposit-taking institutions that cede credit risk to mortgage insurers face strict and ongoing reporting requirements on the condition of insured loans if they are to comply with the terms of their mortgage insurance contracts. These requirements may be easy to satisfy when delinquencies are few, but slippages in compliance may become an issue when default rates are increasing sharply – precisely when lenders most need the protection afforded by their mortgage insurance. APRA is currently giving this particular operational risk close attention.

Mortgage insurance is one of two main vehicles which lenders use to shed credit risk on housing lending. The other is the securitisation market. While the bulk of housing debt remains on the books of authorised deposit-taking institutions, these institutions and mortgage managers alike are securitising (i.e. packaging and selling) an expanding proportion of their housing loans. Since the mid 1990s, securitised mortgages have risen from \$5 billion or 3 per cent of housing debt, to more than \$80 billion or 17 per cent of housing debt.

By distributing credit risk over a wide investor base, rather than allowing it to become concentrated on the balance sheets of a small number of financial institutions, securitisation has the potential to reduce threats to financial stability. At the same time, securitisation can introduce other forms of risk if the end-investor lacks the capacity to manage or absorb credit risk, particularly as deals become more complex. This does not appear to be a particular concern with the residential mortgage-backed securities (RMBS) market in Australia. The majority of RMBS deals are backed by prime, fully insured mortgages and, over time, their performance has typically compared favourably with the mortgages retained on the books of financial institutions. As a result, the senior tranche of RMBS issues is generally rated AAA and the subordinated tranches, which usually cover no more than five per cent of the securities issued, typically carry investment-grade ratings.

Financial intermediaries need to ensure that securitisation does not substitute other forms of risk for credit risk. APRA's prudential guidelines require authorised deposit-taking institutions to hold adequate capital against any exposures arising; to

GRAPH 12 | **SECURITISATION OF RESIDENTIAL MORTGAGES** Per cent of residential mortgage debt outstanding



Sources: ABS; RBA; US Federal Reserve

have systems in place to identify, monitor and control the risks associated with securitisation; and to make clear disclosures to investors that there is no recourse to the institution originating the loans.

A more recent development in the dispersion of credit risk on housing lending is the emergence of "non-conforming" mortgage managers, through which borrowers who do not meet standard lending criteria can gain access to housing finance that might not otherwise be available. The non-conforming loan market in Australia is still only small in overall size (at around 5 per cent of housing loans written), but it is growing strongly. The rate of arrears on non-conforming loans appears to be much higher than the rate on housing lending by traditional lenders.

The non-conforming market does not, at this stage, raise any particular concerns from a financial stability perspective. Banks fund some of the origination and warehousing of these mortgages prior to securitisation and so carry some exposure to non-conforming lenders. Nonetheless, the exposure tends to be for a limited period and is secured against residential property. There may be a less direct impact on financial stability via house prices. At this stage of the cycle, the growth in the non-conforming loan market is adding to demand pressure in the housing market. If economic conditions were to change, however, marginal borrowers are likely to be more vulnerable and might be expected quickly to become distressed sellers in adverse circumstances. In this way, the non-conforming loan market might become a source of additional cyclicality in house prices.

Regulatory Co-operation

The RBA co-operates closely with the Australian Prudential Regulation Authority (APRA), which oversees the health of individual financial institutions, and with the Australian Securities and Investments Commission (ASIC), which has responsibility for market integrity and consumer protection across the financial system. Co-ordination between the three regulatory authorities is ensured at the highest level through the Council of Financial Regulators, which is chaired by the Governor of the RBA.

The Financial System Inquiry (Wallis Committee), whose findings were the genesis of Australia's current financial regulatory framework, thought that co-ordination arrangements with APRA would be bolstered by the presence on the APRA Board of two senior RBA representatives and one senior ASIC representative. However, this view was not shared by the Report of the HIH Royal Commissioner, which was released in April 2003. The Report questioned the participation of RBA and ASIC representatives on the APRA Board, and the usefulness of the Board itself. The Government has accepted the Report's recommendation that the APRA Board be replaced by an executive group, and legislation giving effect to these (and other) changes was passed by Parliament in June 2003. As a result, the RBA/APRA Co-ordination Committee, which was set up in 1998 under the RBA's chairmanship and has been meeting regularly since then, will now become the major focal point for co-operation and the sharing of information between the two agencies. The Council of Financial Regulators will also play a larger role than formerly. In particular, to ensure that co-ordination among the agencies with an interest in financial stability will continue at the highest level, the Treasurer, in June 2003 announced to Parliament that the Treasury would join the Council of Financial Regulators.

Payments System Developments

The Payments System Board of the RBA has a mandate to promote safety, efficiency and competition in the payments system in Australia and, since 2001, to promote the safety of systems that clear and settle securities transactions in Australia's wholesale financial markets.

Over recent years, the Payments System Board has been undertaking a major reform of card networks (credit cards, debit cards and automatic teller machines (ATMs)) that is intended to allow market mechanisms to operate more effectively in the retail payments system in Australia. As part of this initiative, in August 2002 the RBA, after extensive consultations, announced its reforms to credit card schemes in Australia. The reform measures involve:

- a standard on interchange fees that determines an objective, transparent and cost-based benchmark against which interchange fees in credit card schemes can be assessed (interchange fees are the fees paid to financial institutions which issue credit cards by financial institutions which provide services to merchants);
- a standard on merchant pricing which ends the restriction imposed by the international credit card schemes on merchants passing through to cardholders the costs of accepting credit cards; and
- an access regime that allows specialist credit card institutions authorised and supervised by APRA to apply to participate in credit card schemes.

The various reform measures come into effect over the course of 2003. In September 2002, MasterCard International and Visa International each filed applications in the Federal Court to have the reforms overturned. The matter was heard in May and June 2003 and judgment is expected later in 2003.

The RBA has also encouraged industry participants to reform interchange fees and access arrangements in Australia's debit card (EFTPOS) and ATM networks. The Bank believes that current arrangements have no sound basis in costs and that there is considerable scope to increase competition and efficiency in these sectors of the payments system. The ACCC has indicated that it intends to reject an industry proposal that addresses EFTPOS interchange fees but not access. The Bank encourages the industry to take up the ACCC's invitation to also address access to the EFTPOS network.

An industry proposal for a "direct charging" regime that would replace ATM interchange fees has been put out for public consultation. The RBA believes that the proposed regime will lead to more transparent pricing and greater incentives for competition in the provision of ATM services in Australia, to the benefit of ATM users, and has encouraged industry participants to finalise the proposed reform during 2003.

In the safety and stability area, the RBA has strongly supported efforts to reduce foreign exchange settlement risk through the establishment of CLS Bank, a special-purpose bank which settles foreign exchange transactions in major currencies. CLS Bank commenced operations in September 2002, with the Australian dollar one of seven "first wave" currencies to be included. The implications of CLS Bank for the RBA's operations are discussed in the chapter on Operations in Financial Markets.

During 2002/03, the management of Exchange Settlement (ES) accounts which banks and other eligible institutions hold at the RBA was reviewed. When real-time gross settlement (RTGS) arrangements were introduced in Australia in June 1998, it was decided that all banks would settle their RTGS transactions directly through their own ES accounts; the alternative of allowing banks to make their RTGS transactions through an agent was considered unacceptable from a risk perspective. In the light of experience since then, the Payments System Board concluded that, provided agency arrangements were limited to a relatively small proportion of the value of RTGS transactions, there would be no significant risk to financial stability if small institutions had access to another, possibly more efficient, means of making RTGS payments. In changes announced in March 2003, banks and other institutions eligible for an ES account, whose aggregate RTGS transactions are relatively small (defined as less than 0.25 per cent of all RTGS transaction values), may now make their RTGS transactions through an agent, although banks must still maintain an ES account for use in a contingency.

As part of the Payments System Board's broader stability mandate, the RBA has formal responsibility for ensuring that licensees of clearing and settlement facilities conduct their affairs in a way that promotes overall stability in the Australian financial system, and it has the power to set financial stability standards for such licensees. In May 2003, after a period of public consultation, the RBA determined financial stability standards that apply to licences held by entities owned by the Australian Stock Exchange and the Sydney Futures Exchange. There are two separate standards: one for central counterparties and another for securities settlement facilities.

Further information on payments system issues can be found in the Annual Reports of the Payments System Board.

OPERATIONS IN FINANCIAL MARKETS

The past year has seen continued evolution of the RBA's market operations on a number of fronts. A new intra-day liquidity facility was introduced and changes were made to the way open market operations are conducted. A greater range of material was also published on those operations. On the foreign side, the main point of interest for the year was the swing to net purchases of foreign currency, after five years when the RBA was a net seller. The shift in these operations reflected the turnaround in the exchange rate of the Australian dollar.

Domestic Market Operations

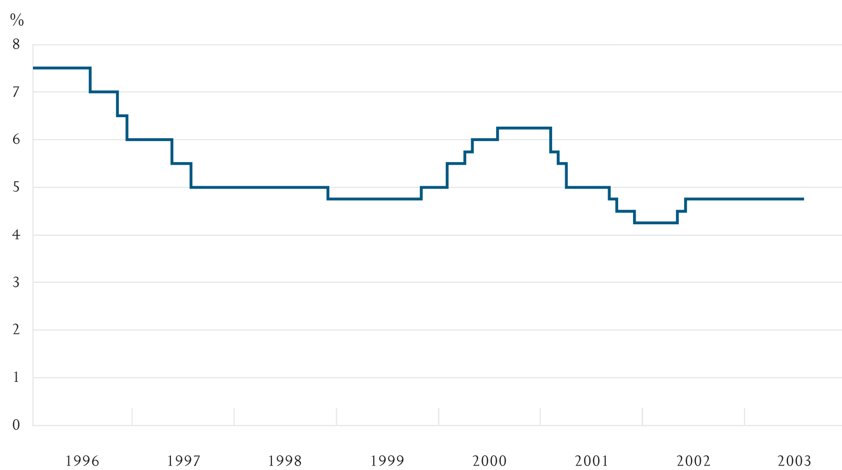
Monetary Policy Implementation [1]

The stance of monetary policy in Australia is expressed in terms of an operating target for the cash rate – the interest rate paid by banks on unsecured overnight loans. The target is determined by the Reserve Bank Board, with any change typically announced at 9.30 am on the day after the monthly Board meeting. The RBA operates in financial markets to maintain the actual cash rate as close as possible to the Board's target.

During 2002/03, the Board kept the target cash rate constant, at 4.75 per cent. The rationale for the Board's decisions was explained through the year, primarily in the quarterly *Statement on Monetary Policy* and in appearances before the House of Representatives Standing Committee on Economics, Finance and Public Administration.

Over recent years, deviations of the actual cash rate from the target have become smaller and less frequent as market participants have become more familiar with

GRAPH 13 | **TARGET CASH RATE**



Source: RBA

1 A detailed account of market operations, including their rationale and the processes involved was given in the June 2003 issue of the Reserve Bank *Bulletin*.

the current operating environment. During 2002/03, the cash rate was at the target on 88 per cent of days and the largest deviation was just 1 basis point.

Open market operations are conducted mainly in short-dated instruments, typically repurchase agreements (repos), most of which have a maturity of less than one month.[2] The use of repos mainly reflects the additional flexibility that they offer in managing day-to-day swings in liquidity. Outright transactions in Commonwealth Government securities (CGS) have been relatively infrequent over recent years, partly as a result of the decline in CGS on issue.

As in previous years, operations in domestic securities during the past year were augmented with foreign exchange swaps. This has been made necessary by the combination of the growth in the RBA's balance sheet and the decline in CGS on issue (see below). Typically, these swaps have maturities of less than three months and they are often rolled forward at maturity. As a result, the RBA's turnover in the swaps market was again significant in 2002/03, at around $90 billion.

A NEW DEALING ROOM, BRINGING TOGETHER THE DOMESTIC AND FOREIGN OPERATIONS IN ONE INTEGRATED AREA, CAME ON STREAM EARLY IN THE YEAR.

Open Market Operations ($ billion)

		1998/99	1999/00	2000/01	2001/02	2002/03
Repurchase agreements [(a)]	– Purchases	300	244	376	423	304
	– Sales	13	14	17	16	17
Short-term CGS	– Purchases	21	9	5	1	3
	– Sales	0	0	0	0	0
Total domestic operations		334	267	398	440	324
Foreign exchange swaps [(a)]		52	67	90	90	90

(a) First leg of transaction

2 Repurchase agreements involve a purchase or sale of securities with a simultaneous undertaking to reverse the transaction at an agreed date and price in the future.

During the year, a number of further changes to procedures for domestic operations were announced. These involved changes to repo operations, new arrangements to accommodate the start of continuous linked settlement, and the provision of more information on daily operations.

Changes to Repo Operations

In July 2002, the RBA began announcing each morning preferred terms for its repurchase agreements. Typically, two or three preferred terms are announced each day, generally for around one month or less. Prior to the new policy being introduced, market participants submitted bids/offers for a range of terms, usually less than one month, and the most suitable were selected. Now market participants have a clearer idea of exactly what maturities are sought, and are therefore in a better position to satisfy the RBA's requirements.

As part of this change, a decision was also taken to offer repos with longer terms in order to facilitate the development of the maturity profile of the repo market. Longer-term repos are usually offered once a week with terms of around 90 and 180 days.

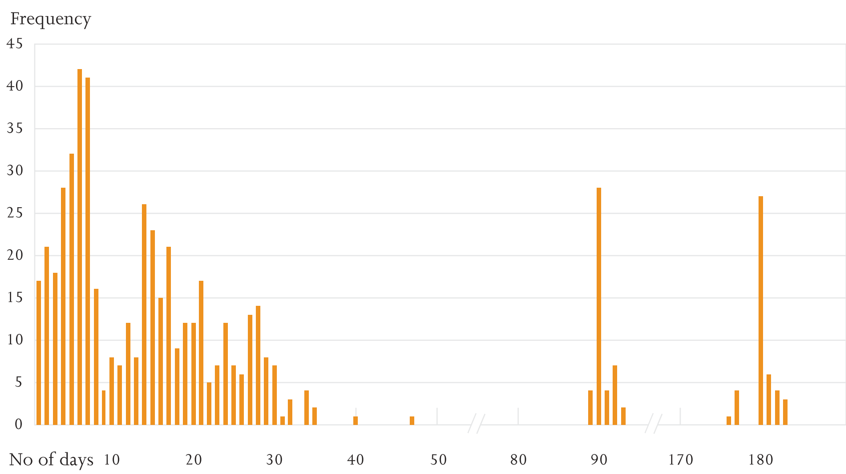
In allocating its operations across maturities, account is taken of forecast estimates of future swings in liquidity, as well as the pricing of the bids/offers received. The attractiveness of all bids/offers, including for the longer-term repos, is judged against market rates. There is no information content about the future course of monetary policy in the terms and rates that are accepted.

Over 2002/03, the RBA's turnover in repos was around $320 billion, of which around $22 billion was accounted for by the 90- and 180-day terms. The use of the longer maturities has meant that total turnover was down considerably on the previous year. It has also led to an increase in the weighted-average term of the RBA's outstanding repurchase agreements.

Continuous Linked Settlement (CLS)

An important development during the year was the commencement of operations of the CLS Bank, which operates a new global system for the settlement of foreign exchange transactions. Details of this system are given in the Business Services chapter.

GRAPH 14 | **RBA OPEN MARKET OPERATIONS – PREFERRED REPO TERMS** 2002/03



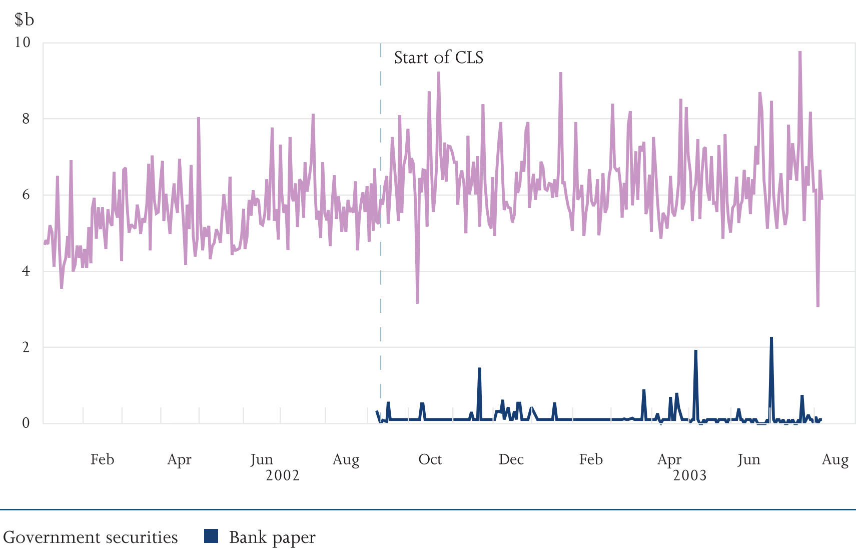
Source: RBA

While CLS has made a material contribution to reducing foreign exchange settlement risk, it has required financial institutions, including the RBA, to extend their operating hours, as CLS settlement takes place early in the European day. The extension to hours is most pronounced during Australian eastern daylight saving time, when the real-time gross settlement (RTGS) system is open until 9.00 pm. CLS has also created additional demands for intra-day liquidity, although to date the effect has been fairly modest. Total payments of Australian dollars to CLS each day have averaged around $2 billion, with most single payments by individual banks being less than $1 billion. Compared with the value being settled, these payments are relatively small reflecting the netting of members' pay-in obligations by CLS.

To assist financial institutions adjust to the introduction of CLS, the RBA introduced a new intra-day liquidity facility in September 2002 supplementing the existing intra-day facility based on government and supranational securities. Under the new facility, the RBA is prepared to undertake intra-day repurchase agreements in bank bills and negotiable certificates of deposit. Only securities issued by banks with a short-term credit rating of A1+ (or equivalent) and a long-term credit rating of at least AA- (or equivalent), and which have maintained a significant amount of eligible securities on issue over the previous year, are accepted. Also, the RBA will accept only third-party securities – a bank cannot present its own securities. A charge of 5 basis points per annum is levied on intra-day repos in bank paper, whereas there is no charge for intra-day repos in government and supranational securities.

The increase in demand for liquidity is evident in the rise in daily average turnover in intra-day repos. In the six months to September 2002, turnover averaged around $5.6 billion per day, while in the nine months since the introduction of CLS it has averaged around $6.5 billion. The new bank bill/certificate of deposit facility has been used on a regular basis, although the additional charge involved has generally made it more attractive for banks to generate intra-day liquidity using government securities, rather than bank-issued paper. Reflecting this, the bulk of the increase in intra-day repos has been under the longer-standing facility. The new facility, however, has played a role on

GRAPH 15 | **INTRADAY REPOS***



* First leg of transaction
Source: RBA

a number of occasions in allowing institutions to overcome payment bottlenecks that might have otherwise caused difficulties, particularly in making payments to CLS Bank.

In contrast to the increase in demand for intra-day liquidity, CLS has not led banks to hold higher balances in their Exchange Settlement accounts. Over the past year, these balances have been around $750 million on most days, a level similar to that in the previous year. Nor has there been any indication of an increase in the amount of borrowing and lending in the interbank cash market. On average, daily reported turnover (borrowing and lending) has remained fairly steady at around $7 billion. Around one fifth of the borrowing and lending that used to take place before 5.15 pm now takes place later in the day, towards the end of the CLS settlement session.

Use of the RBA's other liquidity facility – the overnight repo facility – has also remained subdued, consistent with the generally smooth operations of CLS. In 2002/03, this facility was accessed on only 14 occasions. Only one of the occasions was directly attributable to operational problems with CLS.

Overnight Repurchase Agreement Facility

	Number of times used	Value(a) ($ million)
1998/99	32	1 952
1999/00	11	862
2000/01	18	2 611
2001/02	11	673
2002/03	14	1 673

(a) First leg of transaction

Increased Information on Daily Operations

In June 2003, the RBA began publishing a wider range of information about the outcomes of its market operations. After consultation with financial market participants, it was decided to publish on a daily basis the amount dealt, the weighted-average and cut-off rates for each repurchase agreement term and details of the types of securities bought and sold under repurchase agreements. In addition, the RBA commenced publishing the aggregate level of Exchange Settlement balances on a daily basis, rather than weekly, as was previously the case. This information is now available since the start of 2003 on the website and in the monthly *Bulletin*.

The Government Securities Market

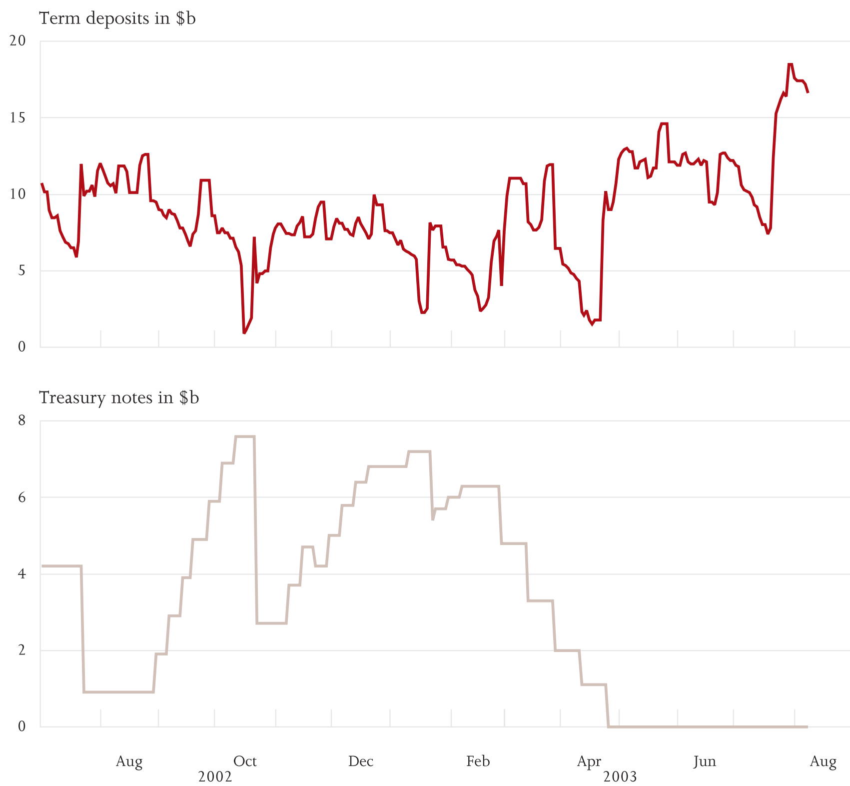
Over recent years, the decline in the stock of CGS on issue and projected budget surpluses and asset sales by the Australian Government had raised concerns about the future viability of the CGS market. In response to these concerns, the Government undertook a review of the market in late 2002, involving the release of a public discussion paper and extensive consultation with stakeholders. In announcing the outcome of the review, the Government indicated that it would maintain sufficient securities on issue to underpin liquidity in the Treasury bond futures market, given the important role that this market plays in the efficient management of interest-rate risk. The decision means that Treasury bonds will continue to be issued, although the outstanding stock of CGS is likely to continue to fall over the next few years.

The decision also means that, under current budget assumptions, the Government will continue to hold significant deposits at the RBA at various points in the year. Most of these deposits are held in term deposits of relatively short maturity, on which a market rate of interest is paid. They are used by the Government to help fund differences in the timing of its expenditure and receipts and thus fluctuate considerably over the course of a year. In 2002/03 they reached a low of just over $1 billion and a high of around $15 billion. As part of the review of the CGS market, the Government announced that, if these deposits were to exceed $25 billion on a sustained basis, it would consider alternative investments. Under current budget projections, and in the absence of the sale of the remainder of Telstra, this is unlikely to occur for some years.

Although the Government's deposits at the RBA can be large at times, they are not sufficient to deal fully with mismatches in timing of its receipts and expenditure. The Government, therefore, has also occasionally issued Treasury notes for within-year cash management, and will continue to do so. However, Treasury notes are no longer issued on a regular schedule, but rather on an as-needed basis. During 2002/03, $13.6 billion of notes were issued, with outstandings peaking in October at $7.6 billion. For the first time in over four decades, there were no Treasury notes outstanding at end June.

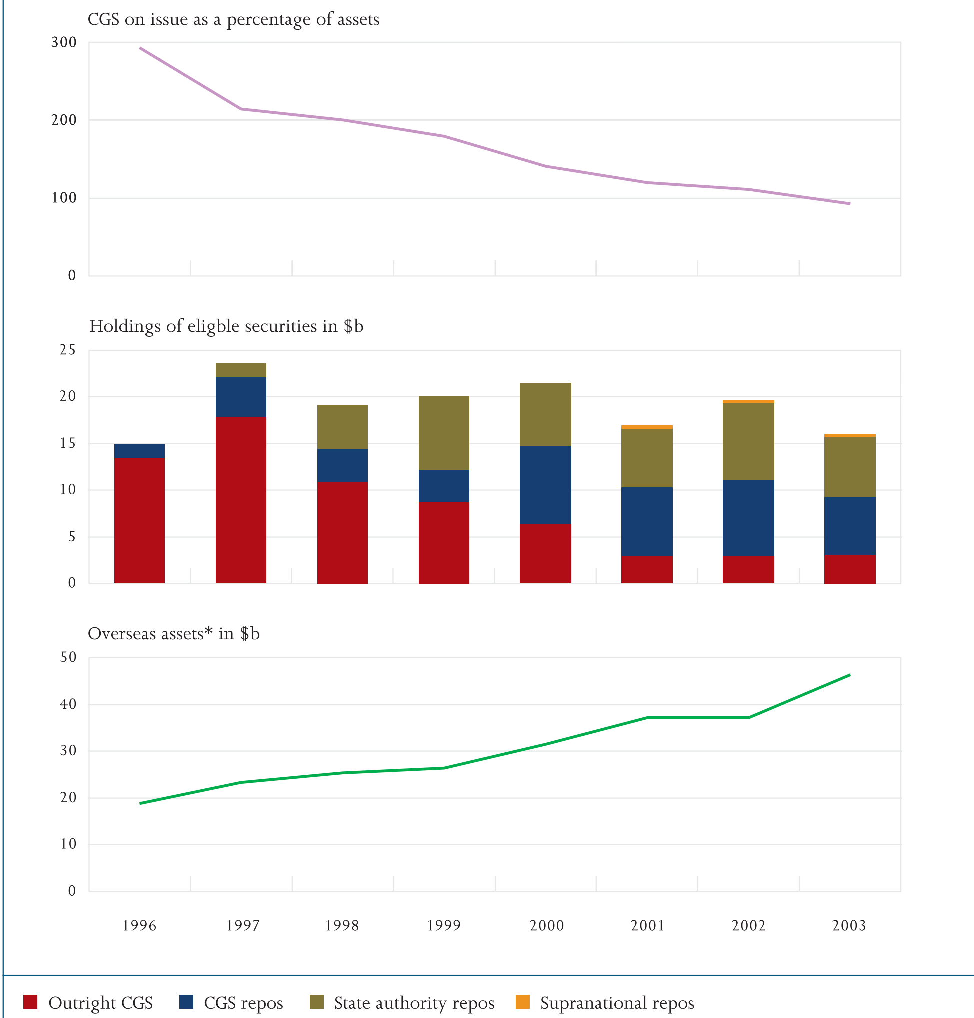
Recent budget outcomes have meant that the stock of CGS on issue has shrunk considerably relative to the RBA's balance sheet, which has continued to grow. In the mid 1990s, the face value of outstanding CGS was around three times the RBA's total assets. In contrast, by June 2003, the RBA's total assets exceeded the face value of CGS on issue. The RBA has responded to this change by widening the range of securities that it is prepared to accept under repurchase agreements when conducting its open market operations. In addition to CGS, it now accepts all domestic, and some offshore, Australian dollar securities issued by State and Territory borrowing authorities and AAA-rated Australian dollar securities issued in Australia by select supranational organisations. Reflecting this widening of eligible collateral, securities issued by entities other than the Australian Government accounted for 42 per cent of the RBA's domestic portfolio at end June 2003, up from 25 per cent five years ago.

GRAPH 16 | **GOVERNMENT TERM DEPOSITS AT THE RBA AND TREASURY NOTES OUTSTANDING**



Sources: AOFM; RBA

GRAPH 17 | **RBA BALANCE SHEET** As at 30 June



* Includes gold reserves and foreign exchange committed to forward sale

Source: RBA

Securities Lending

For many years the RBA has operated a facility through which it is prepared to lend on an outright basis Treasury bonds that it holds. This facility is offered to assist market participants cover temporary shortages of particular issues. The RBA is mindful, however, of not displacing activity among other market participants and lends securities only on terms that are less attractive than those in the market. Securities are lent through repurchase agreements and on an overnight basis, with the liquidity impact being offset by the RBA buying under a repurchase agreement a security that is not in unusually high demand. In 2002/03, the facility was used on 32 occasions, the lowest level of usage in recent years. In part, this outcome reflects the relatively smooth functioning of the CGS market over the past year, despite the further decline in stock on issue.

Securities Lending by the RBA

	Number of transactions	Amount lent face value ($ billion)	Net income ($ million)
1996/97	540	11.9	0.7
1997/98	935	16.7	1.1
1998/99	805	14.6	0.9
1999/00	510	8.9	0.6
2000/01	75	1.2	0.1
2001/02	119	3.1	0.3
2002/03	32	0.9	0.1

Foreign Exchange Operations

The RBA operates in the foreign exchange market both on behalf of clients and on its own account. During the past year the volume of operations undertaken for clients rose, and the RBA stepped up purchases of foreign exchange on its own account.

Client Transactions

The RBA's main client in the case of foreign exchange transactions is the Australian Government, which undertakes all its foreign exchange operations, apart from some small deals by individual agencies, through the RBA. The Government has a substantial ongoing demand for foreign exchange to pay for foreign goods and services. In addition, over the past year or so, it has had demand for foreign exchange in order to repay its cross-currency interest rate swaps, reflecting the decision made in June 2001 to undertake an orderly rundown of the foreign currency swap position that had been built up over the previous 15 or so years.

Reflecting these factors, the amount of foreign currency sold to the Government in 2002/03 rose significantly, to around $7.4 billion. Over the previous few years, sales to the Government had averaged closer to $5 billion. The RBA covered all sales to the Government during the past year by purchases of foreign currency – i.e. it did not meet any of the sales to the Government from its reserves, apart from bridging short-term timing mismatches. This is the normal practice in the absence of strong downward pressure on the exchange rate.

In addition to the above outright sales, the RBA also continued to undertake transactions with the Government to assist it to manage the maturity of its cross-currency interest rate swaps. These began in 2000 while the policy in relation to cross-currency swaps was being reviewed. Rather than enter into new long-term contracts to replace swaps maturing during the review period, the Government decided to roll those maturities into forward positions. These were handled through the RBA, given its long-standing experience in this market. The RBA did not take any of the positions from the Government transactions onto its own book; rather, it passed them through to the market so that, in effect, it acted only as an agent. These transactions involved the RBA supplying to the Government foreign currency which was sourced from the market.

After the Government decided to run off the cross-currency swaps, no new long-term contracts were entered into and any maturing swaps were either repaid or rolled over in short-term transactions with the RBA. As such, the Government's forward position with the RBA continued to rise for a time, reaching a peak of $2.5 billion in September 2002. Since then, it has been reduced to $225 million. This was facilitated by the Government increasing its outright purchases of foreign exchange as the exchange rate rose, allowing it not only to repay maturing cross-currency swaps but also most of the position with the RBA. It is likely that in the period ahead the Government will continue to use transactions with the RBA to bridge timing gaps between maturities of cross-currency swaps (which are quite lumpy) and its purchases of foreign exchange which take place in a smoother fashion.

Operations on Own Account

There is a range of operations that the RBA undertakes in the foreign exchange market on its own account. The most noticeable, though least frequent, outright transactions are those intended to influence the exchange rate – "intervention" in common parlance. In these cases, the RBA buys or sells the Australian dollar in exchange for US dollars, with a view to affecting not only the currency's short-term price but also expectations about its likely course over the longer run. Such transactions are typically infrequent, but in fairly substantial amounts, and may be accompanied by statements making explicit the RBA's views. Their impact on the domestic money market is fully offset, so that they have no impact on domestic monetary conditions.

The RBA also undertakes transactions to restore its reserve position after periods of intervention have occurred. Such transactions are typically consistent over a period of time, but in small amounts. While they probably, at the margin, have some impact on the exchange rate, they are undertaken in ways designed to minimise such effects. Their intention is to take advantage of a more favourable exchange rate to re-position the RBA's portfolio.

The third type of foreign exchange transaction is foreign exchange swaps, where a spot and forward transaction are simultaneously undertaken. There is no change to the RBA's exchange rate exposure and no effect on the exchange rate; these transactions are a regular part of the RBA's management of its own balance sheet and domestic liquidity.

Over the course of 2002/03, the RBA did not undertake any transactions of the first type outlined above. Even though the Australian dollar exchange rate appreciated significantly against the US dollar, it remained at a level below its post-float average and much of the move reflected the unwinding of the US dollar's rise in the second half of the 1990s. The Australian dollar was little changed against the euro for much of 2002/03 and the rise in the trade-weighted index was significantly less than that in the US dollar exchange rate. In other words, the rise in the Australian dollar represented the reversal of some of its overshooting in the downwards direction in earlier years.

The RBA did, however, begin to rebuild its foreign currency reserves by purchasing more than was needed to cover the Australian Government's requirements. These operations were undertaken in a low-key way, the aim being to accumulate reserves rather than to affect the exchange rate. Net foreign exchange reserves rose from $8.7 billion to

GRAPH 18 | **AUSTRALIAN DOLLAR** Daily

US$ per A$ Average 1984–2003
Source: RBA

$11.2 billion over the year. This reversed only part of the rundown in reserves in previous years which resulted from intervention-related sales of foreign currency and sales of foreign exchange to the Government.

The RBA also undertook a number of foreign currency transactions with the IMF during the year. Countries in a strong financial position are often asked by the IMF to provide foreign exchange which the IMF then on-lends to other members. About $545 million of foreign exchange was sold to the IMF during the year. This did not impact on Australia's overall holdings of official reserve assets, as the country's reserve position at the IMF was credited with an amount equal to the foreign currency supplied.

Reserves Management

Foreign currency reserve assets and gold are held primarily to support intervention in the foreign exchange market. In investing these assets, priority is therefore given to liquidity and security, in order to ensure that the assets are always available for their intended policy purposes. Consistent with this, investments are largely confined to instruments issued by highly rated foreign governments, government agencies and financial institutions.

The portfolio is managed passively against a benchmark which specifies asset and currency allocation across the countries in which reserves are held (the United States, the euro area and Japan) as well as the duration of the portfolio. The respective weights given to the three areas are 45 per cent, 45 per cent and 10 per cent, while the duration of the portfolio is set at 30 months. Within narrow limits approved by the Governor, there is some discretion to manage exposures around the benchmark in order to respond to market developments.

The Benchmark Portfolio

	US	Euro area	Japan
Asset allocation			
(% of total)	45	45	10
Currency allocation			
(% of total)	45	45	10
Duration (months)	30	30	30

The return on foreign currency assets for the year was 6.7 per cent measured in Special Drawing Rights (SDRs). This was higher than the previous year and above the average of the past decade. This reflected large capital gains as yields on bonds fell sharply, particularly in the first half of 2003. Returns also benefited from the changes to the benchmark portfolio introduced in 2002. Those changes, which involved a reallocation away from Japan and into the euro area and, to a lesser extent, the US, were undertaken in response to structural changes taking place in Japanese markets and in particular the declining credit rating of Japanese Government bonds. These changes served to boost returns in 2002/03 above those that would otherwise have been achieved, as Japanese investments significantly underperformed those in the euro area.

Rates of Return in Local Currency by Portfolio (per cent)

	US	Euro area	Japan
2000/01	8.6	5.7	2.3
2001/02	6.1	4.7	0.4
2002/03	6.6	7.2	1.3

Decisions taken by portfolio managers under the trading discretion available to them added $77 million, or 25 basis points, to returns for the year. This was split between transactions which took advantage of short-term market anomalies ($51 million) and returns from lending securities ($26 million). The other change to the benchmark which occurred in 2002 – the broadening of euro investments to include French as well as German securities – also helped in this regard as there were increased stock-lending opportunities in the French market.

Actual and Benchmark Returns

	Rates of return in SDRs (per cent) Actual	Benchmark	Value of difference (A$ million)
1991/92	9.8	8.9	165
1992/93	16.3	11.6	420
1993/94	4.0	3.8	31
1994/95	5.2	7.4	-331
1995/96	4.0	3.7	40
1996/97	4.5	4.2	34
1997/98	4.5	4.6	-19
1998/99	4.9	5.1	-26
1999/00	2.8	3.8	-202
2000/01	11.0	10.8	74
2001/02	3.9	3.7	63
2002/03	6.7	6.4	77

The range of eligible securities in the foreign portfolio was widened slightly further late in the year, with the RBA announcing that it would subscribe US$50 million to the Asian Bond Fund. The Fund is an initiative of the EMEAP (Executives' Meeting of East Asian and Pacific central banks) group and is designed not only to expand investment opportunities but also to promote bond markets in the region. The Fund invests in a basket of US-dollar denominated bonds issued by a number of Asian sovereign and quasi-sovereign borrowers and has an initial size of US$1 billion. It is managed by the Bank for International Settlements.

In addition to foreign currency assets, the RBA also holds a small part of its assets in gold-approximately 80 tonnes, or about $1.3 billion. The return on this holding comprises the capital gain or loss resulting from changes in the price of gold, as well as the small interest return available through the gold-lending market.

The price of gold (in US$ terms) was particularly volatile over the past year, owing to the uncertainties about the conflict with Iraq and heightened tensions in north Asia as well as the falling value of the US dollar. At the end of June 2003, the gold price, in US dollar terms, was 8.4 per cent higher than a year earlier.

The RBA continued to lend gold, a program that has been in place for over a decade now. However, interest rates on gold loans fell sharply over 2002/03. The average rate on one-year loans in 2002/03 was around 0.5 per cent, compared with 1.2 per cent in the previous year. Returns from gold lending were, however, cushioned to some extent by the decision in early 2002 to lengthen the average term-to-maturity of gold loans, as this locked in those earlier higher rates. The return for the year was $19 million, down only marginally from the previous year.

Taking into account the increase in the price of gold and the interest on gold loans, the total return on gold assets in 2002/03 (measured in SDRs) was 3.4 per cent, compared with 13 per cent in the previous year. The return in the latest year was below that suggested by the increase in the US dollar price of gold owing to the depreciation of the US dollar against most major currencies. While the gold price has risen in US dollar terms over the past couple of years, it has been fairly steady when measured, for example, in euros.

Risk Management

The RBA is exposed to various risks in undertaking its financial market operations. They can be categorised under five headings.

- **Credit Risk:** The RBA's credit exposures are relatively low as its operations are mainly in government securities markets.

  For much of the RBA's history, domestic dealing was exclusively in Commonwealth Government securities (CGS), which involves no credit risk for the RBA as the Government is its owner. However, as noted above, the falling supply of CGS has meant that the RBA has had to broaden its operations beyond these securities. This began in 1997 when it included as eligible collateral in its repo operations securities issued by State and Territory borrowing authorities and, more recently, supranational organisations that have an AAA rating.

Counterparty exposures arising from domestic dealing relationships are generally small as all securities transactions are settled on a delivery-versus-payment basis – i.e. in settlement systems that allow the simultaneous transfer of cash and securities. There is some exposure to counterparties in repo transactions in the sense that, should a counterparty fail in its obligation to repurchase the securities it has sold to the RBA, it is possible that the value the RBA could realise from liquidating the securities would be less than the cash supplied to the counterparty. However, this risk is reduced by requiring that the counterparty lodge securities in excess of the value of the money being lent, and all security collateral is marked to market daily.

In the case of foreign assets, the RBA again seeks to confine its operations to highly-rated securities. The bulk of the foreign assets (over 80 per cent) is held in the form of securities issued by the US, German, French and Japanese Governments. As in the case of domestic operations, the RBA insists, in all its foreign operations in repos and loans of securities and gold, that collateral supplied by the counterparty is in excess of the value of the cash or assets being loaned.

The RBA also holds deposits with foreign commercial banks, which entail some credit risk. However, tight limits are maintained on these exposures. No more than 25 per cent of each currency portfolio can be held in the form of commercial bank deposits and the maximum maturity of each deposit may be no more than three months. In addition, there are credit limits on individual counterparties, based on the counterparty's financial strength, credit rating and the size of its capital. These credit limits also cover settlement risk and the risk that a counterparty defaults on a repurchase agreement or gold loan. Reflecting the very high standards applying to credit exposures, the RBA has not experienced any losses due to counterparty default.

- **Interest Rate Risk:** With the RBA holding much of its financial assets in the form of fixed income securities, it is exposed to considerable interest rate risk. This is the risk that the value of the securities will fall due to rises in market yields. Importantly, it is impractical to use the liability side of the RBA's balance sheet to offset this risk, owing to the unique composition of these liabilities, viz, notes on issue (which carry no interest rate), current deposits of clients (which pay a floating interest rate) and capital.

As a result, the RBA has developed a framework based on an acceptable level of interest rate risk. This applies only to foreign investments: in the case of the domestic portfolio, the need to give priority to monetary policy considerations means that interest rate risk cannot be managed actively. Interest rate risk in the domestic portfolio is, however, relatively low as the bulk of the portfolio consists of short-term repos.

For foreign assets, as noted earlier, a duration benchmark has been set at 30 months, with the maximum term to maturity of any single security limited to $10^1/_2$ years. This duration target was determined on the basis of the RBA's preferences for risk (i.e. volatility of returns) and return using financial modelling techniques to examine the trade-off between return and risk.

- **Exchange Rate Risk:** The RBA is required to hold a portfolio of foreign currency assets to give it the ability to conduct intervention operations in relation to the Australian dollar. This portfolio is exposed to exchange rate risk resulting from movements in the Australian dollar against the foreign currencies that the RBA holds.

Foreign exchange risk applies only to that part of foreign currency holdings that is held outright, as opposed to that part held under foreign exchange swap agreements. Foreign currency held under swap agreements does not expose the RBA to exchange rate risk as the exchange rate for the forward sale of the currency is agreed at the time the swap is entered into.

The share of the RBA's portfolio of financial assets exposed to exchange rate risk has averaged around 50 per cent in the period since the float of the Australian dollar. However, it has varied widely due to the pattern of intervention operations as the exchange rate has risen and fallen. In the late 1980s, for example, the ratio was as high as 90 per cent when the RBA was intervening in the market, buying foreign exchange and selling Australian dollars to limit the rise in the exchange rate. In contrast, the ratio fell to about 10 per cent in late 2001 when the exchange rate was around an historically low level. Since then, the RBA as noted earlier has begun gradually to rebuild its outright holdings of foreign currencies, and the ratio of assets subject to foreign currency risk has risen to about 20 per cent. This is still well below historical norms.

- **Reputational Risk:** Operations in financial markets also expose the RBA to the risk of damage to its reputation. This could occur, for example, if it were to sustain large financial losses which could have been avoided. Reputational risk may also arise from other means, such as:
  - ineffectual undertaking of policy tasks, such as the targeting of the official cash rate;
  - mismanagement of market or policy-sensitive information; and
  - mismanagement of professional relationships with the public, the market or other official institutions and agencies.

  Damage to the RBA's reputation could impair its ability to carry out its statutory responsibilities, leading to a loss of authority and credibility in performing its core objectives. As a result, the RBA has a number of controls in place designed to limit the potential damage to its reputation. These include extensively documented policies and procedures, regular management review of procedures and controls, ensuring adequate and appropriate training is provided to staff, an internal audit of most areas of the RBA's financial market operations at least once a year and, where possible, the timely release of information to the public.

- **Operational Risk:** The nature of the RBA's operations means that it undertakes a large volume of transactions each day. Around 44 000 transactions were undertaken in 2002/03, compared with 42 000 in the previous year. Average daily settlement flows were around $19 billion. Thus, it is essential that its systems be efficient and robust, and that they ensure adequate separation of duties to prevent staff who initiate transactions from being involved in settling them. These systems have several key elements: there is a clearly defined decision-making hierarchy, with overall guidelines and limits determined by the Governor and authority for decisions clearly delegated below that; there is an organisational structure that maintains clear separation between the front office (dealing), middle office (risk management) and back office (settlement); and computer systems incorporate the various risk controls, which allow dealing staff to monitor compliance with various limits in real time. As discussed below, the RBA is currently upgrading the computer systems that support its financial market operations. It is also currently upgrading disaster recovery arrangements in order to reduce further the risk of disruption to its systems.

The RBA entered into a contract with Openlink in mid 2003 to install a new financial markets trading platform. The system will replace a number of existing systems, some externally provided and some internal, with the aim of putting all the dealing functionality and risk controls onto one integrated platform. The system is expected to be fully operational by mid 2004.

INTERNATIONAL FINANCIAL CO-OPERATION

The RBA works with other areas of the Australian Government to further Australia's interests at the international level through participation in various multilateral forums such as the International Monetary Fund (IMF), the Group of 20 (G20), and the Finance Ministers' process of the Asia-Pacific Economic Cooperation forum (APEC). In several forums – the Bank for International Settlements (BIS) and its associated committees, the Financial Stability Forum (FSF) and the Executives' Meeting of East Asian and Pacific central banks (EMEAP) – the RBA is Australia's representative.

Australia's approach to international economic and financial relations is co-ordinated by the International Economic Policy Group, a Canberra-based committee chaired by a senior official from the Department of Prime Minister and Cabinet. Along with the Departments of Foreign Affairs and Trade and Treasury, AusAID and some other agencies, the RBA is an active participant in this Group.

Bank for International Settlements and Associated Committees

The RBA attended meetings held by the BIS during the year for governors or deputy governors of central banks from the major industrial and emerging market economies. These meetings provide an opportunity for central banks to discuss developments and major issues in the global economy and financial markets. These bi-monthly meetings, usually at the BIS head office in Basel in Switzerland, are supplemented by occasional Special Governors' Meetings held in the Asian region. The most recent of these, in February 2003, was hosted in Sydney by the RBA.

The BIS also hosts a number of committees which aim to promote international co-operation and the sharing of information among central banks. The RBA participated in some of these committees during the year. These included the Markets Committee, the Committee on the Global Financial System (CGFS) and the Committee on Payment and Settlement Systems (CPSS).

The Markets Committee brings together senior officials responsible for market operations to discuss developments in foreign exchange and capital markets. Its discussions during the year focussed largely on market conditions, but it also dealt with a number of special topics, including undisclosed principal trading and the involvement of central banks and the BIS in the continuous linked settlement system for foreign exchange. The CGFS also focuses on financial markets, but with a view to identifying potential sources of vulnerability. Much of the Committee's work in 2002/03 was focused on three working groups, all of which included RBA representation. The working groups on credit risk transfer and incentive structures in institutional asset management issued reports in January and March 2003, respectively. The other, on finance sector foreign direct investment in emerging market economies, is expected to complete its report by the end of 2003. Another working group, on the role of rating agencies in structured finance, is in the process of being established.

The CPSS monitors and analyses developments in domestic payment, settlement and clearing systems, as well as in cross-border and multi-currency settlement schemes. In 2002/03, the RBA contributed to a CPSS report on the policy issues relating to retail payments for central banks and also continued its representation on the CPSS Sub-Group on Foreign Exchange Settlement Risk. The major task of the Sub-Group over the past year has been to co-ordinate approval processes for the inclusion of participating currencies in the continuous linked settlement system and ongoing oversight of participation in the system.

The BIS also undertakes, independently of these committees, programs aimed at improving information exchange between central banks on issues such as central bank governance and statistical collections. The RBA participates regularly in these programs.

Asian Consultative Council

A BIS initiative of particular relevance to members in our region was the establishment, in July 1998 in Hong Kong, of the BIS Representative Office for Asia and the Pacific. This has enabled the BIS progressively to expand its transactional services for central banks in the region, including the RBA. The Office has also organised a number of meetings and workshops on economic and financial issues of relevance to regional central banks. In 2001, the BIS created the Asian Consultative Council (ACC) as a means of guiding the work of the Office and more generally of the BIS in the region. The ACC consists of governors of the major central banks in the region. Ian Macfarlane was the inaugural chairman of the Council before passing the Chair in February 2003 to Joseph Yam, the Chief Executive of the Hong Kong Monetary Authority.

Financial Stability Forum

The FSF was established in 1999 to provide a forum for authorities responsible for financial supervision, surveillance and stability. It includes central banks, ministries of finance and supervisory agencies of the G7 countries (the largest industrial countries) and the governors of the central banks of four other economies with globally significant markets (Australia, Hong Kong, the Netherlands and Singapore).

An important element of the FSF's role is its ongoing monitoring of potential vulnerabilities in the international financial system. In the past year, it has looked at the impact of increased risk aversion in emerging economy bond markets, the transitory impact of war in Iraq, and the pressure placed on financial systems by weak world growth. The Forum has taken a particular interest in developments in household and corporate balance sheets and their sensitivity to changes in interest rates and exchange rates. A discussion of these risks in the Australian context can be found in the Financial System Stability chapter of this Annual Report.

Beyond these conjunctural issues, the Forum has promoted and co-ordinated reform efforts by national authorities and international organisations in areas such as corporate governance, auditor independence and oversight, audit practice standards and accounting standards. Initiatives supported by the FSF in the past year have included an OECD review of its Principles of Corporate Governance, the release of principles on auditor independence and oversight by the International Organisation of Securities Commissions, and progress on convergence between International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) standards. The Forum will continue to assess reforms in these areas with a particular focus on the promotion of coherence and convergence.

Last year the Forum requested decisive action by key reinsurance regulators to improve transparency and disclosure in the reinsurance industry – an area of some interest to Australia following the HIH collapse. This request has been taken up by the International Association of Insurance Supervisors (IAIS). The IAIS Task Force on Enhancing Transparency and Disclosure in the Reinsurance Sector is developing a proposal for a global reinsurance market database that would allow analysis of the nature and scope of the industry's risk-taking, its resilience and soundness, and knock-on effects if a major reinsurer should fail.

One of the ongoing goals for the Forum has been to improve the supervisory, regulatory, information-sharing and co-operation practices of offshore financial centres (OFCs). The IMF has been undertaking assessments of these jurisdictions since late 2000. By the end of 2003, it will have assessed all of the significant OFCs identified by the Forum in May 2000 as priorities for assessment. In the IMF's view, OFCs have been able to focus resources on the areas of offshore business that are important for their jurisdiction. While weaknesses remain, observance of supervisory and regulatory standards among the OFCs assessed to date is similar to that of other countries. The Forum will consider at its meeting in September 2003 how progress can be maintained.

Executives' Meeting of East Asian and Pacific central banks

The mainstay of regional central bank co-operation for the RBA continues to be the EMEAP group of eleven central banks from the region (Australia, China, Hong Kong SAR, Indonesia, Japan, Korea, Malaysia, New Zealand, the Philippines, Singapore and Thailand). The group meets at the governor, deputy governor and working group levels and has also introduced a new forum for information technology (IT) directors.

In addition to being active at all levels of EMEAP, the RBA has in the past year hosted meetings of IT directors, the Working Group on Financial Markets and the Working Group on Payment and Settlement Systems.

One of EMEAP's major achievements over the past year has been the establishment of the Asian Bond Fund (ABF), in conjunction with the BIS. EMEAP member central banks have invested a total of US$1 billion of foreign exchange reserves in the Fund, which will in turn invest in a basket of US-dollar denominated bonds issued by sovereign and quasi-sovereign issuers in EMEAP economies (other than Japan, Australia and New Zealand). At the same time as establishing the US-dollar denominated ABF, EMEAP announced that it will study the feasibility of extending the investment to include bonds denominated in regional currencies. Australia's investment in the ABF is discussed in the chapter on Operations in Financial Markets.

While only a small step when judged against either the size of aggregate foreign reserves in the EMEAP group or even against the size of regional bond market issuance, the establishment of the ABF is significant for EMEAP. It represents a firm commitment by the member central banks to regional bond market development and, while most of the potential benefits from this would come from the local-currency fund which is yet to be established, the initial US-dollar based step represents EMEAP's first collaborative financial commitment.

International Monetary Fund

Although Australia's relationship with the IMF is conducted mainly through the Treasury, there are several areas where the RBA has a role. In the past year, these have been primarily in the debate on sovereign debt restructuring and in the provision of resources for technical assistance co-ordinated by the IMF.

Sovereign Debt Restructuring

The possible benefits from, and design for, a well-defined and predictable mechanism for working-out sovereign debt crises were placed on the international agenda in late 2001 in a speech by IMF First Deputy Managing Director, Anne Krueger. She proposed a statutory international system – a Sovereign Debt Restructuring Mechanism (SDRM) – that would be established by amending the IMF's Articles. In its initial form, the proposal entailed a significant role for the IMF in co-ordinating and approving restructurings, though later refinement of the proposal reduced the Fund's direct role to providing an independent judicial body to verify claims and settle disputes.

At the same time that the IMF was refining its proposal, there was a parallel push for a system where, rather than overriding the contractual terms of debt contracts, the contracts themselves would be amended to include mechanisms to make it easier to restructure sovereign debt – referred to as collective action clauses (CACs). New bond contracts could, among other things, include terms which allowed decisions of a large majority of bondholders to bind the minority, reducing the incentives for minority bondholders to hold out for a better deal. A third approach, based on a code of conduct among lenders and borrowers, also gathered some momentum during the year.

The debate on these proposals was conducted in a number of forums in 2002/03, most importantly in the IMF itself and in the G20 (see below). In April 2003, the IMF's International Monetary and Financial Committee concluded that there was not enough support among members to move forward with the SDRM at this time. On the other hand, much progress was made on the more widespread acceptance of CACs in sovereign bond contracts. Beginning with Mexico in February 2003, several sovereigns have issued bonds containing CACs into the US market, including Brazil, Korea, South Africa and Uruguay (as part of a debt exchange).

The RBA was an active participant in the debate. An RBA research project supported the conclusion that collective action clauses do not increase borrowing costs for sovereign bond issuers, negating the concerns of many emerging market investors, as well as a number of sovereigns, that the CAC approach to restructuring would lead to higher borrowing costs for emerging markets. The RBA presented these and related findings in a number of international forums, including the G20 and the Reinventing Bretton Woods Committee.

IMF-Sponsored Technical and Financial Assistance

The Australian Government, under the *International Financial Agreements Act*, provides financial assistance from time to time to individual countries in conjunction with assistance programs from the IMF and other bodies. Sometimes this assistance is provided by the RBA, as agent of the Government. The one outstanding example of such financial assistance in 2002/03 was the foreign exchange swap facility established with the Bank of Thailand in 1997, as part of a regional financing package in support of the program put in place by the IMF to assist Thailand in dealing with what became the Asian financial crisis. Drawings of US$862 million were made under this facility up to mid 1999, and repayments began in early 2001. By the end of June 2003 only US$43.8 million remained outstanding, with this amount repaid by mid July 2003.

During 2002/03, the RBA provided assistance in a training course in Singapore sponsored by the IMF, and in the reviews of Hong Kong SAR and Macedonia that were undertaken by the IMF under its Financial Sector Assessment Program.

Group of Twenty

The G20 was established in 1999 to bring together a cross-section of systemically significant economies to broaden dialogue on major economic and financial policy issues and to promote sustainable and equitable economic growth through international co-operation. The main meetings of the G20 are an annual meeting of finance ministers and central bank governors, at which Australia is represented by the Treasurer and the Governor, and bi-annual meetings of senior officials from participating countries, at which Australia is represented by Treasury and RBA staff. The G20 also sponsors occasional conferences on major issues, such as the conference on Globalisation, Living Standards and Inequality which was jointly hosted by the RBA and Treasury in Sydney in May 2002.

The focus of the G20 over the past year has been on members' experiences with globalisation and market reform. Group members finalised in 2002 case studies outlining their own – predominantly positive – experiences with globalisation. The present G20 agenda aims to build upon this work, with member countries undertaking further case studies on the role of financial sector institution-building in promoting economic growth. These studies are due to be finalised later in 2003. An Australian study is being prepared jointly by the RBA and Treasury.

Other issues discussed by the G20 over the past year have included combating terrorist financing and money-laundering, improving the effectiveness of official development assistance, promoting international trade and investment flows and, as discussed above, new proposals on sovereign debt crisis prevention and resolution.

APEC

The RBA participates in the Finance Ministers' process within the APEC forum, together with Treasury. In the past year, the main contribution has been to act as Convenor of the Expert Panel for Thailand in the APEC initiative on Securitisation and Credit Guarantee Markets in Asia.

Bilateral Relations and Technical Assistance

A large number of bilateral and informal relationships with regional central banks have been maintained. An important element of these bilateral linkages is the provision of technical assistance. Assistance in the past year was given to a number of central banks in the Asia-Pacific area, mainly in areas of liquidity management and securities markets. The RBA also provided technical experts to lecture at training courses run at the SEACEN (South East Asian Central Banks) Centre.

BUSINESS SERVICES

The RBA provides a range of services including banking services to the Australian Government and other customers; a registry of Commonwealth Government securities and other securities; payments and settlement services; and currency distribution services. The commercial activities are run as individual businesses which seek to recover their full costs, and earn a return on notional capital, through fees and charges.

The RBA's principal focus in carrying out these activities as a central bank derives directly from the *Reserve Bank Act* which, among other things, says that:

- the RBA is empowered to carry on business as a central bank, and shall, in so far as the Commonwealth requires it to do so, act as banker and financial agent for the Commonwealth; and
- the RBA is empowered to print currency notes, and to issue, reissue and cancel currency notes.

Accordingly, the principal focus is:

- for banking and registry, to service the Commonwealth's requirements;
- for settlement services, to develop and operate sound, reliable payment and settlement systems that ensure that risks are well identified and controlled and that limit the spread of any problems that might arise; and
- for currency services, to meet the community's requirements for clean, counterfeit-free currency.

These activities are carried out by the Business Services Group which comprises the Banking, Payments Settlements and Note Issue Departments. Services are delivered through Head Office in Sydney, the branch in Canberra and via the National Note Processing Centre (NNPC) operated by the RBA's subsidiary, Note Printing Australia Limited (NPA), at Craigieburn, Victoria.

During the year, the South Australian Government completed the evaluation of tenders for its transactional banking requirements and decided to move its banking from the RBA to another supplier. As a result, the RBA's Adelaide branch was closed on 14 March 2003.

Government Banking

Over recent years, the RBA's government banking activities have been repositioned to manage the effects of the Australian Government's competition policy on the market for transactional banking services. Since 1 July 1999, the banking business has been separated into two components – a core central banking facility is provided to the Department of Finance and Administration (Finance), which is non-contestable in terms of the Australian Government's competition policy, and transactional banking services are provided for government agencies in competition with private sector service providers.

In its core central banking role, the RBA maintains a group of bank accounts for the Australian Government, including the Official Public Account (OPA), whose aggregate balances represent the Government's daily cash balance and a term deposit facility for the investment of temporarily surplus Government funds. The Australian Government also has access to a strictly limited overdraft facility.

Under the core banking arrangements, payments are made from the OPA to agencies and end-of-day balances of agencies which come within the scope of the *Financial Management and Accountability Act 1997* (*FMA Act*) held with transactional bankers are swept back to the OPA overnight. These balances are returned to transactional bankers at the start of the next business day. The service also includes electronic collection of forecasting data and reporting on high-value transactions from agencies and transactional bankers to assist the RBA in the discharge of its monetary policy and liquidity management responsibilities. Finance has indicated that these reporting arrangements will be extended to include agencies subject to the *Commonwealth Authorities and Companies Act 1997* (*CAC Act*).

Over recent years, the RBA has also administered a term deposit facility on behalf of Finance into which agencies deposit temporarily surplus departmental funds. During 2002/03, 5 042 deposits totalling $49 billion were made using this facility, compared with $62 billion (7 300 deposits) in the previous year. The much lower usage by agencies of the term deposit facility in the current year partly reflects changes following a Finance review of the operation of the facility which saw this arrangement discontinued from 1 July 2003.

The other component of the banking business is the provision of contestable transactional banking services to government customers. Under the Australian Government's devolved banking arrangements, agencies governed by the *FMA Act* are required to market-test their transactional banking requirements. Market-testing has been taking place over the past few years and the RBA has retained the business of 70 per cent of the agencies which have reviewed their transactional banking requirements and supplier arrangements. With all but a few agencies having now completed market-testing, emphasis has moved from consolidation of the banking business to continuing the development of transactional banking products and service delivery methods designed specifically for the unique needs of the Government. Monitoring and reporting of performance against the service level standards specified in contracts is ongoing. Feedback from customer service reviews confirms a very high level of customer satisfaction.

A major feature of transactional banking activity performed for government agencies is the processing and distribution of electronic direct entry transactions through the RBA's Government Direct Entry Service system. The number of electronic transactions processed during 2002/03 showed a slight decrease to 215 million, from 218 million the previous year. The fall in transactions, caused by the loss of the South Australian State Government business during the year, was partly offset by a general increase in electronic transactions by government agencies serviced by the RBA.

Earnings after tax for the contestable transactional banking business in 2002/03 were $3.2 million, compared with $2.9 million in the previous year.

Business Developments

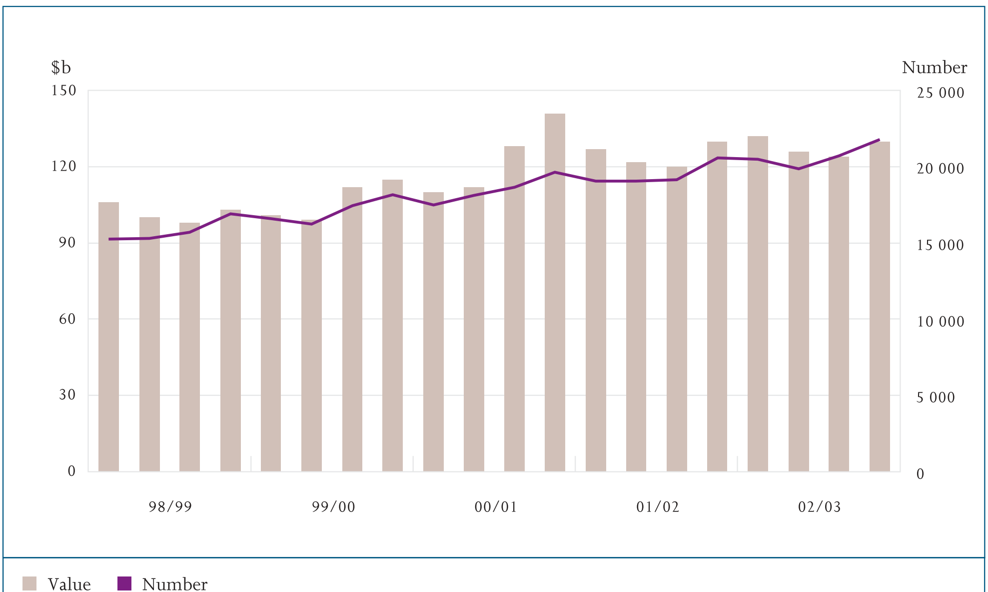
The facility developed in conjunction with Centrelink to enable the direct crediting of Australian pension payments to overseas bank accounts in local currency has now been fully implemented. The facility enables Centrelink to make Australian pension payments directly into overseas bank accounts using recipient countries' automated clearing houses. Approximately 75 per cent of Centrelink's overseas pensioners now use this secure and timely delivery method. The new service has provided Centrelink with a number of service improvements including reduced transaction costs and back office savings, but just as importantly has delivered significant benefits to pensioners living overseas, including improved timing, lower cost and greater convenience over traditional paper-based payments. In the past these payments, made by cheque, took between two and four weeks to be delivered due to printing and local mail service delays and were often subject to expensive and lengthy clearance processes. In light of this very favourable feedback, Centrelink proposes to mandate direct crediting of overseas payments in those countries where the automated clearing house facilities are available.

The RBA's Cheque Reconciliation and Verification System (CRVS), which was developed in response to an increase in the incidence and sophistication of cheque fraud, has continued to be highly successful in detecting fraudulently altered cheques. The system combines cheque issue data provided by customers and image technology to verify that the information on the cheques when presented through the banking system is the same as that printed on the cheque when issued. CRVS enables the RBA to detect quickly changes to cheque information, thereby protecting itself and its customers from losses due to fraudulent cheque alteration. In the twelve-month period to end June, CRVS detected 178 fraudulent cheque alterations with a total value of approximately $2.2 million. CRVS also provides a same-day cheque tracking and reconciliation system to complement the cheque verification component of the system. It is intended that those features of the cheque reconciliation system which assist enquiry and reconciliation processes will be made available to customers during 2003/04. A number of additional back-office processes, such as dishonouring cheques, have also been integrated into CRVS, reducing reliance on physical access to cheques and vouchers to perform the tasks involved. In addition to saving staff time, this has reduced the volume of cheques transported between processing centres.

While the majority of government agencies use *ReserveLink*, an electronic banking package, to transfer and receive data files with the RBA, work continued during the year on establishing the infrastructure for secure banking services via the Internet. The new facility will provide customers with an account enquiry function and access to the output of back-office cheque processing functions to provide on-line reports on the status of cheque presentations as well as high-resolution images of presented cheques. A successful pilot of the system has been conducted and discussions are under way with interested customers on implementing the service over coming months. There are no plans to allow value payments to be effected via the Internet. These payments will continue to be made via *ReserveLink* or direct data link. However, the RBA is monitoring developments in Internet security technologies which might provide the required level of security and meet all relevant Australian Government guidelines to enable value payments to be made over the Internet.

In response to the specific needs of a number of Australian Government agencies, the RBA broadened

GRAPH 19 | **RTGS TRANSACTIONS** Average daily value and number



Source: RBA

its range of payment collection services to include a phonepay collection service known as *Government EasyPay*.

Settlement and Registry Services

The Reserve Bank Information and Transfer System (RITS) is used by banks and other approved institutions to settle interbank payments across their Exchange Settlement (ES) accounts conducted with the RBA. By value, the bulk of these transactions is settled on a real-time gross settlement (RTGS) basis.

While no longer providing an electronic depository and settlement service for Commonwealth Government securities (CGS), RITS still provides a facility for members to participate in electronic tenders for CGS. Settlement of successful bids occurs in the Austraclear System, which has provided depository and settlement services for CGS since February 2002.

RTGS and Other Settlement Services

About 90 per cent of the value of interbank payments is settled on an RTGS basis; this includes all wholesale debt and money market settlements, a range of time critical customer payments and Australian dollar foreign exchange settlements (including those settled by CLS Bank for which a net settlement is made across RITS).

The average daily number of payments settled in RITS in 2002/03 of 20 700 was 6.4 per cent higher than the previous financial year. Growth in the value of payments settled was more moderate, at 2.4 per cent. Since inception on 22 June 1998, there has been a significant increase in both the number and value of RTGS transactions. The end of financial year peak on 30 June 2003 of 31 000 transactions totalling $201 billion compares with 21 000 and $158 billion, respectively, on 30 June 1998.

Two developments of particular significance to the operation of RITS took place during 2002/03. First, as foreshadowed in last year's Annual Report, the RBA assumed responsibility for the computer operations, software development and support functions for RITS that were previously performed under contract by Austraclear Limited. The RBA worked in close co-operation with the SFE Corporation (the owner of Austraclear Limited) during this project to ensure the

HAVING BEEN OUTSOURCED FOR SOME YEARS, THE COMPUTER FUNCTIONS OF RITS WERE LAUNCHED 'IN-HOUSE' ON 21 OCTOBER 2002 BY GEOFF BOARD, ASSISTANT GOVERNOR (BUSINESS SERVICES). THE OPENING OF THE SYSTEM FOR SETTLEMENT PROCESSING WAS WITNESSED BY DAVID BROWN, MICHAEL HOGAN AND MANY STAFF MEMBERS INVOLVED IN THE PROJECT.

continuance of high service standards to RITS members. Following internal and industry testing, RITS successfully cut over to in-house operations on 21 October 2002.

Secondly, as discussed in the chapter on Operations in Financial Markets, the continuous linked settlement (CLS) initiative to reduce foreign exchange settlement risk commenced operations in September 2002. Foreign exchange settlements in CLS occur across the books of CLS Bank, with net obligations in CLS being funded by payments to CLS Bank across participating RTGS systems, including RITS. CLS Bank has been granted an ES account with the RBA for this purpose. Currently nine banks in Australia make payments to CLS Bank on their own account or that of other CLS settlement members.

To the extent that Australian dollar foreign exchange settlements take place across CLS Bank rather than direct gross payments across RITS, it is expected that, over time, this will cause the number and value of transactions settled by RITS to decline. To date, however, it is too early to discern any clear trends.

The introduction of CLS has also meant extended operating hours for RITS in order to synchronise with CLS settlement hours during the European morning. Settlement in RITS closes at 7.00 pm in Australian eastern standard time and 9.00 pm in Australian eastern daylight saving time, compared with its previous closing time of 5.15 pm.

In addition to RTGS payments, RITS settles two batches of netted interbank payments each day. The 9.00 am batch consists of positions collated by the RBA on behalf of the Australian Payments Clearing Association arising from the previous day's "low value" clearings (paper, and bulk and retail electronic). The second batch settles net positions for equity transactions in CHESS, the electronic settlement system operated by the Australian Stock Exchange.

Work is under way to update RITS, as follows:

- The user interface for on-line access to RITS by members is being redeveloped to provide a windows-based facility. A firm implementation date has not yet been set; however, current planning is for members to be able to use the new interface by the end of 2004.
- A major means of sending payments to RITS is via the SWIFT FIN service. SWIFT has commenced a global project to migrate the transmission of SWIFT FIN messages to a new, more modern network which uses Internet-protocol technology. This will entail a compulsory, phased migration for all members of SWIFT. In Australia, the RBA is working in collaboration with the Australian Payments Clearing Association to ensure an efficient migration of SWIFT payments to the new network. As part of this, the RBA is planning to cut over the RITS SWIFT connections to the new "SWIFTNET" service by the end of November 2003.
- A range of enhancements to RITS functionality is also under development, including improved batch settlement facilities. The first package of changes, comprising a number of smaller enhancements, such as additional search criteria for banks to use in viewing settled payments, is expected to be implemented by the end of 2003.

Settlement services are also provided for financial market transactions undertaken by the RBA in the domestic securities and foreign exchange markets, and other RBA transactions such as those relating to banks' currency note lodgements and withdrawals. The Australian Government also uses the service for its high value transactions including, for example, the settlement of tenders in CGS, as do around 22 overseas central banks and official institutions for settlement of their Australian dollar investment transactions.

Registry Services

The RBA maintains the CGS register on behalf of the Australian Office of Financial Management (AOFM) and other smaller registries for a number of official foreign institutions who have Australian dollar debt programs. Services were also provided to the South Australian Government Financing Authority until November 2002, when their business was transferred to another service provider.

Core services provided by the registry include the issue, transfer and registration of securities, the maintenance of ownership records, the distribution of interest payments and the redemption of securities at maturity. In addition to these core functions, a number of services specific to CGS are provided, including:

- management and encashment of physical securities in circulation (some of which date back to, or beyond, the Second World War);
- maintenance of records and management of unclaimed monies relating specifically to CGS holdings;
- performance of historical searches, as a result of the large stockholder base associated with previous issues of Australian Savings Bonds and the Australian Government's long history as an issuer of debt securities; and
- operation of a small investor facility, enabling retail investors to access CGS by purchasing securities from the RBA's own portfolio at market-related prices. The RBA also repurchases CGS through the same facility.

Registry activity in 2002/03 remained low by historical standards, but was in line with recent years. The registry operations continue to be actively managed to ensure that services are delivered in as cost-effective a manner as possible, given the small size of the operation, while retaining a focus on quality of service.

Earnings after tax for the contestable registry business in 2002/03 were $0.1 million, compared with $0.2 million in the previous year.

Note Issue

The RBA's note issue functions include the issue of new and reissuable quality notes; the processing of notes returned from circulation for authentication and quality-control purposes; general oversight of cash distribution arrangements; and research into, and development of new note designs and security features.

During 2002/03, the RBA continued to work with the commercial banks to fine tune the new cash distribution arrangements introduced in November 2001. Under these arrangements, the commercial banks own the working stocks of notes and coin required to operate the cash distribution system and are encouraged to deal, wherever possible, directly with each other in managing short-term surpluses and shortfalls in their holdings of currency. Under previous arrangements, the RBA owned the working stocks and individual commercial banks dealt directly with the RBA for their note and coin requirements. The RBA continues to make payments to the commercial banks for interest forgone on the working stocks, up to a specified maximum, provided the stocks are held in approved cash centres and the commercial banks sort notes for quality according to a specified standard.

During the period November 2002 to June 2003, average daily commercial bank holdings of working stocks were some $915 million lower than for the corresponding period in 2001/02. The reduced holdings reflect a higher level of comfort by the commercial banks with the new arrangements. As commercial banks gain further experience with the new system and develop new, more efficient arrangements for the exchange of cash between them, working stock levels should continue to decline.

The RBA is in the process of upgrading its high-speed note processing equipment to improve its ability to check notes for authenticity and the quality-of-fitness-sorting being done by the commercial banks, and to monitor the general quality of notes in circulation. The new equipment will be progressively installed during 2003/04 at the National Note Processing Centre (NNPC).

Notes on Issue

The value of Australian notes on issue rose by $243 million, or 0.8 per cent, over 2002/03 to $32.2 billion. The increase is significantly lower than the 2001/02 increase of $4.8 billion, or 17.5 per cent which, in large part, reflected the changed ownership arrangements for the cash distribution working stocks. Under the new cash distribution arrangements, the working stocks are recorded as "on issue" whereas previously they were not. Excluding the effect of the new arrangements, notes on issue still grew more slowly over 2002/03 (3.6 per cent) than during 2001/02 (6.2 per cent), the first time for a number of years that growth in the value of notes on issue has not matched growth in the economy. The increase occurred in the value of $100 (2.8 per cent) and $50 (1.4 per cent) notes on issue, with the value of other denominations decreasing, continuing the underlying trend towards a greater proportion of notes on issue being accounted for by the higher denominations.

Note Processing and Distribution

Note processing and distribution activities are centralised at the NNPC. Armoured car companies transport notes to and from the NNPC on behalf of the commercial banks. Under arrangements between the RBA and the commercial banks, unfit notes, surplus fit notes following seasonal peaks in demand, and notes sought by the RBA for authenticity and quality sampling purposes are returned to the NNPC. The commercial banks also draw notes from the NNPC to meet demand when notes cannot be obtained from other commercial banks.

During 2002/03 192 million notes ($6.4 billion) were despatched from the NNPC and 205 million ($6.2 billion) were returned. This level of activity is similar to the previous year. Of the 205 million notes returned 199 million notes were processed through high-speed note processing equipment for verification, authentication and quality control compared to 125 million notes processed during 2001/02. Notes deemed fit for reissue represented 41 per cent of notes processed compared with 47 per cent last year. The increase in processing volume and the levelling-out of the proportion of notes classified

Value of Notes on Issue ($ million)

At end June	$1(a)	$2(b)	$5	$10	$20	$50	$100	Total	Increase (per cent)
1997	19	47	351	601	1 837	8 912	8 297	20 064	4.6
1998	19	47	361	617	1 804	9 523	9 280	21 651	7.9
1999	0 (c)	46	379	639	1 850	10 356	10 282	23 552	8.8
2000	0 (c)	46	397	646	1 917	11 188	11 240	25 434	8.0
2001	0 (c)	45	431	662	2 014	12 055	11 961	27 168	6.8
2002	0 (c)	45	530	791	2 789	14 718	13 057	31 930	17.5
2003	0 (c)	45	515	759	2 510	14 918	13 426	32 173	0.8

(a) Last issued May 1984
(b) Last issued June 1988
(c) See Notes To and Forming Part of the Financial Statements, Note 1(k)

as fit for reissue over recent years reflects familiarisation with the changes made to processing and distribution arrangements.

The NNPC also receives and assesses for value notes that have been mutilated and are difficult for the general public and commercial banks to assess accurately. During the year the NNPC assessed 10 865 mutilated note claims with a total value of $2.6 million. This was around twice the number assessed last year. The increase in mutilated note claims in large part reflects instances of incorrect classification of unfit notes into the mutilated category on the part of banks and armoured car companies. Over the period ahead, the RBA will work with participants to increase the level and quality of fitness sorting.

Counterfeiting Activity

Counterfeiting of Australian currency notes decreased in 2002/03, with around 9 counterfeits passed per million notes in circulation, compared to around 14 counterfeits per million in 2001/02. The rate of counterfeiting remains very low compared with the experience of other countries.

Around 90 per cent of counterfeits passed in 2002/03 were paper reproductions of polymer notes – typically $50 notes. The vast majority of counterfeits are of poor quality and are generally easily detected by inspection and feel.

To maintain the standing of polymer notes at the forefront of anti-counterfeiting technology, the RBA continues to maintain active research and development programs into new security features.

NOTE PRINTING AUSTRALIA AND SECURENCY

Note Printing Australia

Note Printing Australia Limited (NPA), based at Craigieburn in Victoria, is a wholly owned subsidiary of the RBA that produces banknotes and other security documents for Australia and for export. It has been the world pioneer in employing polymer in the manufacture of banknotes and now prints predominantly on Guardian® polymer substrate manufactured by Securency Pty Ltd (see below).

The Board of NPA, operating under a broad charter from the Reserve Bank Board, comprises chairman Graeme Thompson (a former Deputy Governor of the RBA), Richard Warburton (a former non-executive member of the Reserve Bank Board), Les Austin (a former Assistant Governor of the RBA) and Mark Bethwaite (Chief Executive of Australian Business Ltd). John Leckenby has been NPA's Chief Executive since 1998.

The international note printing market remains very competitive, but interest continues to grow in the polymer technology around the world and NPA is currently pursuing a number of export opportunities in both banknotes and passports. A major activity for NPA in the past year was the fulfilling of an export order for the Nepal Rastra Bank, Nepal becoming the twenty-first country to issue polymer banknotes. NPA has also worked closely with a European and two Asian customers in the design and production of banknotes on polymer. These are expected to be released early in 2004.

During the year, NPA produced 145 million bank notes for export and, significantly, 95 million of these were repeat orders. The RBA placed orders for Australian $5 and $10 notes and 107 million of these were supplied.

Progress on the printing and assembly of the new Australian passport for the Department of Foreign Affairs and Trade has been slower than expected due to trialing and testing of new security devices. Full production is due to commence in August 2003.

NPA restructured its activities during the year, creating a Support Services Group that encompasses areas such as product tooling, ink manufacture, maintenance and logistics. The aim of this group is to improve the responsiveness to, and support for, the production process to raise quality and efficiencies. NPA has purchased new note inspection equipment to improve quality and throughput of banknotes.

Productivity in the National Note Processing Centre, operated by NPA under contract from the RBA, continued to improve through the year. A major upgrade of the note processing equipment at the National Note Processing Centre is expected to be completed and fully operational by June 2004.

NPA has continued to work closely with Securency on research and development, marketing and customer support activities. The marketing efforts of Securency promise to provide NPA with larger "start-up" orders from countries converting from paper to polymer banknotes with their own printworks. These "start-up" notes will be produced as part of a formal technology training and knowledge transfer program conducted by PolyTeQ Services, a jointly funded initiative of NPA and Securency that assists banknote issuers and printers to introduce polymer banknotes.

Securency

Securency Pty Ltd was formed in 1996 as a joint venture between the RBA and Belgian-owned Surface Specialities UCB (UCB Group), a manufacturer of

NPA Polymer Notes Export Orders

Year of first issue	Customer	Denomination	Issue
1990	Singapore	50 Dollar	Commemorative
1991	Western Samoa	2 Tala	Circulating
1991	Papua New Guinea	2 Kina	Special Issue Circulating
1993	Kuwait	1 Dinar	Commemorative
1994	Indonesia	50 000 Rupiah	Special Issue Circulating
1995	Papua New Guinea	2 Kina	Special Issue Circulating
1996	Papua New Guinea	2 Kina	Circulating
1996	Brunei Darussalam	1, 5, 10 Dollar	Circulating
1996	Thailand	50 Baht 500 Baht	Commemorative Special Issue Circulating
1997	Thailand	50 Baht	Circulating
1997	Western Samoa	2 Tala	Circulating
1998	Sri Lanka	200 Rupee	Circulating
1998	Malaysia	50 Ringgit	Commemorative
1999	New Zealand	5, 10, 20, 50 & 100 Dollar 10 Dollar Millennium Note	Circulating Commemorative
1999	Papua New Guinea	50 Kina	Circulating
1999	Romania	2 000 Lei	Commemorative/circulating
1999	Indonesia	100 000 Rupiah	Circulating
2000	Romania	10 000 Lei	Circulating
2000	Romania	500 000 Lei	Circulating
2000	Papua New Guinea	2, 10, 50 Kina	Special Issue Circulating
2000	Papua New Guinea	10 Kina	Circulating
2000	Bangladesh	10 Taka	Circulating
2001	Kuwait	1 Dinar	Commemorative
2001	Solomon Islands	2 Dollar	Special Issue Circulating
2002	Mexico	20 Peso	Circulating
2002	Nepal	10 Rupee	Circulating

unique polypropylene films. Securency supplies its press-ready polymer substrate, Guardian®, to NPA and to overseas printers for banknotes and Sentinel® for other high-security documents such as land titles. These products are produced by applying unique coatings and security features to specialised films manufactured by UCB Group.

Securency's Board comprises three directors appointed by the RBA, three appointed by UCB Group and the company's Managing Director, a non-voting member. Myles Curtis has been Securency's Managing Director since 1996. Securency's offices and plant are located at Craigieburn, close to NPA's.

In 2002/03, Securency produced substrate both for repeat orders and new customers. Substrate was manufactured for a range of existing denominations in Australia, Brunei, New Zealand, Papua New Guinea and Romania. Romania is now the third country, after Australia and New Zealand, to have a complete series of circulating polymer notes.

The substrate order for 20 Peso notes for Banco de Mexico was completed during the year. The 20 Peso is the largest volume circulating banknote in Mexico, and polymer's proven durability and quality led Banco de Mexico to adopt polymer for this denomination. Following a period of assessment, Banco de Mexico will decide on other denominations. In September 2002 the Governor of Banco de Mexico, Dr Guillermo Ortiz Martinez, with Australian Treasurer Peter Costello, launched the note which has been well received by the public. Securency also produced substrate for the Nepalese 10 Rupee note printed by NPA.

Some significant new contracts were secured. Production commenced in late 2002 for a major customer requiring several denominations, with the new notes to be launched in early 2004. Additionally, the Bank of Zambia has decided to issue two denominations on polymer, the 500 and 1000 Kwacha – the first Guardian® polymer notes to be issued on the African continent. The notes will be printed by Canadian Bank Note Company, an accredited preferred polymer printer, and will be issued in the latter half of 2003.

To meet growing demand for polymer banknotes into the future, Securency has issued its first Technology Licensing Agreement in Europe to its joint shareholder, UCB Group. A global licensing program will help ensure that Securency can continue to meet the needs of customers around the world, as demand for the technology increases.

Due to the increasing global concern for security there has also been a considerable interest in innovative polymer-based security documents and cards substrate. This has led to the development of a range of substrates for government-issued documents, which became commercially available during 2002/03.

Securency's 'Symposium' identity card was a finalist in the technical achievement category at the International Card Manufacturer Association Awards in 2002 in Canada.

Significant process improvements were completed during the period. The joint venture partners have committed investment to further develop additional process automation and for the commercialisation of Securency's research developments. The partners also increased Securency's financial resources during 2002/03, in order to ensure that the company is positioned to take advantage of opportunities to offer polymer technology to potential new customers.

IN SEPTEMBER 2002 IN MEXICO CITY, THE GOVERNOR OF BANCO DE MEXICO, DR GUILLERMO ORTIZ MARTINEZ, AND AUSTRALIAN TREASURER, PETER COSTELLO, LAUNCHED THE MEXICAN 20 PESO NOTE, PRINTED ON POLYMER SUBSTRATE PRODUCED BY SECURENCY.

THE RBA IN THE COMMUNITY

Regional Offices

Previous years' Annual Reports detailed the establishment of Regional Offices in Queensland, Victoria and Western Australia.[1] In March 2003, a Regional Office was opened in South Australia. The establishment of these Offices followed the closure of the RBA's branches in these States. Their creation is designed to maintain the RBA's presence in the community and to ensure that channels for receiving information about economic conditions remain open. In fact, the Regional Offices undertake activities that have increased substantially the RBA's interaction with a broad cross-section of the community and have opened new channels of communication.

The Regional Offices have three main roles. These are liaison activity, with economists in the Regional Offices gathering timely information about business conditions; the analysis of this and related information to help inform the RBA's assessment of the economy and, ultimately, its policy deliberations; and a representation role. The following sections provide details on these activities.

Summary of Contact by All Offices
(up to 30 June 2003)

	Number of agencies consulted	Total number of interviews
Government agencies	119	190
Research bodies	20	25
Industry groups	155	456
Businesses	773	1 261
Total	1 067	1 932

Liaison Activity

Initially, staff in the Regional Offices sought to establish relations with State-based economic agencies, such as Treasuries and other government departments, and industry associations. In this way, they developed familiarity with regional and industry developments prior to approaching individual firms. A business register was purchased with the contact details of some 5000 large and 3000 medium-sized businesses, which are representative of each State's economy (in that the number of businesses in each industry is proportional to that industry's share of production in the State). A sample of businesses was chosen from this register for liaison, largely at random, and other businesses have been progressively added in response to economic developments.

Contact with businesses is first made in writing to the CEO, and the purpose of the liaison, its voluntary participation and the confidential nature of discussions are explained. Of those who agree to participate, it is intended that they will receive a minimum of one annual on-site visit. The regularity of contact does, however, vary significantly and firms indicate the amount of contact that is appropriate for them.

Comparing the number of agencies consulted with the total number of interviews provides an indication of the amount of "repeat contact". The program has reached a stage of maturity where there is a deal of repeat contact with businesses. The frequency of repeat contact with businesses is, however, less than with industry groups. This reflects a desire to minimise inconvenience for businesses,

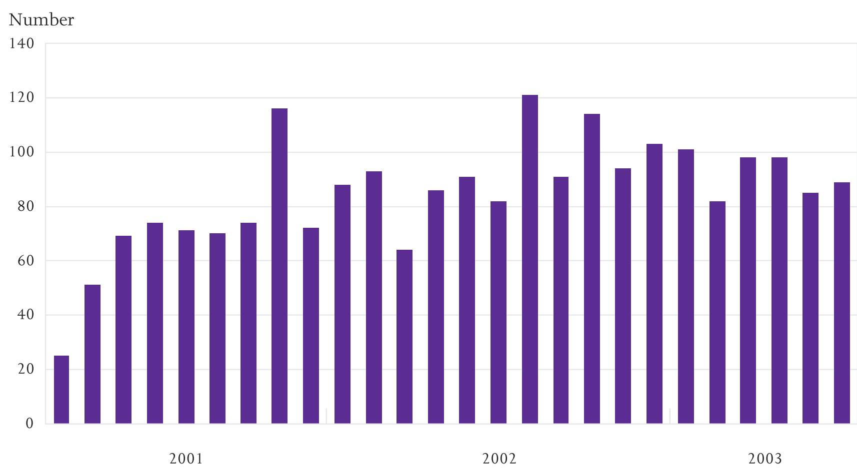
1 The Victorian Office services Tasmania, the Queensland Office services the Northern Territory and staff in Head Office service New South Wales and the Australian Capital Territory.

but also the time taken for businesses to cumulate significant new information about their business conditions. In contrast, a high level of repeat contact is made with industry associations, for whom visits are less of an imposition. Furthermore, they typically have access to a broader set of information than an individual business has and are well placed to share timely information about whole sectors of the economy. To help reduce inconvenience, where appropriate, liaison visits are conducted jointly with the Treasury.

The amount of liaison has grown steadily over the past two years, and has now levelled out at around 90 contacts per month. There are a few industries in which the share of liaison has been disproportionate to the industry share of GDP. These include tourism and transport, and reflect liaison associated with the impact on airline travel and tourism of the collapse of Ansett, the events of September 11, 2001 and more recently the SARS outbreak. Liaison has also been over-represented in construction and related manufacturing, reflecting the Offices' monitoring of the housing cycle and its effects on the wider economy. More recently, there has been a focus on the drought, so that a disproportionate share of liaison has been conducted with agricultural businesses and agencies. While various economic shocks have encouraged the liaison effort to be skewed towards particular sectors over the past year or so, the intention is to develop familiarity with organisations across all sectors of the economy so that the RBA is well placed to obtain intelligence about policy-relevant issues as they emerge.

In addition to the liaison by the Regional Offices, a longstanding contact with around 15 large retailers has been maintained. The RBA also chairs the Small Business Advisory Panel. This Panel, established in 1993, meets once a year to discuss issues relating to the provision of finance for small businesses. Membership of the Panel is drawn from a wide range of industries and from across the country. The Panel represents a valuable source of information on the financial conditions faced by small businesses.

GRAPH 20 | **REGIONAL OFFICE LIAISON CONTACTS PER MONTH***



* December and January figures each year are combined and reported in January
Source: RBA

TOM ROHLING, SENIOR REPRESENTATIVE IN THE WESTERN AUSTRALIAN REGIONAL OFFICE, ON AN INDUSTRY VISIT TO OIL AND GAS FACILITIES IN THE PILBARA.

Economic Reporting

A valuable feature of the liaison program has been the preparedness of firms and agencies to share both qualitative and quantitative information about developments in their industry or region. Qualitative assessments of current conditions are valuable because of industry participants' proximity to real economic activity, their ability to explain the nature of recent events and risks to the outlook, and the timeliness of their information. Periodically, these qualitative assessments are enhanced by the provision of data, much of which relates to the current period, is high frequency or a census of observations. Intelligence obtained from the liaison program is often more timely than official statistics or private-sector surveys, and can help fill gaps in information. Information gathered through liaison has proven particularly useful to form an assessment of: the initial impact of the shocks of September 11, 2001 and the collapse of Ansett, the subsequent process of recovery and more recently of the effect of SARS on the tourism industry; demand and supply conditions in the apartment market; and on the severity of the drought and the financial situation of farmers.

Each month, both qualitative and quantitative evidence gathered from liaison is summarised and the findings feed directly into the RBA's monetary policy process. The output from liaison has motivated a number of internal pieces of analytical work, while other projects have been conducted by the Regional Offices using official statistics so that the information gathered in liaison can be more fully appreciated. These forms of written output provide material that feeds regularly into the monthly information provided to the Board, as well as the RBA's economic publications including the *Statement on Monetary Policy*.

Regional Representation

In addition to their contact with businesses and other agencies, Regional Office staff are the first point of contact with the RBA for the general public in their States. They field a large number of enquiries about the role of the RBA, economic statistics and monetary policy decisions. Regional Office staff also give presentations to the public in their geographic areas. Many of these have been to teachers' associations, but they have also included presentations to local industry bodies and universities. They have generally been about the framework for monetary policy or current economic conditions.

The more substantive form of representation, however, comes from the functions hosted at the Regional Offices. Two of the Offices have hosted Board meetings, and the facilities in each Office allow for potential rotation of Board meetings in regional areas. Presentations on the *Statement on Monetary Policy* have become a regular occurrence. These are given by senior management and communicate the main themes of the *Statement* to liaison contacts, as well as providing an opportunity for dialogue between senior management and these contacts. When other RBA staff are visiting the regions, they are encouraged to give presentations on research work. These presentations have become an important device to help give something in return for the liaison contacts.

Accountability

As an independent central bank with carriage of monetary and financial system policies, the RBA is required to be accountable to the Parliament for its actions. Beyond those formal requirements, the RBA provides comprehensive and timely information on all its processes and operations. Accountability and its companion, transparency, are important elements in ensuring a broad understanding and acceptance of the policy framework.

Since 1996 the RBA has attended twice-yearly hearings of the House of Representatives Standing Committee on Economics, Finance and Public Administration. In the past financial year, the Governor and senior officials attended hearings in Warrnambool and Melbourne to answer the Committee's questions on a range of topics including the economic outlook, monetary policy, household debt, exchange rates and reform of the payments system. This is now the major formal mechanism the Parliament uses to ensure accountability. It augments the long-standing practice of tabling in Parliament an annual report on the RBA's operations and financial accounts, as required by law.

A quarterly *Statement on Monetary Policy* is published, with the latest analysis of economic and financial conditions, the outlook for inflation and the rationale for recent policy decisions. The *Statement* is issued in February, May, August and November; those for May and November are an important input for the Standing Committee's deliberations and its questioning of the RBA. The media can gain access to embargoed copies of the *Statement on Monetary Policy* through attendance at a "lock-up" prior to the official publication time. This facilitates the ability of the media to digest, analyse and then report on this core RBA publication.

AT THE HEARING OF THE HOUSE OF REPRESENTATIVES STANDING COMMITTEE ON ECONOMICS, FINANCE AND PUBLIC ADMINISTRATION, IN WARRNAMBOOL, VICTORIA, IN DECEMBER 2002: FROM LEFT, RIC BATTELLINO, ASSISTANT GOVERNOR (FINANCIAL MARKETS); IAN MACFARLANE, GOVERNOR; JOHN LAKER, ASSISTANT GOVERNOR (FINANCIAL SYSTEM); AND GUY DEBELLE, HEAD OF ECONOMIC ANALYSIS.

Communication

Speeches by the Governor and senior officials are an important mechanism for communicating the RBA's views. In the past year there were speeches to various forums in Adelaide, Brisbane, Canberra, Melbourne, Perth and Sydney on topics such as inflation targeting, deflation, household debt, the international economy, capital flows and the economic outlook.

The Information Department acts as a point of first contact for media enquiries as well as questions from the public. In total these enquiries ran to about 550 per month on average in the past year.

The monthly *Bulletin* continues to be the document of record for material such as speeches, media releases and statistics. The *Bulletin* also serves as a source of articles on specific topics of interest. In the past year articles were published covering issues such as developments in the household sector, the labour market, exchange rates, the funds management industry, bank fees, international finance and the RBA's open market operations.

Research work by the staff is published in the Research Discussion Paper series. There were eleven papers in 2002/03. These papers, which are of most interest to professional economists, ranged over topics such as exchange rate issues, the usefulness of business surveys, financial markets and monetary policy transparency, labour market trends and statistical measurement issues. While these research papers focus on issues of relevance to policy, they represent the views of the authors rather than the RBA or its Boards and are designed to contribute to general debate among researchers in these fields, both within Australia and overseas. Where possible, non-technical versions are published in the *Bulletin* to assist wider public access to RBA research.

In a similar vein, since the late 1980s the RBA has hosted an annual economic conference on a subject of general and current interest. The conference held in August 2003 was on the topic of Asset Prices and Monetary Policy. The conference brought together prominent economists from overseas and Australia to discuss papers on the nature of asset price movements and their implications for monetary policy, drawing on history and recent experiences in other countries such as Japan and the United States. A volume of conference proceedings will be published by the end of the year.

Over recent years the means by which information is disseminated has evolved substantially. Demand for hard copies of RBA publications has continued to decline while use of the website (www.rba.gov.au) is growing at a fast pace. In 2002/03 subscriptions to the *Bulletin*, for example, declined by 16 per cent to around 1 250 while use of the website rose by over 30 per cent. The website's free email service, which covers all recent news items, had 4 700 subscribers at end June 2003, double the number of a year earlier. A separate email service for Research Discussion Papers had nearly 900 subscribers.

All information published by the RBA is available free-of-charge on its website. The anticipated timing of future publications and events is also flagged under "Coming Up" on the home page. During the past year a number of measures to enhance further the usefulness of the website were undertaken. These included a review and modification of the site to ensure best possible access for visitors with disabilities. Another was the inclusion of a separate "Education" section for teachers and students, which brings together educational material already on the site in a more accessible way.

Financial Assistance for Economic and Financial Research and Education

The RBA has a long-standing commitment to provide assistance for various educational and research activities. In this context, funding is provided towards the costs of a monthly survey of inflation expectations, undertaken by the Melbourne Institute of Applied Economic and Social Research at the University of Melbourne, and of a quarterly survey of union inflation and wage expectations, by the Australian Centre for Industrial Relations Research and Training at the University of Sydney.

RBA support for scholarships under the Elite Executive Honours Scholarship Program, organised by Axiss Australia, the government agency charged with promoting Australia's position as a global financial services centre, continued during 2003. This year, the two scholarships funded by the RBA under this Program were for study, respectively, at the University of New South Wales in Sydney and the University of Queensland in Brisbane. The RBA has also become a co-sponsor, along with the Australian Prudential Regulation Authority (APRA), of the Brian Gray Scholarship Program, established in 2002 in memory of a former senior executive of the RBA and APRA; four scholarships for 2003 were awarded under this Program, to Honours students for study at the Universities of Melbourne, New South Wales and Sydney and at Macquarie University.

Each year, part of the RBA's financial assistance to Australian universities takes the form of a contribution to the costs of their organising conferences in economics and closely related endeavours. In 2002/03, these conferences included: the 31st Conference of Economists, organised by the South Australian Branch of the Economic Society at Glenelg in September/October 2002; the annual Conference for PhD students in Economics and Business, held at the Australian National University in Canberra in November 2002; and the 15th Australasian Finance and Banking Conference at the University of New South Wales in December 2002. In 2003, the RBA for the first time provided some financial assistance towards the costs of the Economics and Business Studies Competitions, conducted throughout the country for senior secondary students and organised by a committee of students from the Commerce and Economics Society at the University of New South Wales.

From time to time, the RBA also assists with contributions towards the costs of running other conferences whose subject matter and/or organising bodies are related to the RBA's areas of responsibility and interest, in particular our international relations in the Asian region. In one such case in the past year, the RBA's assistance took the form of provision of accommodation free-of-charge at the HC Coombs Centre for Financial Studies, in Kirribilli, for attendees at the APEC Future Economic Leaders Think Tank, hosted by Axiss Australia in June 2003. The RBA has also provided financial support towards the costs of running the 9th Commonwealth Study Conference, to be held in Australia and New Zealand in October 2003.

The RBA seeks to encourage open discussion of issues related to public policy. For several years, it has made a modest contribution to the general running costs of two Sydney-based think tanks, the Centre for Independent Studies and the Sydney Institute.

In the international sphere, the RBA made a third annual contribution, along with those of a number of other central banks and other institutions, to the reconstituted International Accounting Standards Committee. The RBA also continued its long-standing practice of contributing to the Group of Thirty to support its program of research and publications in the area of international finance.

Charitable Donations

During the year, the RBA increased the overall level of its support for charitable organisations. As in other recent years, the RBA contributed a total of $25 000 to 17 Australian charities, whose work covers a broad range of medical problems and disabilities. In addition, the RBA undertook, along with a number of other major Australian financial institutions, to provide $50 000 per annum for ten years to the Financial Markets Foundation for Children, of which the Governor is Chairman.

Statutory Obligations

Equal Employment Opportunity (EEO)

As required under the *Equal Employment Opportunity (Commonwealth Authorities) Act 1987*, the RBA reports to the Australian Parliament each year on its EEO Program. The *Equity & Diversity Annual Report 2002* was tabled on 16 October 2002, and included a review of the RBA's Disability Action Plan.

Health and Safety, Compensation and Rehabilitation

The RBA is required, by Section 74 of the *Occupational Health and Safety (Commonwealth Employment) Act 1991* (OH&S Act) and the conditions of its licence as a Licensed Authority under the *Safety, Rehabilitation and Compensation Act 1988*, to report each year on matters of health and safety, workers' compensation and rehabilitation as they affect the RBA.

The RBA's current licence to self-insure and manage claims for workers' compensation expires at end June 2004. The RBA determined 25 claims for workers' compensation in 2002/03; these were all of a minor nature and there was no requirement for formal Return to Work Plans. No incidents required notification to Comcare in terms of Section 68 of the OH&S Act. The RBA's contract with Australia Post to manage requests for reconsideration of determinations was renewed during 2002/03. No reconsideration requests were lodged by employees in that period.

During the year, the RBA's management systems for prevention, rehabilitation and workers' compensation claims were reviewed by external auditors in accordance with the Conditions of Licence. These audits confirmed that the RBA continues to comply fully with the requirements of its licence and the relevant legislation.

The RBA provided a Management Systems Review and Improvement Program Report to Comcare in March 2003 as required. That report indicated that the RBA continued to perform well against indicators set by the Safety, Rehabilitation and Compensation Commission and its performance compared favourably with other self-insurers.

Freedom of Information

Section 8 statement

The RBA is an exempt agency under the *Freedom of Information Act 1982* in respect of documents concerning its banking operations (including individual open market operations and foreign exchange dealings) and exchange control matters.

Organisation and functions: The RBA is Australia's central bank. It was established by Commonwealth legislation in 1911. Its functions, powers and responsibilities are specified in the *Reserve Bank Act 1959*, the *Banking Act 1959*, the *Financial Corporations Act 1974*, the *Commonwealth Authorities and Companies Act 1997*, the *Payment Systems (Regulation) Act 1998*, the *Payment Systems and Netting Act 1998*, and the *Corporations Act 2001* and in Regulations made under those Acts. An organisational chart appears at the end of this Report.

Categories of documents: Lists of publications, including speeches, articles, occasional papers, information booklets, conference volumes, regular media releases and other publications are published from time to time in the RBA *Bulletin*; this information is also included on the website (www.rba.gov.au). Other documents are held in the form of working notes and files covering policy and operational matters, statistical data, personnel, premises and general administration.

Facilities for access and Freedom of Information procedures: Inquiries under the *Freedom of Information Act 1982*, including requests for access to documents, should be directed to the Secretary (in Head Office), the Senior Representatives in the Regional Offices (in Adelaide, Brisbane, Melbourne and Perth) or the Manager of the branch (in Canberra). Applications should be accompanied by the application fee (currently $30). Facilities to inspect documents to which access has been granted are available.

Section 93 statement

Four requests (including one transferred from another agency) for access to documents under the *Freedom of Information Act 1982* were received in 2002/03, compared with nine requests in 2001/02 (two of which were in progress at the end of that year). In 2002/03, access was granted in full on one request and in part on three requests, while one request was withdrawn and one was still being processed at year's end. No applications for internal review were received during the latest year and, on the one such request which had carried over from the previous year, access was granted in part.

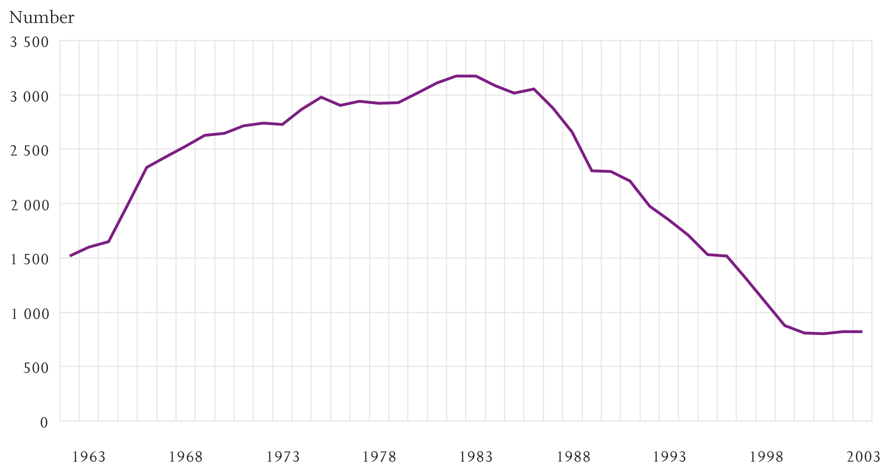
The total cost to the RBA of administering the *Freedom of Information Act 1982* in 2002/03 was estimated to have been approximately $60 900, compared with approximately $436 700 in 2001/02. Application fees of $60 and charges of $566.45 were collected.

MANAGEMENT OF THE RBA

Staffing levels in the RBA changed little in 2002/03, with total employees of 820 at 30 June. The recent experience of a levelling-out in staffing numbers comes after a long period of large staff reductions dating from the mid 1980s. The RBA now has about a quarter of the number of employees it had in 1983, when staff numbers reached a peak. These developments have been explained in detail in previous Annual Reports.

While aggregate staff numbers have been steadier in recent years, there has continued to be some change in activities within the RBA, as management has met new demands and reviewed the resources applied to a number of ongoing operations. As discussed in the Business Services chapter, the branch in Adelaide was closed in March 2003 as a consequence of the loss of the banking business of the South Australian Government. This saw 26 staff made redundant. The RBA now provides banking services – almost exclusively for the Australian Government – only from Sydney and Canberra. Branches in other State and Territory capital cities have been progressively closed since 1997, mainly, as in South Australia, in response to State governments transferring their banking business to commercial banks. This business had been fundamental to the economic viability of the RBA's branches in most States, especially once technology permitted the consolidation of the Australian Government's banking and registry functions in Head Office. So the loss of State government business led directly to the closure of the branches concerned. The operation in Canberra is small, with 11 staff, and remains for the convenience of the major Australian Government customers located there.

GRAPH 21 | **NUMBER OF RBA STAFF** As at 30 June, excluding NPA



Source: RBA

Provision of Financial Services to State and Territory Governments (Year in which service ceased)

State/Territory	Banking	Registry	Branch closed in:
Northern Territory	1986	(a)	1997
Tasmania	1998	(a)	1998
Queensland	1995	(a)	2000
Western Australia	1999	1998	2000
Victoria	(a)	(a)	2000
Australian Capital Territory	1999	(a)	remains open
South Australia	2003	2003	2003
New South Wales (b)	(a)	1997	1997

(a) Function never supplied by the RBA

(b) The RBA's banking and registry operations have been centralised as business lines in its Head Office, but the branch for New South Wales closed in 1997

As the branches have been closed, representation has been retained in most States by opening Regional Offices to liaise on economic matters with local companies, industry bodies, government agencies and universities. In 2003 a new Regional Office in Adelaide was established, with three staff. In previous years, Regional Offices were opened in Brisbane, Melbourne and Perth. Thirteen staff now work in these Offices around Australia and are part of Economic Analysis Department, which has seven staff engaged directly on regional and industry analysis. More information on the activities of the Regional Offices is given in the chapter on The RBA in the Community.

Small increases in staffing levels within Head Office were brought about by changing activities. The most significant of these was the completion of the project to take direct control of the system for real-time gross settlement (RTGS) of interbank obligations. Also, additional dealing staff were employed, and hours of operation of settlement were extended, to accommodate new domestic money market arrangements introduced with the start of operations of CLS Bank.

Risk management is considered an integral part of management's function, with clear responsibilities assigned for the control and monitoring of risk. To improve further the already strong management of risks across the RBA's operations, a Risk Management Unit has recently been established, with the primary objective of ensuring a consistent framework for the definition, assessment and monitoring of risks throughout the institution. The Head of this unit reports to a Risk Management Committee, made up of senior officers and chaired by the Deputy Governor. The Risk Management Committee will liaise with the Audit Committee. This group will see a small rise in staff numbers over time.

The RBA continues to seek high-calibre honours graduates in economics and related disciplines when recruiting new staff, especially for the policy functions. Thirty four graduates were employed under the Graduate Development Program, which provides two years of structured training and development for these recruits. The RBA also aims to attract staff of suitable quality by offering cadetships to students about to begin their honours year. Cadetships provide two months of work experience before the honours year begins and financial support during the honours year itself. Reflecting the demand for highly qualified staff, 14 cadetships were offered for 2003. Fourteen of this year's graduate intake had previously been cadets.

Opportunities for staff to develop their knowledge and skills in relevant disciplines are also provided. The Post-Graduate Study Award Program offers support for selected staff of the highest standard to study full-time for post-graduate qualifications at universities in Australia and overseas. As at end June, six staff were studying under this Program. Other staff are encouraged to obtain qualifications of value to the RBA and relevant to their career. Fifty six staff are undertaking part-time tertiary studies in Australia, with the RBA meeting tuition fees on successful completion of courses. About two-thirds of staff have tertiary qualifications and one in six has post-graduate qualifications.

The RBA also encourages staff to broaden their experience through secondments to relevant organisations. Over the years, staff have worked at the Bank for International Settlements, Treasury, the Australian Taxation Office, APRA and other central banks. The RBA continues to attract staff with relevant overseas experience. A number of senior staff have significant international experience, including at the IMF, the OECD and other central banks.

For over 15 years, employment for trainees has been provided through the Australian Government's New Apprenticeship Scheme. A total of 158 individuals have completed this training. This year a further 10 trainees were employed in the fields of business administration, IT and print design.

The process of modernising remuneration arrangements to attract and retain staff of the standard required continued in 2002/03. Over recent years, this process has involved the increasing use of individual employment contracts to allow greater flexibility. Almost 60 per cent of staff are now on individual agreements, up from 53 per cent a year ago, and compared with only a few of the most senior staff in 1999. The contracts offered have been most attractive to professional staff with potentially highly marketable skills. These agreements require employees to forgo, among other things, any entitlement to housing loan assistance. None of the most senior staff has a housing loan from the RBA. The move to individual agreements is entirely voluntary. Staff who decline the offer of contract employment retain their existing conditions.

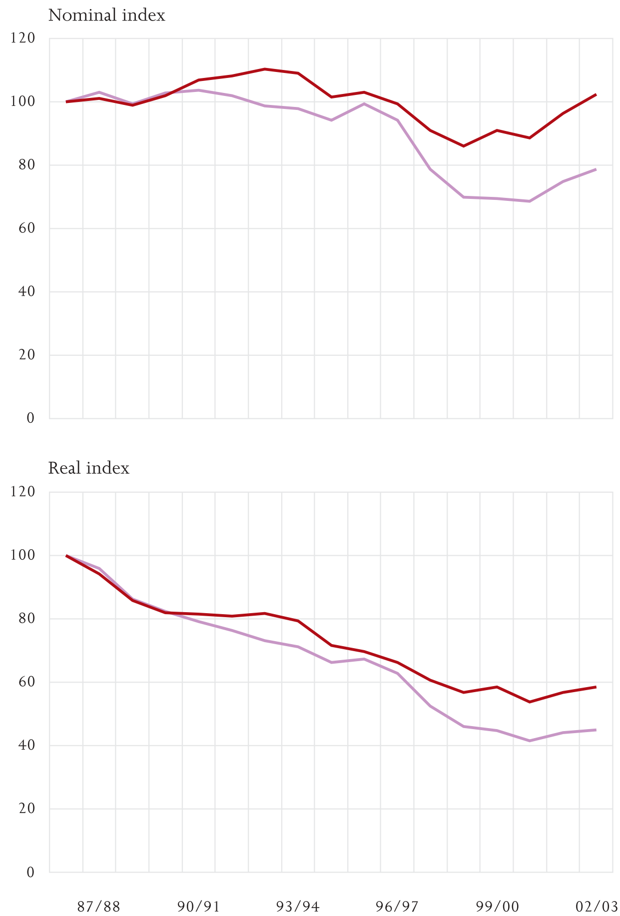
Consultations were held during the year on a new enterprise bargaining agreement (EBA), which provides the basis for changes to salary and employment conditions for staff generally. Key items are changes to performance pay – to provide more scope to reward better staff within the same budget constraint – and more flexibility to manage work and family commitments. Some useful administrative efficiencies will also be achieved. Staff covered by this agreement will receive an annualised salary increase of 4 per cent in November 2003 and November 2004. Staff on individual contracts will receive, on average, the same annual increase as staff covered by the EBA.

Operating Costs

Operating costs in 2002/03 were boosted substantially by expenses, amounting to $6.1 million, for the litigation in relation to the credit card reform proposals. Costs associated with currency processing and distribution also rose as the National Note Processing Centre geared up further and the RBA sampled more banknotes in circulation to ensure that the quality of these notes remained high. The full-year effect in 2002/03 of the project to bring the RTGS system in-house also increased costs, and depreciation charges increased as the Head Office consolidation project was completed. The sale of the building in Adelaide, and the closing of the banking business there, helped contain costs. Total operating costs rose by 6 per cent in 2002/03. Despite this rise, these costs remain lower in nominal terms than at their peak in the mid 1990s; in real terms, they are about 40 per cent below their peak.

The rise in staff costs reflected a rise in base salaries of 3.8 per cent in July 2002, plus some performance payments. Average staff levels were also higher in 2002/03 than in the previous year. Nominal staff costs remain three-quarters of their level at the peak in 1990/91.

GRAPH 22 | **RBA OPERATING COSTS** 1986/87 = 100



Total Staff
Source: RBA

Operating Costs (a)
($ million)

	1994/95	1995/96	1996/97	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03
Staff costs	93.0	98.3	93.0	77.7	69.1	68.7	67.7	73.9	77.8
Other costs	46.4	43.2	43.4	47.2	49.1	56.1	54.1	58.4	62.7
Underlying operating costs	139.4	141.5	136.4	124.9	118.2	124.8	121.8	132.3	140.5
Cost of redundancies	18.0	1.3	7.5	20.7	18.4	9.3	2.6	3.4	2.6

(a) Costs associated with the ongoing operation of the RBA, excluding NPA

Distribution of Underlying Operating Costs (a)
(Per cent)

	Monetary policy	Financial system surveillance	Note distribution	Banking and registry	Settlement
1997/98	30	14	23	23	10
1998/99	35	8	20	23	14
1999/00	35	8	23	20	14
2000/01	41	9	17	18	15
2001/02	43	9	15	18	15
2002/03(b)	45	10	13	17	15

(a) Excludes NPA

(b) Because costs of financial system surveillance have been distorted in 2002/03 by costs associated with litigation, these latter costs are excluded from the figures in the table

The share of operating costs in the core policy areas of monetary policy and financial system surveillance is now over half of total costs. This partly reflects the opening of the Regional Offices in recent years. This pattern differs from a few years ago, when policy functions accounted for around 40 per cent of operating costs, even though, at that time, the RBA also had responsibility for bank supervision.

The remaining costs are now spread fairly evenly between note distribution, banking and registry operations, and the provision of settlement services. (Details on these activities are provided in the chapter on Business Services.) The share of resources devoted to the provision of settlement services has increased, with the introduction of RTGS, and, subsequently, with its in-house operation. Costs associated with note processing and distribution continue to decline as a share of total costs, representing about half their share in 1997/98. The share of costs incurred by banking and registry has also fallen as these activities have been consolidated and, with the exception of Canberra, branch operations have been closed.

Facilities Management

Lower staffing, the consolidation of activities, such as note distribution, and smaller interstate representation has resulted in an overall reduction in the RBA's accommodation requirements. Property holdings have been rationalised accordingly, by making surplus space available to external tenants in Sydney; selling buildings, when no business needs exist to own them; and letting space in the remaining buildings in Melbourne and Canberra.

A major element of this rationalisation strategy has been the consolidation of activities within the Head Office building. This included undertaking major works to convert under-used plant and back-of-house space to usable office space. The construction phase of this project commenced in September 2001, following consideration of the project by the Joint Parliamentary Standing Committee on Public Works and its endorsement by Parliament in December 2000. Construction was completed in December 2002 ahead of schedule and within the approved budget of $21.5 million. A total of about 6000 square metres of floor space was made available to let.

A campaign to lease this space commenced early in 2002, with two tenants signing long-term leases for occupation of about a third of this space. The first tenant arrived in January 2003. The remaining space continues to be marketed and has been the subject of interest from potential occupants.

As a result of the closure of branch operations in South Australia, the Adelaide premises were sold in February 2003 for $4.6 million. Soon after, the new Regional Office for South Australia was temporarily established in these premises, pending relocation to more suitable long-term leased accommodation in September 2003.

The RBA continues to have a business need to own its buildings in Melbourne and Canberra. The Melbourne building houses the Victorian Regional Office and supports the operations of the NNPC. The premises in Canberra support the RBA's transactional banking business. The RBA occupies about one quarter of the available floor space in these buildings; 93 per cent of the remaining space was let to tenants as at 30 June.

THE VARIABILITY OF RESERVE BANK PROFITS

Over the past 30 years, the RBA has returned profits averaging about $4^1/_2$ per cent of assets, although these have been lower in recent years. This is a relatively high rate of return for a financial institution; commercial banks, for example, typically return about 1 per cent on assets. Central banking tends to be profitable because a proportion of assets can be funded by issuing currency notes, rather than interest-paying liabilities such as deposits. About half the RBA's assets are funded by the issue of currency (the rest is funded from deposits from banks and governments and from capital).

A less favourable characteristic of central banking is that it carries a high degree of risk. This is because central banks are required to hold large amounts of securities denominated in domestic and foreign currency in order to carry out their responsibilities, which exposes them to market risk. This is the risk that interest rates and/or exchange rates will move in a way which will adversely affect the value of assets, and therefore profits. As with other countries' central banks, the RBA's exposures to interest rates and exchange rates far exceed those of commercial banks.

It is not surprising, therefore, that the RBA's profits exhibit a high degree of variability. Further, the potential for variability has increased over time because of changes to accounting practices. In years past, central banks coped with the unique risks they faced by operating under special accounting practices. Often these did not immediately recognise in profits all changes in the value of assets; in essence, these practices involved the smoothing of profits over a number of years. But as central banks have come under increasing pressure to be more transparent and accountable, there has been a tendency to adopt conventional accounting rules which, among other things, involve the constant marking to market of asset portfolios, with valuation fluctuations reflecting immediately in profits.

This chapter discusses the implications of this for the variability of the RBA's profits. In doing so, it distinguishes two aspects of profits:

- underlying earnings, which reflect the net interest income earned on assets (less operating costs); and
- valuation gains and losses on holdings of assets.

Underlying Earnings

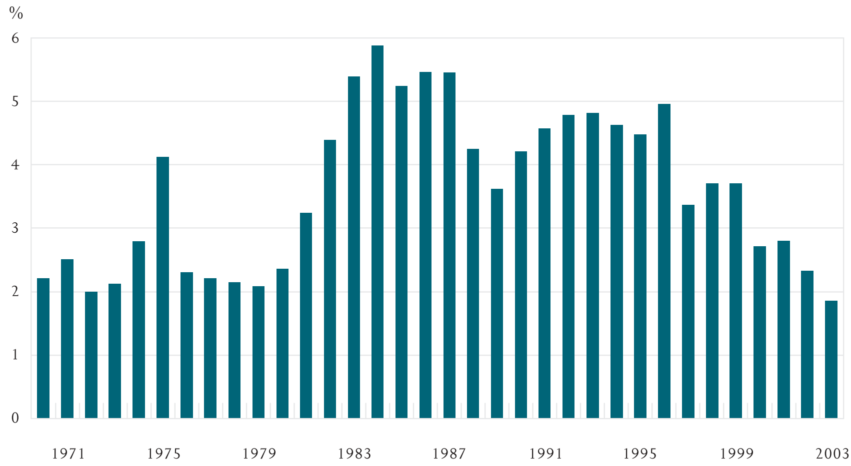
Underlying earnings accrue from the fact that interest earnings on assets exceed interest payments on liabilities. This occurs because, as noted, a substantial proportion of liabilities is in the form of currency notes, on which no interest is payable. Liabilities in the form of capital also do not involve any interest payments.

In contrast, virtually all the financial assets held earn interest. These are mainly domestic and foreign securities and deposits with foreign banks. Interest payments by the RBA in the past year averaged only 1.3 per cent when measured across all liabilities, while interest earnings were 3.5 per cent of assets.

Operating costs tend to be fairly small relative to the flows of interest payments and receipts, so it is not surprising that underlying earnings for the year were only a little lower than the net interest margin – about 2 per cent of assets.

Underlying earnings are a relatively stable component of profits from year to year, but they do move over time with the long cycle in interest rates. They rose with interest rates in the 1980s to an average of almost 5 per cent of assets before declining to about 2 per cent recently as interest rates, both in Australia and overseas, fell.

GRAPH 23 | **UNDERLYING EARNINGS** Per cent of assets



Source: RBA

In absolute terms, the size of underlying earnings also reflects, of course, the size of the RBA's balance sheet; higher holdings of assets will normally yield higher underlying earnings. The balance sheet has expanded considerably over recent years, for a variety of reasons, but the growth has not been sufficient to offset the effect of the decline in interest margins. As such, underlying earnings have contracted from about $1.75 billion in the mid 1990s to around $1.25 billion last year.

Valuation Gains and Losses

As noted, the RBA's policy responsibilities require it to hold a high proportion of its assets whose value is affected by changes in interest rates and exchange rates. Ninety-eight per cent of the RBA's assets are subject to interest rate risk and, of these, about half on average has tended also to be subject to exchange rate risk.

Rises in the general level of interest rates cause the market value of existing securities to fall. A summary measure of the interest rate sensitivity of a portfolio of securities is given by the portfolio's duration. This is a measure of the weighted average maturity of all the cash flows (coupon payments and maturities) associated with the portfolio. The longer the duration of a portfolio, the more sensitive it is to changes in interest rates.

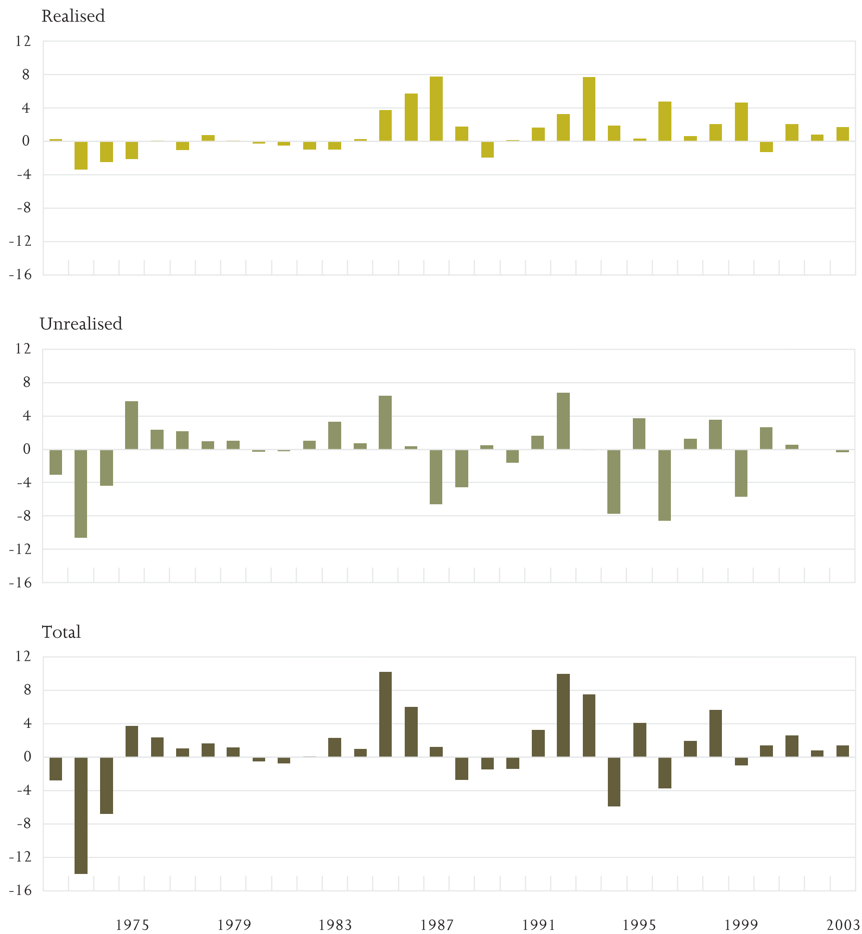
The duration of the RBA's holdings of securities is about 2 years. This means that each rise of 1 percentage point in the general level of interest rates will reduce the market value of the securities by 2 per cent. On a portfolio of about $65 billion, this translates to an absolute loss of about $1.3 billion. Given that interest rates on securities can move by several percentage points in a year, the potential losses faced from this source are very large.

For that proportion of assets held in foreign currencies, there is an additional risk associated with changes in exchange rates of those currencies against the Australian dollar. Foreign currency assets are held as part of Australia's official reserves, and provide scope to intervene in the foreign exchange market.

On average, about half the RBA's assets have tended to be in foreign currencies. At present the proportion is higher than this, at around 60 per cent, but a large part of these foreign currency investments is held under swap agreements and is therefore not subject to foreign exchange risk as the exchange rate at which they are to be sold has been agreed. As such, the proportion of assets exposed to foreign exchange risk is about 20 per cent.

The proportion of assets exposed to foreign exchange risk tends to vary over the exchange rate

GRAPH 24 | **VALUATION GAINS AND LOSSES** Per cent of assets



Source: RBA

cycle as the RBA undertakes intervention in relation to the Australian dollar. When the exchange rate of the Australian dollar is at low levels, for example, the RBA is likely to be a buyer of Australian dollars and a seller of foreign currencies; this means that the proportion of its assets held in foreign currencies tends to fall. Conversely, when the Australian dollar is at high levels, the RBA tends to be a seller of Australian dollars and a buyer of foreign currencies, so the proportion of assets held in foreign currencies tends to be above average. Although this intervention is undertaken for the purpose of influencing the exchange rate, it has the side benefit of helping to limit the RBA's exchange risk and, on average, results in profits from foreign exchange intervention. This is because intervention operations, if carried out successfully, mean that the proportion of assets held in foreign currency tends to be at its lowest when the exchange rate is at a low level, which is also when the probability of a rise in the exchange rate is at its highest. Conversely, reserves tend to be at their highest level when the exchange rate is at its highest, and therefore when a fall will most likely occur.

Even with the present relatively low proportion of foreign currency assets, the foreign exchange risks faced by the RBA are still substantial in absolute terms. For example, with net foreign currency assets currently at around $12 billion, a 10 per cent rise in the Australian dollar would result in a valuation loss of around $1.2 billion.

Periods of rising interest rates and a rising exchange rate can coincide (in fact, in the past, they have often done so) so the losses from interest rate movements and currency movements may occur simultaneously, adding to the potential losses faced by the RBA. The potential valuation losses are substantially larger than the RBA's underlying earnings, thereby giving rise to the possibility that the RBA could record an accounting loss in any year.

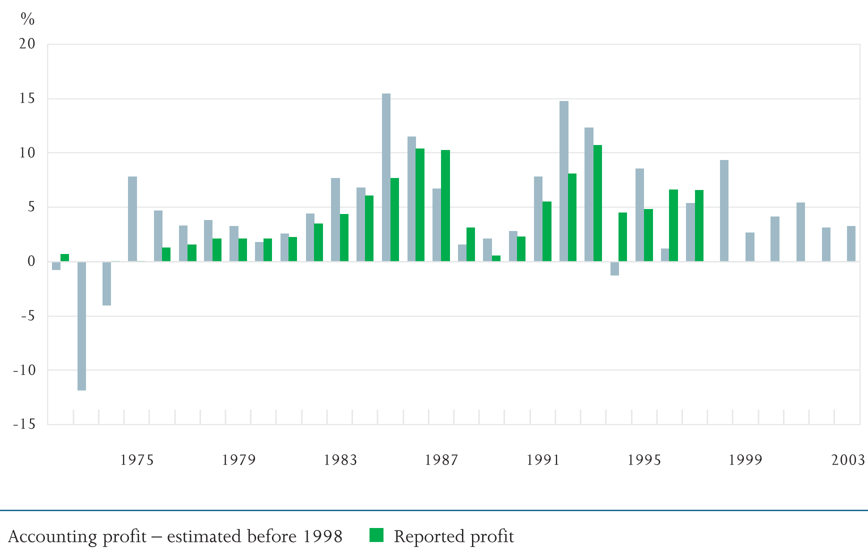
The largest valuation loss over the past 30 years was in 1973, at 14 per cent of assets; the largest valuation gain was in the mid 1980s, at 10 per cent of assets. Both of these were due mainly to foreign currency movements. Gains and losses have averaged about $3^1/_2$ per cent of assets (in absolute terms) over the past 30 years, which has been broadly similar to the average size of the RBA's underlying earnings over that period. On balance, they have added to profits as the number of years in which gains have been recorded have outnumbered years of losses by two to one. This reflected the fact that for a good part of this period there was a downward trend in the exchange rate, which produced gains on foreign currency assets. There is no reason to believe that this will continue in the future, so the incidence of gains and losses should become more evenly balanced.

The Impact of Accounting Standards

Since 1998, the RBA has reported its accounting profits consistent with Australian Accounting Standards and the *Commonwealth Authorities and Companies Act*. This means that all valuation gains and losses on financial assets are now fully reflected in accounting profits. This was not always the case. In earlier years, the RBA complied with reporting standards determined by regulations under the *Reserve Bank Act*. Under these arrangements, some valuation gains or losses on traded assets were not immediately reflected in profits but were absorbed into various reserves or provisions. This had the effect of smoothing profits from year to year.

The experience of the early 1970s provides a good illustration. As noted, the RBA's largest loss on foreign currency positions was in 1973, when total

GRAPH 25 | **ACCOUNTING PROFITS** Per cent of assets



Source: RBA

losses amounted to about 12 per cent of assets. At that time, Australia had a pegged exchange rate and there were widespread expectations that the currency would be revalued upwards. This led to a rise in the RBA's holdings of foreign exchange as, in order to clear the foreign exchange market each day as it was required to do, the RBA had to buy foreign currency and sell Australian dollars to absorb the opposite pressures from the market. In addition, the RBA was also required to provide forward foreign exchange cover to companies engaged in international trade and its forward commitments (to buy foreign exchange at the then current exchange rate) trebled over a short period.

When the exchange rate was revalued upwards, the RBA incurred large losses both on its outright holdings of foreign currencies and its forward position. Yet the profit and loss account for that year did not show a large loss, as might have been expected under current accounting rules, but a very small profit. The foreign exchange losses were, to a small degree, absorbed by transfers from financial reserves and from net interest earnings, but the bulk was treated as an "unfunded adjustment account" on the balance sheet. This accounting treatment was consistent with the reporting requirements applying to the RBA at that time, as certified by the Auditor General.

Reported profits before 1998 can be adjusted to provide a series that is broadly consistent with the current measure of total accounting profits. If current accounting practices had been followed over the past thirty years, the RBA would have shown losses in four years, whereas the results actually recorded have never shown a loss. On the whole, the current approach would also have resulted in greater variability in profits, as shown in the table. A net loss of 11.8 per cent of assets would have been made in 1973, while the largest profit would have been 15.5 per cent of assets. The largest profit recorded under the previous regulations was 10.7 per cent of assets. These adjusted numbers give a better indication than reported profits of the likely variability in profits the RBA could face going forward.

Although the earlier approach resulted in a less volatile pattern of profits it did not systematically overstate profits in the longer-term since periods of large valuation losses, which were at least partly provisioned, were often followed by periods of valuation profits which were treated in a similar way.

RBA Profit and Loss: 1972–2003
(per cent of assets)

	Largest loss	Largest profit	Overall variability*
Reported profit	–	10.7	2.6
Estimated accounting profit	-11.8	15.5	3.7

* Average absolute deviation from mean

Earnings Available for Distribution

The RBA pays dividends out of profits to its shareholder, the Australian Government. Only profits that are realised are eligible to be paid to the Government. Included in this measure are underlying earnings and any gains or losses that are realised on the sale of assets. This is consistent with best practice among central banks and with the *Reserve Bank Act*. To do otherwise could potentially require the RBA to sell assets in order to fund a dividend payment to the Government.

This treatment means that there is a difference between accounting profits and earnings available for distribution. Further, because the latter is an important component feeding into the Government's budget, it tends to receive more attention than the RBA's accounting profits.

Earnings available for distribution on average are likely to be more stable than accounting profits as only those gains or losses that are realised are included. Unrealised gains or losses are, under this concept, reflected the Unrealised Profits Reserve. Only if unrealised losses are so large that they exceed the balance in the Unrealised Profits Reserve is an amount charged against earnings available for distribution, in order to restore the balance in this reserve to zero.

Even though realised gains and losses will on average be smaller than total valuation gains or losses, they are still potentially large relative to underlying earnings. As such, earnings available for distribution can be volatile from year to year.

EARNINGS AND DISTRIBUTION

The *Reserve Bank Act* determines that underlying earnings, which are mainly interest earnings on the RBA's assets, net of interest payments on liabilities and operating costs, plus any gains (or losses) realised from the sale of assets are available to be distributed as a dividend to the Australian Government, the RBA's owner. This is subject to any transfers to augment the Reserve Bank Reserve Fund or to meet other contingencies. Unrealised gains on assets are not available for distribution, but are transferred to a reserve. A longer run treatment of the RBA's profitability and the risks to which it is exposed is contained in the preceeding chapter. The current chapter is confined to a discussion of the results in 2002/03.

In 2002/03, underlying earnings were $1 238 million, compared with $1 400 million in 2001/02, and an average of about $1 600 million in the 1990s. This decline reflects the exceptionally low level of interest rates around the world over the past year or two.

Realised gains on assets amounted to $1 159 million in 2002/03, compared with $489 million in 2001/02. The main source of realised gains was the appreciation in value of foreign bonds as interest rates around the world moved to historical lows. Sales of foreign securities resulted in realised gains of $965 million, compared with $53 million last year. Realised foreign exchange gains were $252 million, $244 million lower than in 2001/02. With the Australian dollar exchange rate appreciating during the year, fewer of the RBA's foreign exchange transactions involved the sale of foreign exchange from its portfolio so fewer gains were realised (the RBA realises gains on foreign exchange transactions only when it sells foreign currencies from its reserves. When it buys foreign exchange, as it has been doing on balance during the past year, there is no immediate effect on profits; profits will be earned when the foreign exchange is subsequently sold).

Profits earned in 2002/03 and available for distribution amounted to $2 397 million.

Accounting Profits

As well as calculating "earnings available for distribution", the RBA also calculates accounting profit. This is done according to generally accepted accounting principles, under which all valuation gains or losses – whether realised or unrealised – are brought to the profit and loss account. The fall in interest rates around the world in 2002/03 saw the RBA make substantial valuation gains on its fixed-interest investments, partially offset by valuation losses from the appreciation in the Australian dollar exchange rate. Combined with underlying earnings of $1 238 million, valuation gains of $935 million gave an accounting profit of $2 173 million (compared with $1 868 million in 2001/02).

Reserves and Dividend

As with other financial institutions, the RBA maintains reserves which are available to absorb losses that might arise in the course of its operations. The major reserve, the Reserve Bank Reserve Fund (RBRF), is available to cover potential losses from a range of risks, including market risk and other events, such as fraud and operational risks, to which most financial institutions are exposed in the course of their activities. The RBRF is funded from transfers from profit and is akin to capital.

The *Reserve Bank Act* provides for the Treasurer to

Sources of Earnings Available for Distribution
($ million)

	Underlying earnings	Realised gains and losses	Earnings available for distribution
1986/87	1 412	2 035	3 447
1987/88	1 062	464	1 526
1988/89	891	-474*	417
1989/90	1 049	46*	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	1 750	1 524	3 274
1998/99	1 816	1 860*	3 676
1999/00	1 511	-708	803
2000/01	1 629	1 205	2 834
2001/02	1 400	489	1 889
2002/03	1 238	1 159	2 397

* Includes unrealised losses in excess of previous years' unrealised gains held in reserves

determine, after consultation with the Board, the amount, if any, to be credited to the RBRF from earnings available for distribution. The balance of distributable earnings is payable to the Australian Government after any such transfers. The Treasurer has agreed to transfer to the RBRF an amount of $133 million from profits for 2002/03. Accordingly, the balance in the RBRF stood at $6 285 million on 30 June 2003, a level which the Board regards as satisfactory.

After allowing for the transfer to the RBRF, the dividend payable to the Government amounted to $2 264 million. In recent years, the RBA has usually paid this dividend early in the financial year following that in which it was earned. The exception was in 1998/99, when the Treasurer decided to defer the receipt of some of that year's profits, spreading the dividend over the following two years. The Treasurer has again decided to delay receipt of part of the dividend due from earnings in 2002/03. A sum of $1 300 million has been paid to the Government in August 2003, with a further $964 million to be paid in the 2004/05 year.

The RBA maintains other reserves which are available to absorb losses. Under the *Reserve Bank Act*, and consistent with international practice for central banks, unrealised gains are not available to be paid to the Australian Government but are transferred to the Unrealised Profits Reserve. Balances in this reserve remain available to absorb future losses that might arise from adverse movements in interest or exchange rates, or they are realised when relevant assets are sold. On 30 June 2003, the balance in the Unrealised Profits Reserve was slightly lower, at $1 576 million, than it had been a year earlier.

The RBA also maintains asset revaluation reserves, with the value in these reserves reflecting the amount by which the market value of the RBA's holdings of gold and property exceed the price at which they were purchased. The amounts in these reserves stood at $1 513 million on 30 June 2003, a little lower than a year earlier.

Reserve Bank Payments to Government
($ million)

	Earnings available for distribution	Transfers to reserves	Payments to the Australian Government				
			Balance available from current year's profit	Interim payment from current year's profit	Payment from previous year's profit	Payment delayed from previous year	Total payment
1990/91	1 713	210	1 503	400	275	–	675
1991/92	2 554	200	2 354	400	1 103	–	1 503
1992/93	4 563	750	3 813	600	1 954	–	2 554
1993/94	1 508	–	1 508	–	3 213	–	3 213
1994/95	1 772	–	1 772	200	1 508	–	1 708
1995/96	2 486	150	2 336	200	1 572	–	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	3 676	–	3 676	–	2 726	–	2 726
1999/00	803	–	803	–	3 000	–	3 000
2000/01	2 834	–	2 834	–	803	676	1 479
2001/02	1 889	–	1 889	–	2 834	–	2 834
2002/03	2 397	133	2 264	–	1 889	–	1 889
2003/04	–	–	–	–	1 300	–	1 300
2004/05	–	–	–	–	–	964	n/a

The financial statements for 2002/03 are presented in the following pages.

FINANCIAL STATEMENTS

AS AT 30 JUNE 2003

DIRECTORS' STATEMENT

In the opinion of the directors, the financial statements for the year ended 30 June 2003 give a true and fair view of the matters required by the Finance Minister's Orders 2002-03 made under the *Commonwealth Authorities and Companies Act 1997*. The Reserve Bank is and will be able to pay its debts as and when they become due.

IJ Macfarlane

Chairman, Reserve Bank Board
13 August 2003

STATEMENT OF FINANCIAL POSITION As at 30 June 2003

Reserve Bank of Australia and Controlled Entities

	Note	2003 $M	2002 $M
ASSETS			
Cash and liquid assets	6, 19	839	606
Australian dollar securities	1(d), 18	18 933	21 987
Foreign exchange	1(c), 18	44 929	35 650
Gold	1(b), 18	1 350	1 459
Property, plant and equipment	1(f), 8	287	277
Loans, advances and other	7	255	149
Total Assets		66 593	60 128
LIABILITIES			
Deposits	1(g), 9	14 736	13 992
Distribution payable to Australian Government	1(i), 3	2 264	1 889
Other	10	8 007	2 807
Australian notes on issue	1(k)	32 172	31 930
Total Liabilities		57 179	50 618
Net Assets		9 414	9 510
Capital and Reserves			
Reserves:			
Unrealised Profits Reserve	1(h), 5	1 576	1 798
Asset revaluation reserves	1(h), 5	1 513	1 520
Reserve Bank Reserve Fund	1(h), 5	6 285	6 152
Capital	5	40	40
Total Capital and Reserves		9 414	9 510

STATEMENT OF FINANCIAL PERFORMANCE For the year ended 30 June 2003

Reserve Bank of Australia and Controlled Entities

	Note	2003 $M	2002 $M
REVENUES			
Interest revenue	2	2 175	2 196
Net gains on securities and foreign exchange	2	935	468
Dividend revenue	2	3	4
Fees and commissions	2	20	20
Other revenue	2	37	39
Total revenue		3 170	2 727
EXPENSES			
Interest expense	2	804	684
General administrative expenses	2	170	149
Other expenses	2	23	26
Total expenses		997	859
Net Profit		2 173	1 868
Net revaluation adjustments in asset revaluation reserves	1(h), 5	(5)	100
Net profit plus net revaluation adjustments in asset revaluation reserves		2 168	1 968

STATEMENT OF DISTRIBUTION For the year ended 30 June 2003

Reserve Bank of Australia and Controlled Entities

	Note	2003 $M	2002 $M
Net Profit		2 173	1 868
Transfer from Unrealised Profits Reserve	5	222	11
Transfer from asset revaluation reserves	5	2	10
Earnings available for distribution		2 397	1 889
Distributed as follows:			
Reserve Bank Reserve Fund	5	133	–
Payable to the Australian Government	3	2 264	1 889
		2 397	1 889

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS 30 June 2003

Reserve Bank of Australia and Controlled Entities

NOTE 1 SUMMARY OF ACCOUNTING POLICIES

The financial statements have been prepared in accordance with the *Reserve Bank Act* and the *Commonwealth Authorities and Companies Act 1997*.

The form and content of the financial statements incorporate the requirements of the Finance Minister's Orders 2002-2003. These orders provide that the financial statements of agencies and authorities must comply with accounting standards and accounting interpretations issued by the Australian Accounting Standards Board. As the Reserve Bank of Australia (RBA) is a financial institution, the financial statements have been prepared using AAS32 – *Specific Disclosures by Financial Institutions*.

The RBA has been granted an exemption from the requirements of the Orders as detailed in Note 1 (m). This exemption relates to matters of disclosure and presentation which are of a minor nature and are adequately dealt with in these financial statements.

The statements are a general purpose financial report prepared in accordance with Australian Accounting Standards. All amounts are expressed in Australian dollars unless another currency is indicated. Current market values are used for the RBA's major assets, including domestic and foreign marketable securities, gold and foreign currency, as well as for premises. In the case of plant and equipment, an historical cost basis of accounting is used. Revenue and expenses are brought to account on an accrual basis. All revenues, expenses and profits are from ordinary activities of the RBA. Unless otherwise stated, the accounting policies and practices followed in these statements are consistent with those followed in the previous year.

(a) Consolidation and associated company The financial statements show information for the economic entity only; this reflects the consolidated results for the parent entity, the Reserve Bank of Australia, and its wholly owned subsidiary, Note Printing Australia Limited. The results of the parent entity do not differ materially from the economic entity and have therefore not been separately disclosed other than in Note 15, Related party and other disclosures. Note Printing Australia Limited was incorporated as a wholly owned subsidiary of the RBA on 1 July 1998, with an initial capital of $20 000 000.

The assets, liabilities and results of Note Printing Australia Limited have been consolidated with the parent entity accounts in accordance with AAS24 – *Consolidated Financial Reports*. All internal transactions and balances have been eliminated on consolidation. Note Printing Australia Limited is subject to income tax; its income tax expense is included in the Statement of Financial Performance.

The RBA accounts for its investment in Securency Pty Ltd in accordance with AAS14 – *Accounting for Investments in Associates*. The carrying amount of the RBA's investment in Securency Pty Ltd is reviewed annually to ensure that it is not in excess of its recoverable amount. The RBA's investment in Securency Pty Ltd is included in Note 7.

(b) Gold Gold holdings (including gold on loan to other institutions) are valued at the Australian dollar equivalent of the 3pm fix in the London gold market on the last business day of June. The RBA lends gold to financial institutions participating in the gold market. Gold loans are secured to 110 per cent of their market value by Australian dollar denominated collateral security. Interest on gold loans is accounted for on a standard accrual basis.

(c) Foreign exchange Foreign exchange holdings are invested mainly in securities (issued by the governments of the United States, Germany, France and Japan) and bank deposits (with major OECD foreign commercial banks, central banks and international agencies). The RBA engages in interest rate futures and foreign currency swaps.

Assets and liabilities denominated in foreign currency are converted to Australian dollar equivalents at exchange rates ruling on the last business day of June. Realised and unrealised gains or losses on foreign currency are immediately taken to profit, but only realised gains are available for distribution.

Foreign government securities

Foreign government securities comprise coupon and discount securities and repurchase agreements. Coupon securities have biannual or annual interest payments depending on the currency and type of security. Interest earned on discount securities is the difference between the actual purchase cost and the face value of the security. The face value is received at maturity. Interest earned on securities is accrued over the term of the security.

Marketable securities, other than those contracted for sale under repurchase agreements, are reported at market values on the last business day of June; realised and unrealised gains and losses arising from changes in market valuations during the year are taken to profit. Earnings on foreign currency investments are converted to Australian dollars using the exchange rate on the date they are accrued.

Foreign currency swaps

The RBA uses foreign currency swaps to assist daily domestic liquidity management and to manage its balance sheet holdings. A currency swap is the simultaneous purchase and sale of one currency against another currency for specified maturities. The cash flows are the same as borrowing one currency for a certain period, and lending another currency for the same period. The pricing of the swap must therefore reflect the interest rates applicable to these money market transactions. Interest rates are implicit in the swap contract but interest itself is not paid or received.

Foreign exchange holdings contracted for sale beyond 30 June 2003 (including those under swap contracts) have been valued at market exchange rates (refer Note 18).

Interest rate futures

The RBA uses interest rate futures contracts on overseas exchanges to hedge risks on its portfolio of foreign securities. An interest rate futures contract is a contract to buy or sell a specific amount of securities for a specific price on a specific future date.

Interest rate futures and foreign currency swaps are off-balance sheet items. The RBA did not trade in any other derivative instruments during 2002/03.

(d) Australian dollar securities The RBA holds Commonwealth Treasury Fixed Coupon Bonds, Treasury Notes and Treasury Capital Indexed Bonds. It also holds Australian dollar denominated securities, issued by the central borrowing authorities of State and Territory Governments and certain highly-rated supranational organisations, where these are acquired under repurchase agreements. Realised and unrealised gains or losses on Australian dollar securities are immediately taken to profit, but only realised gains are available for distribution.

Commonwealth Treasury Fixed Coupon Bonds are coupon securities; the interest is payable biannually at the coupon rate. Commonwealth Treasury Notes are discount securities; the interest earned is the difference between the purchase price and the face value on redemption. Treasury Capital Indexed Bonds are coupon securities with the nominal value of the security indexed in line with movements in the Consumer Price Index each quarter until maturity; interest is paid quarterly.

Securities are valued at market prices on the last business day of June except when contracted for sale under repurchase agreements.

(e) Repurchase agreements In the course of its financial market operations, the RBA engages in repurchase agreements involving foreign and Australian dollar marketable securities.

Securities sold and contracted for purchase under repurchase agreements are reported on the Statement of Financial Position within the relevant investment portfolio and are valued at market prices; the counterpart obligation to repurchase is included in Other Liabilities. The difference between the sale and purchase price is recognised as interest expense over the term of the agreement.

Securities purchased and contracted for sale under repurchase agreements are reported within the relevant investment portfolio at contract amount. The difference between the purchase and sale price is recognised as interest income over the term of the agreement.

(f) Property, plant and equipment A formal valuation of all RBA properties is conducted on a triennial basis. The most recent valuation was at 30 June 2001, when Australian properties were valued by officers of the Australian Valuation Office and overseas properties were valued by local independent valuers. The valuations have been incorporated in the accounts.

Valuations on Australian properties are updated annually for developments in the property markets where the RBA's assets are held. Annual depreciation is based on market values and assessments of useful remaining life.

Plant and equipment are recorded at cost less depreciation, which is calculated at rates appropriate to the estimated useful life of the relevant assets. Depreciation rates are reviewed annually, and adjusted where necessary to reflect the most recent assessments of the useful life of assets.

In the opinion of the Board, values of plant and equipment in the financial statements do not exceed recoverable values.

Details of annual net expenditure, revaluation adjustments and depreciation of these assets are included in Note 8.

(g) Deposits Deposits include deposits at call and term deposits. Deposit balances are shown at their face value. Interest is accrued over the term of deposits and is paid periodically or at maturity. Interest accrued but not paid is included in Other Liabilities. Details of deposits are included in Note 9.

(h) Reserves Reserves are maintained to cover the broad range of risks to which the RBA is exposed. The Reserve Bank Reserve Fund (RBRF) is a general reserve which provides for events which are contingent and non-foreseeable, mainly those which arise from movements in market values of the RBA's holdings of Australian dollar and foreign securities; the RBRF also provides for potential losses from fraud and other non-insured losses. Amounts set aside for this reserve are determined by the Treasurer after consultation with the Board.

Asset revaluation reserves reflect the impact of changes in the market values of a number of the RBA's assets (gold, premises, and shares in international financial institutions).

Unrealised gains on foreign exchange and Australian dollar securities are recognised in profit from ordinary activities. Until such gains are realised, they are not available for distribution to the Australian Government; in the interim, the amounts are retained in the Unrealised Profits Reserve.

(i) Profits Profits of the RBA are dealt with in terms of Section 30 of the *Reserve Bank Act* as follows:

(1) Subject to subsection (2), the net profits of the Bank in each year shall be dealt with as follows:

(a) such amount as the Treasurer, after consultation with the Reserve Bank Board, determines is to be set aside for contingencies; and

(b) such amount as the Treasurer, after consultation with the Reserve Bank Board, determines shall be placed to the credit of the Reserve Bank Reserve Fund; and

(c) the remainder shall be paid to the Commonwealth.

(2) If the net profit of the Bank for a year is calculated on a basis that requires the inclusion of unrealised gains on assets during the year, the amount to which subsection (1) applies is to be worked out as follows:

(a) deduct from the net profit an amount equal to the total of all amounts of unrealised gains included in the net profit; and

(b) if an asset in respect of which unrealised gains were included in the net profit for a previous year or years is realised during the year – add to the amount remaining after applying paragraph (a) the total amount of those unrealised gains.

(j) Provisions The RBA maintains provisions for accrued annual leave, calculated on salaries prevailing at balance date and including associated payroll tax. The RBA also maintains provisions for long service leave and post-employment benefits, in the form of health insurance and housing assistance, and associated fringe benefits tax; these provisions are made on a present value basis in accordance with AASB 1028 – *Employee Benefits*. In addition, the RBA makes provision for future workers' compensation claims in respect of incidents which have occurred before balance date, based on an independent actuarial assessment.

(k) Australian notes on issue The RBA assesses regularly the value of notes still outstanding at least five years after the note issue ceased which are judged to have been destroyed and therefore unavailable for presentation. No amount was written off Australian notes on issue in 2002/03, or in 2001/02.

In 2001/02, the RBA began to pay interest on working balances of currency notes held by banks under revised cash distribution arrangements. Interest is paid on balances up to a certain limit.

(l) Rounding Amounts in the financial statements are rounded to the nearest million dollars unless otherwise stated.

(m) Exemptions The RBA has been granted an exemption from the following requirements of the Finance Minister's Orders 2002-03:-

Requirement	Description	Detail of exemption
Appendix A	Forms of Financial Statements	Details of revenues and expenses are disclosed in Note 2.

NOTE 2 NET PROFITS

	Note	2003 $M	2002 $M
Interest revenue			
Overseas investments	1(c)	1 056	1 186
Australian dollar securities	1(d)	1 062	957
Overnight settlements		37	30
Gold loans	1(b)	19	22
Loans, advances and other		1	1
		2 175	2 196
Net gains/(losses) on securities and foreign exchange			
Overseas investments	1(c)	1 036	207
Australian dollar securities	1(d)	49	(99)
Foreign currency	1(c)	(150)	360
		935	468
Dividend revenue			
Earnings on shares in Bank for International Settlements		3	4
Fees and commissions			
Banking services fees received		20	20
Other revenue			
Reimbursement by Australian Government for loan management and registry expenses		1	1
Rental of Bank premises		4	5
Sales of note products		19	19
Other		13	14
		37	39
Total		3 170	2 727
Less:			
Interest expense			
Deposit liabilities	1(g)	513	454
Currency note holdings of banks	1(k)	136	78
Repurchase agreements	1(e)	155	152
		804	684
General administrative expenses			
Staff costs		101	86
Special redundancy/retirement payments	12	3	4
Depreciation of property	8	7	7
Depreciation of plant and equipment	8	9	8
Premises and equipment		25	25

	Note	2003 $M	2002 $M
NOTE 2 CONTINUED			
Materials used in note production		8	8
Travel		3	3
Consultants' fees	14	8	2
Other		6	6
		170	149
Other expenses			
Agency business reimbursement		3	3
Subsidiary income tax		–	–
Cash distribution expenses		4	4
Other		16	19
		23	26
Total		997	859
Net Profit		2 173	1 868

Staff costs in 2002/03 include an expense of $8 million associated with the increase in the balance of the Provision for post-employment benefits (refer Note 10).

NOTE 3 DISTRIBUTION TO AUSTRALIAN GOVERNMENT

Section 30 of the *Reserve Bank Act* requires that the net profits of the Reserve Bank of Australia, less amounts set aside for contingencies or placed in the RBRF as determined by the Treasurer, shall be paid to the Australian Government (see Note 1 (i) for details). Of the sum payable to the Australian Government of $2 264 million out of profits for 2002/03, $1 300 million will be paid in August 2003 and the balance of $964 million will be paid in 2004/05.

NOTE 4 INTEREST REVENUE AND INTEREST EXPENSE

Analysis for the year ended 30 June 2003

	Average balance $M	Interest $M	Average annual interest rate %
Interest revenue			
Overseas investments	39 533	1 056	2.7
Australian dollar securities	20 055	1 062	5.3
Loans, advances and other	38	1	3.4
Overnight settlements	818	37	4.5
Gold loans	1 465	19	1.3
	61 909	2 175	3.5
Interest expense			
Banks' Exchange Settlement balances	771	35	4.5
Deposits from governments	9 905	470	4.7
Deposits from overseas institutions	190	2	1.2
Overseas repurchase agreements	6 495	95	1.5
Domestic repurchase agreements	1 268	60	4.7
Currency note holdings of banks	2 865	136	4.7
Other deposits	146	6	4.2
	21 640	804	3.7
Analysis for the year ended 30 June 2002			
Interest revenue total	57 800	2 196	3.8
Interest expense total	18 357	684	3.7

	2003 $M	2002 $M

NOTE 5 RESERVES

Changes in the RBA's various reserves are shown below.

	2003 $M	2002 $M
Asset revaluation reserves (Note 1(h))		
Gold		
Opening balance	1 339	1 260
Net revaluation adjustments	(117)	79
As at 30 June	1 222	1 339
Shares in international financial institutions (Note 7)		
Opening balance	74	68
Net revaluation adjustments	105	6
As at 30 June	179	74
Bank properties (Notes 1(f), 8)		
Opening balance	107	102
Net revaluation adjustments	7	15
Transfers to Statement of Distribution	(2)	(10)
As at 30 June	112	107
Total asset revaluation reserves		
Opening balance	1 520	1 430
Net revaluation adjustments	(5)	100
Transfers to Statement of Distribution	(2)	(10)
As at 30 June	1 513	1 520
Unrealised Profits Reserve (Note 1(h))		
Opening balance	1 798	1 809
Net transfers to Statement of Distribution	(222)	(11)
As at 30 June	1 576	1 798
Reserve Bank Reserve Fund (Note 1(h))		
Opening balance	6 152	6 152
Transfer from Net Profit	133	–
As at 30 June	6 285	6 152
Capital		
Opening and closing balance	40	40
Total capital and reserves		
Opening balance	9 510	9 431
Net profit plus net revaluation adjustments in asset revaluation reserves	2 168	1 968
Distribution payable to Australian Government	(2 264)	(1 889)
As at 30 June	9 414	9 510

NOTE 6 CASH AND LIQUID ASSETS

This includes net amounts of $822 million owed to the RBA for overnight clearances of financial transactions through the clearing houses; an amount of $586 million was owed to the RBA at 30 June 2002.

NOTE 7 LOANS, ADVANCES AND OTHER ASSETS

	2003 $M	2002 $M
Shareholding in Bank for International Settlements	181	76
Officers' Home Advances	25	27
Gold coin	17	19
Investment in Securency	11	5
Other	21	22
As at 30 June	255	149

The Reserve Bank of Australia has a 50 per cent share in Securency Pty Ltd, which is incorporated in Victoria Australia, and whose principal activity is the marketing and manufacture of polymer substrate. The capital of Securency as at 30 June 2003 was $36 530 001 ($21 530 001 at 30 June 2002); during 2002/03 the RBA invested $7 500 000 in Securency. The carrying value of the RBA's investment in Securency as at 30 June 2003 was $11 164 670 ($5 001 000 at 30 June 2002). Securency Pty Ltd has a 31 December balance date.

As at 30 June 2003, other assets included receivables of $17.2 million, of which $15.9 million is current.

NOTE 8 PROPERTY, PLANT AND EQUIPMENT

	Land $M	Buildings $M	Plant and equipment $M	Computer software $M	Total $M
Gross Book Value as at 30 June 2002	86	141	119	5	351
Accumulated depreciation	–	–	(71)	(3)	(74)
Net Book Value	86	141	48	2	277
Additions	–	3	21	1	25
Net Revaluation increment/decrement	6	1	–	–	7
Depreciation/amortisation expense	–	(7)	(8)	(1)	(16)
Disposals	(3)	(2)	(1)	–	(6)
Gross Book Value as at 30 June 2003	89	136	135	5	365
Accumulated depreciation	–	–	(75)	(3)	(78)
Net Book Value	89	136	60	2	287

The triennial independent revaluation of all RBA properties occurred at 30 June 2001 (Note 1 (f)). Valuations have been updated annually since then to reflect developments in Australian property markets in which the RBA's properties are located.

	2003 $M	2002 $M
NOTE 9 DEPOSITS		
Banks' Exchange Settlement balances	628	1 091
Australian Government	13 784	12 387
State Governments	13	256
Foreign governments, foreign institutions and international organisations	244	146
Other depositors	67	112
As at 30 June	14 736	13 992
NOTE 10 OTHER LIABILITIES		
Provisions (Note 1(j))		
Provision for accrued annual leave	8	8
Provision for long service leave	21	20
Provision for post-employment benefits	55	47
Provision for workers' compensation	1	1
As at 30 June	85	76
Other		
Amounts outstanding under repurchase agreements (contract price) (Note 1 (e))	7 833	2 671
Interest accrued on deposits	55	34
Other	34	26
As at 30 June	7 922	2 731
Total other liabilities	8 007	2 807

NOTE 11 CONTINGENT LIABILITIES AND OTHER ITEMS NOT INCLUDED IN STATEMENT OF FINANCIAL POSITION

Contingencies

The RBA has a contingent liability, amounting to $72.6 million at 30 June 2003 ($79.0 million at 30 June 2002), in respect of the uncalled portion of its shares held in the Bank for International Settlements.

In the course of providing services to its customers, the RBA provides performance guarantees to third parties in relation to customer activities. Such exposure is not material and has not given rise to losses in the past.

Other items

The RBA has commitments of $8.2 million at 30 June 2003 ($11.8 million at 30 June 2002) payable within one year; and $0.5 million commitments payable beyond one year.

The RBA carries its own insurance risks except where external insurance cover is considered to be more cost-effective or required by legislation.

NOTE 12 SPECIAL REDUNDANCY/RETIREMENT PAYMENTS

The RBA's expenses in 2002/03 include $3 million paid or payable to, or on behalf of, staff who accepted special redundancy/retirement offers. Corresponding payments in 2001/02 totalled $4 million. Staff leaving the RBA in 2002/03 under these arrangements numbered 34 (31 in 2001/02).

NOTE 13 REMUNERATION OF EXECUTIVES

The number of executives whose remuneration packages, measured in terms of costs to the RBA, fell within the following bands was:

Remuneration band	Number 2003	Number 2002
$100 000 – $109 999	1	4
$110 000 – $119 999	1	
$120 000 – $129 999	6	8
$130 000 – $139 999	5	14
$140 000 – $149 999	14	13
$150 000 – $159 999	13	7
$160 000 – $169 999	6	4
$170 000 – $179 999	3	4
$180 000 – $189 999	2	3
$190 000 – $199 999	4	5
$200 000 – $209 999	5	1
$210 000 – $219 999		1
$220 000 – $229 999	1	
$230 000 – $239 999	2	
$240 000 – $249 999	1	6
$250 000 – $259 999		1
$260 000 – $269 999	4	1
$270 000 – $279 999	1	
$300 000 – $309 999		4
$310 000 – $319 999	1	
$320 000 – $329 999	4	
$340 000 – $349 999		1
$380 000 – $389 999	1	
$490 000 – $499 999		1
$500 000 – $509 999	1	

Total remuneration received or due and receivable by these 76 executives amounted to $14.140 million (78 executives totalling $13.668 million in 2001/02). Remuneration includes cash salary, the RBA's contribution to superannuation, housing assistance, motor vehicles, car parking and health insurance and the fringe benefits tax paid or payable on these benefits. Remuneration excludes amounts paid to executives posted outside Australia, or seconded to other organisations for the whole or part of the financial year. Remuneration includes amounts paid to executives who are also members of the Bank Board (refer Note 15).

Termination payments of $0.228 million were made to executives who left the Bank during 2002/03 ($1.055 million in 2001/02); these payments are not reflected in the above table.

NOTE 14 REMUNERATION OF AUDITOR

Fees paid or payable to the statutory auditor (Auditor-General of the Commonwealth of Australia) for audit services totalled $186 000 in 2002/03 ($179 000 in 2001/02). They are included in "Consultants' fees" in Note 2, which also covers legal fees and payments made to specialists for "review and advice" services.

NOTE 15 RELATED PARTY AND OTHER DISCLOSURES

The Remuneration Tribunal determines the remuneration appropriate to the RBA's non-executive Board members. In 2002/03, payments to executive and non-executive Board members totalled $1 146 065 ($1 241 410 in 2001/02). Remuneration includes amounts paid to members of the Bank Board who are also executives (refer Note 13).

The number of directors whose remuneration packages, measured in terms of costs to the RBA, fell within the following bands was:

Remuneration band	Number 2003	Number 2002
$10 000 – $19 999	1	
$30 000 – $39 999	4	4
$40 000 – $49 999	2	1
$60 000 – $69 999		1
$160 000 – $169 999		1
$340 000 – $349 999		1
$380 000 – $389 999	1	
$490 000 – $499 999		1
$500 000 – $509 999	1	

At 30 June 2003 and 30 June 2002 there were no loans by the RBA to the Governor, Deputy Governor or non-executive members of the Board.

There were no other related-party transactions with Board members; transactions with director-related entities which occurred in the normal course of the RBA's operations were conducted on terms no more favourable than similar transactions with other employees or customers.

In addition, $106 401 was paid for the services of non-executive members of the Board of Note Printing Australia Limited who are not employees of the RBA or members of the Bank Board ($101 787 in 2001/02). The RBA also paid $154 055 for the services of members of the Payments System Board who are not employees of the RBA ($147 252 in 2001/02).

NOTE 16 SUPERANNUATION FUNDS

Two superannuation funds are operated pursuant to the *Reserve Bank Act*: the Reserve Bank of Australia Officers' Superannuation Fund (OSF) and the Reserve Bank of Australia UK Pension Scheme. A small part of the assets of the OSF is held by the RBA as nominee for the trustees of the OSF; such assets are not included in these statements. Payment of the funds' current and future benefits is funded by member and Bank contributions and the funds' existing asset bases. The RBA's contributions to the OSF in accordance with the Reserve Bank (Officers' Superannuation) Rules, and to the UK Pension Scheme in accordance with the UK Trust Deed, are included in staff costs in Note 2. Administration and other operational costs (eg salaries, overheads, legal costs and valuation fees) incurred by the RBA for superannuation arrangements are also included in Note 2. There were no other related-party transactions between the RBA and the funds during 2002/03.

At 30 June 2003, the OSF had a surplus of assets over accrued benefits of $66 million ($183 million at 30 June 2002). The UK Pension Scheme had a surplus equivalent to $5 million ($5 million at 30 June 2002). During 2002/03, the RBA made superannuation contributions of $2.3 million ($2.3 million in 2001/02).

Details of the Funds as at 30 June are as follows:

	2003 $M	2002 $M
Reserve Bank of Australia Officers' Superannuation Fund		
Accrued benefits	542	426
Net market value of assets	608	609
Surplus	66	183
Vested benefits	508	435
Reserve Bank of Australia UK Pension Scheme		
Accrued benefits	19	20
Net market value of assets	24	25
Surplus	5	5
Vested benefits	16	18
Total Superannuation Funds		
Accrued benefits	561	446
Net market value of assets	632	634
Surplus	71	188
Vested benefits	524	453

Accrued benefits refer to the present value of future benefits payable to current fund members, taking into account assumed future salary increases. Vested benefits are the benefits payable if all current members were to terminate their fund membership at balance date.

NOTE 17 SEGMENT REPORTING

The RBA's primary function as a Central Bank is the implementation of monetary policy in one geographical area – Australia. Over 95 per cent of the RBA's assets (and a similar proportion of revenues) are managed for that purpose by the Financial Markets Group. Additional information on the make-up of the RBA's financial assets is provided in Note 18.

NOTE 18 FINANCIAL INSTRUMENTS

Australian Accounting Standard AAS33 – *Presentation & Disclosure of Financial Instruments* requires disclosure of information relating to: both recognised and unrecognised financial instruments; their significance and performance; accounting policy terms & conditions; net fair values and risk information.

A ***financial instrument*** is defined as any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. The identifiable financial instruments for the RBA are its Australian dollar securities, its foreign government securities, bank deposits, interest rate futures, foreign currency swap contracts, gold loans, notes on issue and deposit liabilities.

Net fair value is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction, and is usually determined by the quoted market price net of transaction costs. The RBA's recognised financial instruments are carried at current market value which approximates net fair value.

Financial risk of financial instruments embodies price risk (currency risk and interest rate risk); credit risk; liquidity risk and cash flow risk. AAS33 requires disclosure on interest rate risk and credit risk.

The interest rate risk and credit risk tables are based on the RBA's settled portfolio as reported in the RBA's Statement of Financial Position.

Interest rate risk

Interest rate risk is the risk that the value of a financial instrument will fluctuate due to changes in market interest rates. The following table shows the RBA's Statement of Financial Position restated in compliance with AAS33.

NOTE 18 CONTINUED

Interest rate risk As at 30 June 2003

	Balance sheet total $M	Floating interest rate $M	Repricing Period $M 0 to 3 months	3 to 12 months	1 to 5 years	Over 5 years	Not bearing interest $M	Weighted average rate %
Assets								
Gold								
Gold loans	1 333	–	316	630	366	–	21	1.2
Gold holdings	17	–	–	–	–	–	17	n/a
Sub-total	**1 350**							
Foreign exchange								
Securities sold under repurchase agreements	6 530	–	–	–	3 190	3 340	–	3.0
Securities purchased under repurchase agreements	10 453	–	10 453	–	–	–	–	1.5
Deposits and other securities	27 741	941	8 950	5 000	9 313	3 284	253	1.8
Accrued interest – foreign exchange	205	–	–	–	–	–	205	n/a
Sub-total	**44 929**							
Australian dollar securities								
Securities sold under repurchase agreements	1 303	–	–	–	563	740	–	4.7
Securities purchased under repurchase agreements	14 259	–	11 086	3 173	–	–	–	4.7
Other securities	3 263	–	1 635	2	802	824	–	4.6
Accrued interest – Australian dollar securities	108	–	–	–	–	–	108	n/a
Sub-total	**18 933**							
Property, plant & equipment	287	–	–	–	–	–	287	n/a
Cash and liquid assets	839	831	–	–	–	–	8	4.5
Loans and advances	25	25	–	–	–	–	–	3.3
Other	230	–	–	–	–	–	230	n/a
Total assets	**66 593**	**1 797**	**32 440**	**8 805**	**14 234**	**8 188**	**1 129**	**2.7**
Liabilities								
Australian notes on issue	32 172	2 456	–	–	–	–	29 716	0.4
Deposits	14 736	2 490	12 200	–	–	–	46	4.6
Distribution payable to Australian Government	2 264	–	–	–	–	–	2 264	n/a
Other	8 007	–	7 833	–	–	–	174	1.5
Total liabilities	**57 179**	**4 946**	**20 033**	**–**	**–**	**–**	**32 200**	**1.4**
Capital and reserves	9 414							
Total balance sheet	**66 593**							
Off balance sheet items								
Interest rate futures	72	–	–	–	–	72	–	n/a

NOTE 18 CONTINUED

Interest rate risk As at 30 June 2002

	Balance sheet total $M	Floating interest rate $M	Repricing Period $M 0 to 3 months	3 to 12 months	1 to 5 years	Over 5 years	Not bearing interest $M	Weighted average rate %
Total assets	60 128	1 420	34 164	4 182	10 094	9 206	1 062	3.5
Total liabilities	50 618	6 142	13 071	–	–	–	31 405	1.4
Capital and reserves	9 510							
Total balance sheet	60 128							
Off balance sheet items	38	–	–	–	–	38	–	n/a

Other liabilities includes amounts outstanding under sale repurchase agreements.

All recognised financial instruments are shown at net fair value.

Off-balance sheet items are shown at nominal market value (difference from net fair value is negligible).

All financial instruments are shown at their repricing period which is equivalent to the remaining term to maturity.

Interest rate futures reflect the positions in interest rate contracts traded in foreign futures exchanges to manage interest rate risk on Official Reserve Assets.

Credit risk

Credit risk in relation to a financial instrument is the risk that a customer, bank or other counterparty will not meet its obligations (or be permitted to meet them) in accordance with agreed terms.

The RBA's maximum exposure to credit risk in relation to each class of recognised financial assets, other than derivatives (off-balance sheet items), is the carrying amount of those assets as indicated in the balance sheet. The RBA's exposures are to highly rated counterparties and its credit risk is very low.

As part of an IMF support package during 1997/98, 1998/99, 1999/2000, 2000/01, 2001/02 and 2002/03, the RBA undertook a series of foreign currency swaps with the Bank of Thailand. The RBA provided United States dollars, receiving Thai baht in exchange. The amount outstanding on the swaps at 30 June 2003 was the equivalent of $66 million ($606 million at 30 June 2002), on which the RBA is earning a yield of 1.2 per cent (2.0 per cent in 2001/02). The swaps represent 0.1 per cent of the RBA's total assets as at 30 June 2003 (1.0 per cent at 30 June 2002). The remaining tranche of the swap was repaid in July 2003.

NOTE 18 CONTINUED

The RBA's maximum credit risk exposure in relation to off-balance sheet items is:

1. ***Foreign exchange swaps*** – As at 30 June 2003 the RBA was under contract to purchase $16.0 billion of foreign currency and sell $43.1 billion of foreign currency. As of that date there was an unrealised net gain included in net profit of $2 089 million on these swap positions. The credit risk exposure of these contracts is the cost of re-establishing the contract in the market in the event of the failure of the counterparty to fulfil its obligations.

2. ***Interest rate futures*** – As at 30 June 2003 the amount of credit risk on interest rate futures contracts was approximately $0.8 million ($0.9 million at 30 June 2002). As at 30 June 2003 there was an unrealised loss brought to account on those contracts of $2.7 million ($42 000 unrealised loss at 30 June 2002).

Concentration of credit risk

The RBA operates to minimise its credit risk exposure through comprehensive risk management policy guidelines. The following table indicates the concentration of credit risk in the RBA's investment portfolio. See Note 1(c) Foreign Exchange.

Credit Risk

	Risk rating of security issuer*	Risk rating of counterparties*	% of total asset portfolio as at 2003	% of total asset portfolio as at 2002
Australian dollar securities				
Holdings of Commonwealth Government securities	AAA	n/a	5.1	5.4
Securities sold under repurchase agreements	AAA	AA	1.5	1.7
	AAA	other	0.4	0.1
Securities held under repurchase agreements	AAA	AA	18.6	25.9
	AAA	other	1.0	1.2
	AA	AA	1.9	1.9
	AA	other	0.0	0.3
Foreign investments				
Holdings of securities	AAA	n/a	25.3	29.8
	AA	n/a	8.1	5.4
Securities sold under repurchase agreements	AAA	AA	8.9	1.2
	AAA	other	0.9	1.5
Securities held under repurchase agreements	AAA	AA	14.8	9.7
	AAA	other	0.9	3.6
Deposits	n/a	AAA	0.6	1.2
	n/a	AA	7.8	6.0
	n/a	other	0.1	1.0
Gold loans	n/a	AAA	0.2	0.2
	n/a	AA	1.0	1.6
	n/a	other	0.8	0.5
Other			2.1	1.8
			100%	100%

* Standard & Poor's equivalent ratings

NOTE 19 CASH FLOW STATEMENT

The following cash flow statement appears as a matter of record to meet the requirements of AAS 28 – *Statement of Cash Flows*; in the RBA's view, it does not shed any additional light on the RBA's financial results. For the purpose of this statement, cash includes the notes and coin held at the Reserve Bank and overnight settlements system account balances with other banks.

STATEMENT OF CASH FLOWS For the financial year ended 30 June

	2003 Inflow/(outflow) $M	2002 Inflow/(outflow) $M
Cash flows from operating activities		
Interest received on investments	2 011	2 056
Interest received on loans, advances, and on net overnight settlements systems	38	32
Loan management reimbursement	1	1
Banking service fees received	23	21
Rents received	4	5
Net payments for and proceeds from sale of investments	(73)	(622)
Interest paid on deposit liabilities	(492)	(484)
Interest paid on currency note holdings of banks	(136)	(78)
Staff costs (including redundancy)	(94)	(94)
Premises and equipment	(25)	(25)
Other	(105)	9
Net cash provided by operating activities	1 152	821
Cash flows from investment activities		
Net expenditure on property, plant and equipment	(16)	12
Net cash used in investing activities	(16)	12
Cash flows from financing activities		
Profit payment to Australian Government	(1 889)	(2 834)
Net movement in deposit liabilities	744	(2 872)
Net movement in loans and advances	2	8
Net movement in notes on issue	242	4 762
Other	(2)	29
Net cash provided by financing activities	(903)	(907)
Net increase/(decrease) in cash	233	(74)
Cash at beginning of financial year	606	680
Cash at end of financial year	839	606

NOTE 19 CONTINUED

Reconciliation of cash	2003 $M	2002 $M
Cash	17	20
Overnight settlements systems	822	586
	839	606

Reconciliation of net cash provided by operating activities to Net Profits in terms of the *Reserve Bank Act*	2003 $M	2002 $M
Net Profit	2 173	1 868
Increase/(decrease) in interest payable	22	(30)
Net loss/(gain) on overseas investments	(1 036)	(207)
Net loss/(gain) on Australian dollar securities	(49)	99
Net loss/(gain) on foreign currency	150	(360)
Decrease/(increase) in income accrued on investments	48	65
Depreciation of property	7	7
Depreciation of plant and equipment	9	8
Net payments for and proceeds from sale of investments	(73)	(622)
Other	(99)	(7)
Net cash provided by operating activities	1 152	821

INDEPENDENT AUDIT REPORT

To the Treasurer

Scope

I have audited the financial statements of the Reserve Bank of Australia for the year ended 30 June 2003. The financial statements include the consolidated financial statements of the consolidated entity comprising the Reserve Bank of Australia and the entities it controlled at the year's end or from time to time during the financial year. The financial statements comprise:

- Directors' Statement;
- Statements of Financial Position;
- Statement of Financial Performance;
- Statement of Distribution; and
- Notes to and forming part of the Financial Statements.

The members of the Board are responsible for the preparation and presentation of the financial statements and the information they contain. I have conducted an independent audit of the financial statements in order to express an opinion on them to you.

The audit has been conducted in accordance with the Australian National Audit Office Auditing Standards, which incorporate the Australian Auditing Standards, to provide reasonable assurance as to whether the financial statements are free of material misstatement. Audit procedures included examination, on a test basis, of evidence supporting the amounts and other disclosures in the financial statements and the evaluation of accounting policies and significant accounting estimates. These procedures have been undertaken to form an opinion as to whether, in all material respects, the financial statements are presented fairly in accordance with Accounting Standards and other mandatory professional reporting requirements in Australia and statutory requirements so as to present a view which is consistent with my understanding of the Reserve Bank of Australia's and the consolidated entity's financial position, their financial performance and their cash flows.

The audit opinion expressed in this report has been formed on the above basis.

Audit Opinion

In my opinion the financial statements:

(i) have been prepared in accordance with Finance Minister's Orders made under the *Commonwealth Authorities and Companies Act 1997*; and

(ii) give a true and fair view, in accordance with applicable Accounting Standards and other mandatory professional reporting requirements in Australia and the Finance Minister's Orders, of the financial position of the Reserve Bank of Australia and the consolidated entity as at 30 June 2003, and their financial performance and cash flows for the year then ended.

P.J. Barrett
Auditor-General

Sydney
13 August 2003

GPO Box 707 CANBERRA ACT 2601
Centenary House 19 National Circuit
BARTON ACT
Phone (02) 6203 7500 Fax (02) 6273 5355
Email barrep@anao.gov.au

PRO FORMA BUSINESS ACCOUNTS

The following sets of accounts for each of the RBA's contestable businesses have been prepared in accordance with competitive neutrality guidelines. These accounts do not form part of the audited financial statements.

	Transactional Banking Business		Registry	
	2001/02 **$ million**	**2002/03** **$ million**	**2001/02** **$ million**	**2002/03** **$ million**
Revenue				
– Service fees	17.4	17.1	0.8	0.7
– Other revenue	3.8	3.6	0.1	0.1
Total	21.2	20.7	0.9	0.8
Expenditure				
– Direct costs	13.6	12.7	0.5	0.5
– Indirect costs	3.5	3.3	0.2	0.2
Total	17.1	16.0	0.7	0.7
Net profit/(loss)	4.1	4.7	0.2	0.1
Net profit/(loss) after taxes (a)	2.9	3.2	0.2	0.1
Assets (b)				
– Domestic market investments	529.2	332.2	1.4	1.3
– Other assets	8.8	2.9	0.1	0.1
Total	538.0	335.1	1.5	1.4
Liabilities (b)				
– Capital & reserves	25.0	25.0	1.0	1.0
– Deposits	506.1	306.1		
– Other liabilities	6.9	4.0	0.5	0.4
Total	538.0	335.1	1.5	1.4

(a) In accordance with competitive neutrality guidelines, income tax expense has been calculated and transferred to the Commonwealth as a notional part of the RBA's annual profit distribution

(b) As at 30 June

THE RESERVE BANK BOARD AND GOVERNANCE

The Role of the Board

Sections 8A and 10 of the *Reserve Bank Act* 1959 give the Reserve Bank Board responsibility for "monetary and banking policy". The relationship of the Board and the government-of-the-day is set out in Section 11. Routinely, the "Government is to be informed, from time to time, of the Bank's monetary and banking policy". In practice this is done in the regular monthly meetings which the Governor, Deputy Governor and senior officers have with the Treasurer shortly after each Board meeting.

The Act itself has not been changed with respect to the mandate for monetary policy, but procedures and practices have evolved over time, in order to keep the RBA's policy-making process relevant to the changing environment, and in parallel with developments overseas. In 1996, the responsible Minister, the Treasurer, and the Governor jointly signed the *Statement on the Conduct of Monetary Policy*, which confirmed the RBA's independence in making monetary policy, and endorsed the Bank's inflation target. The Governor's twice-yearly appearances before the House of Representatives Standing Committee on Economics, Finance and Public Administration, and the quarterly *Statement on Monetary Policy*, have reinforced this process. An updated, though basically unchanged, second *Statement on the Conduct of Monetary Policy* was released at the time of the announcement by the Treasurer in July 2003 of the appointment of the Governor for a term of a further three years.

When the Australian Prudential Regulation Authority was established in 1998, it took on the prudential supervision of banks, but the RBA retained responsibility for overall financial system stability. (See chapter 1 for an assessment of financial system stability.) The Treasurer's statement in Parliament on 2 September 1997 confirmed that the RBA, in addition to monetary policy, was responsible for overall financial system stability and regulation of the payments system.

The *Reserve Bank Act* 1959 was amended in 1998 to establish the Payments System Board, which is responsible for payments system policy, and reports separately in its own Annual Report.

Composition of the Board

The Board comprises the Governor, who is Chairman, the Deputy Governor, the Secretary to the Treasury and six external members, appointed by the Treasurer – a total of nine. Details of the current members are set out on pages 104 and 105. Five members form a quorum for a meeting of the Board.

Under Section 17(1) of the *Reserve Bank Act* 1959, members of the Board may not be a director, officer or employee of an authorised deposit-taking institution for the purposes of the *Banking Act* 1959.

Meetings of the Board

The *Reserve Bank Act* 1959 does not stipulate the frequency of Board meetings. For many years the Board's practice has been to meet eleven times each year, on the first Tuesday of each month, except January. Most meetings are held at the Head Office in Sydney. By custom, one meeting each year is usually held in Melbourne and, from time to time, the Board meets in other State capitals.

Number of Meetings Attended by Each Member in 2002/03

IJ Macfarlane	10	(11)
GR Stevens	11	(11)
KR Henry	11	(11)
JR Broadbent	11	(11)
RG Gerard +	2	(3)
FP Lowy	9	(11)
DG McGauchie	11	(11)
WJ McKibbin	11	(11)
HM Morgan	11	(11)
RFE Warburton *	6	(6)

+ Mr Gerard was appointed to the Board on 20 March 2003.

* Mr Warburton's term as a member of the Board ended on 21 December 2002.

(The figure in brackets is the number of meetings the member was eligible to attend.)

Audit Committee

The primary objectives of the Audit Committee are to:

- ensure a high-quality, independent and effective audit process;
- assist the Governor and the Board in fulfilling their obligations relating to financial reporting, compliance with laws and regulations, internal control, employee conflicts of interest, business ethics and prevention of fraud; and
- enhance contact between management and the Audit Department.

The Committee also acts, at the request of the Note Printing Australia Limited (NPA) Board, as NPA's Audit Committee.

The Audit Committee is made up of the Deputy Governor as Chairman, a non-executive member of the Reserve Bank Board, JR Broadbent, and an external appointed member, GH Bennett, company director and former National Executive Chairman, KPMG Peat Marwick. During 2002/03, the Committee met on four occasions; all members attended each of these meetings.

Periodically, the Committee has commissioned external reviews of the audit function, including its own operations. During 2002/03, the Committee considered reviews, conducted by separate major accounting firms, of both the RBA internal audit function and the processes and structure of the Committee itself.

Minutes of Audit Committee meetings are circulated to the Reserve Bank Board for information, and discussion as appropriate, and a report on the Committee's activities for the year is prepared for the Board at the time of the presentation of the annual accounts.

Obligations under the *Commonwealth Authorities and Companies (CAC) Act 1997*

The *CAC Act* is one of three Acts which deal with the financial management, accountability and audit of Commonwealth agencies, authorities and companies. The *CAC Act* sets standards of conduct for directors and officers of Commonwealth authorities, with many of these requirements being modelled on comparable areas of the Corporations Law.

The RBA is a Commonwealth authority for the purposes of the *CAC Act* and, for these purposes, the members of the Reserve Bank Board are the directors of the RBA. As such, they are responsible for the preparation of the Annual Report and, at the meeting of the Board on 5 August 2003, they resolved that the Chairman sign the Report, and the Financial Statements as at 30 June 2003, transmit them in accordance with the requirements of the *CAC Act*, and arrange publication.

The House of Representatives Standing Committee on Economics, Finance and Public Administration has, in its Standing Orders, an obligation to review the Annual Report of the RBA, and the Annual Report of the Payments System Board.

Remuneration

Fees of the non-executive members of the Board are determined by the Remuneration Tribunal.

A committee of the non-executive Board members, currently chaired by DG McGauchie, reviews annually the remuneration of the Governor and Deputy Governor in terms of Section 24A of the *Reserve Bank Act 1959*.

Indemnities

Under the provisions of Section 27 of the *CAC Act*, and pursuant to a Board resolution on 3 November 1998, members of the Reserve Bank Board have been indemnified against liabilities incurred arising out of the proper discharge of their responsibilities, provided that any such liability does not arise from conduct involving a lack of good faith. This indemnity does not extend to claims by the RBA itself or any subsidiary of the RBA. A similar indemnity was extended to the members of the Payments System Board, pursuant to a resolution by the Reserve Bank Board on 3 November 1998.

RESERVE BANK BOARD

Chairman, IJ Macfarlane
Governor since 18 September 1996
Term ends 17 September 2006
Chairman – Payments System Board
Chairman – Council of Financial Regulators

GR Stevens
Deputy Governor since 21 December 2001
Present term ends 20 December 2008

KR Henry
Secretary to the Treasury
Member since 27 April 2001

JR Broadbent AO
Member since 7 May 1998
Present term ends 6 May 2008
Director – Coca Cola Amatil Limited
Director – Special Broadcasting Service
Director – Westfield America Management Limited
Director – Westfield Management Limited
Director – Woodside Petroleum Limited

RG Gerard AO
Member since 20 March 2003
Present term ends 19 March 2008
Chairman & Managing Director –
Gerard Industries Pty Ltd

FP Lowy AC
Member since 27 June 1995
Present term ends 9 December 2005
Chairman – Westfield Holdings Limited
Chairman – Lowy Institute for International Policy
Chairman – Soccer Australia Limited
Director – Daily Mail and General Trust PLC (UK)

DG McGauchie
Member since 30 March 2001
Present term ends 29 March 2006
Chairman – Rural Finance Corporation of Victoria
Deputy Chairman – Australian Wool Testing Authority Limited
Deputy Chairman – Ridley Corporation Limited
Director – Australian Centre for International Agricultural Research
Director – GrainCorp Limited
Director – National Foods Limited
Director – Telstra Corporation Limited

WJ McKibbin
Member since 31 July 2001
Present term ends 30 July 2006
Professor of International Economics and Convenor of Division of Economics, Research School of Pacific & Asian Studies – Australian National University
Non-Resident Senior Fellow–The Brookings Institution, USA
President – McKibbin Software Group Inc (USA)
Director – McKibbin Software Group Pty Ltd
Director – EconomicScenarios.com Pty Ltd

HM Morgan AC
Member since 14 August 1996
Present term ends 28 July 2007
Chief Executive Officer – First Charnock Pty Ltd
Joint Chairman – Commonwealth Business Council

ORGANISATIONAL CHART

July 2003

GLOSSARY

ABF	Asian Bond Fund
ACC	Asian Consultative Council
AOFM	Australian Office of Financial Management
APEC	Asia-Pacific Economic Cooperation
APRA	Australian Prudential Regulation Authority
ASIC	Australian Securities and Investments Commission
BIS	Bank for International Settlements
CAC	Collective Action Clause
CAC Act	*Commonwealth Authorities and Companies Act* 1997
CGS	Commonwealth Government securities
CGFS	Committee on the Global Financial System
CHESS	Clearing House Electronic Subregister System of the Australian Stock Exchange
CLS	Continuous linked settlement
CPSS	Committee on Payment and Settlement Systems
CRVS	Cheque reconciliation and verification system
EEO	Equal employment opportunity
EMEAP	Executives' Meeting of East Asian and Pacific central banks
FASB	US Financial Accounting Standards Board
Finance	Department of Finance and Administration
FMA Act	*Financial Management and Accountability Act* 1997

FSF	Financial Stability Forum
G7	Group of Seven
G10	Group of Ten
G20	Group of Twenty
GDP	Gross Domestic Product
HLI	Highly leveraged institution
IAIS	International Association of Insurance Supervisors
IASB	International Accounting Standards Board
IMF	International Monetary Fund
LVR	Loan-to-valuation ratio
NNPC	National Note Processing Centre
NPA	Note Printing Australia Limited
OECD	Organisation for Economic Co-operation and Development
OFC	Offshore financial centre
OH&S	Occupational health & safety
OPA	Official public account
RBA	Reserve Bank of Australia
RITS	Reserve Bank Information and Transfer System
RMBS	Residential mortgage-backed securities
RTGS	Real-time gross settlement
SDRs	Special drawing rights
SDRM	Sovereign debt restructuring mechanism

HEAD OFFICE MANAGEMENT

End July 2003

Governor: Ian Macfarlane
Deputy Governor: Glenn Stevens

Economic Group

Assistant Governor: Malcolm Edey

Economic Analysis Department

Head: Philip Lowe
Deputy Heads: Jacqui Dwyer*
Luci Ellis

Economic Research Department

Head: Tony Richards

Financial Markets Group

Assistant Governor: Ric Battellino

Domestic Markets Department

Head: Chris Ryan
Chief Manager: James Whitelaw

International Department

Head: Bob Rankin
Chief Managers: Chris Aylmer
Mike Sinclair

Financial System Group

Assistant Governor: John Veale*

Payments Policy Department

Head: Michele Bullock*
Chief Manager: Heidi Richards*

System Stability Department

Head: Keith Hall

Business Services Group

Assistant Governor: Geoff Board

Banking Department

Head: Phil Martin

Note Issue Department

Head: John Taylor

Payments Settlements Department

Head: Bill Hands

Corporate Services Group

Assistant Governor: Frank Campbell

Facilities Management Department

Head: Richard Mayes

Financial Administration Department

Head: Darryl Ross

Systems & Technology Department

Head: John Wightman

Personnel Department

Head: Graham Rawstron

Secretary's Department

Secretary: David Emanuel

Information Department

Head: Paul Barry

Audit Department

Head: Paul Apps

* Acting in position

Head Office

65 Martin Place
Sydney 2000
Telephone: (02) 9551 8111
Fax: (02) 9551 8000
Internet: www.rba.gov.au
E-mail: rbainfo@rba.gov.au

Regional Offices

Victoria

Senior Representative Officer: Wes Maley
60 Collins Street
Melbourne 3000
Telephone: (03) 9270 8600
Fax: (03) 9270 8610

Queensland

Senior Representative Officer: Peter Gallagher
12 Creek Street
Brisbane 4000
Telephone: (07) 3002 6100
Fax: (07) 3002 6110

Western Australia

Senior Representative Officer: Tom Rohling
45 St Georges Terrace
Perth 6000
Telephone: (08) 9323 3200
Fax: (08) 9323 3210

South Australia

Senior Representative Officer: Barry Noble
25 Grenfell Street
Adelaide 5000
Telephone: (08) 8113 3500
Fax: (08) 8113 3510

Australian Branch

Australian Capital Territory
Manager: Jim Payne
20-22 London Circuit
Canberra 2600
Telephone: (02) 6201 4800
Fax: (02) 6201 4875

Overseas Offices

Europe

Chief Representative: Peter Stebbing
Deputy Chief Representative: Andrew Langdon
7 Moorgate
London EC2R 6AQ
Telephone: 44 20 7600 2244
Fax: 44 20 7710 3500

New York

Chief Representative: John Broadbent
Deputy Chief Representative: Jeff Grow
1 Liberty Plaza
New York 10006-1404
Telephone: 1 212 566 8466
Fax: 1 212 566 8501

Note Printing Australia Limited

Chief Executive: John Leckenby
Hume Highway
Craigieburn 3064
Telephone: (03) 9303 0444
Fax: (03) 9303 0491