



RESERVE
BANK
of
AUSTRALIA

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ANNUAL REPORT 2006

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Reserve Bank

Governor's Foreword

The Reserve Bank's activities in 2005/06 took place against a background of a strong global economy, where central banks around the world were gradually moving interest rates up to more normal levels. Although world inflation is still relatively low, it has been increasing, as have yields on marketable securities. In Australia, output growth picked up after a small slowing in the second half of 2005 and inflation moved up gradually. There was one tightening of monetary policy during the financial year – a 25 basis point rise in the cash rate in May, followed by another in August 2006.

The developments in monetary policy during the year have been explained thoroughly in the quarterly *Statement on Monetary Policy*, testimony before the House of Representatives Standing Committee on Economics, Finance and Public Administration, media releases and speeches by senior officers. The other main policy responsibility of the Reserve Bank is to contribute to the stability of the financial system. The part of this work that is directed to the payments system is detailed in the Annual Report of the Payments System Board and in media releases. The work that is directed at financial stability itself is covered in the twice-yearly *Financial Stability Review*, which is presented to the Council of Financial Regulators before being released to the public. For these reasons, the Annual Report has for some years now concentrated on giving an account of the other activities of the Reserve Bank during the year, as well as presenting the financial statements. Among the various activities that occurred during the year, the following are worthy of mention.

Domestic money market operations were, as usual, aimed at maintaining the cash rate at the target level set by the Board. The task of achieving it is a daily one involving large sales and purchases of securities outright and under repurchase agreements. In international operations, the main tasks were the investment of international reserves and the provision of foreign exchange for the Government. No outright foreign exchange intervention was undertaken, but reserves were replenished by a further \$2.3 billion. Management of the Reserve Bank's balance sheet has become a larger job as its size has grown: total assets now exceed \$100 billion, compared with \$58 billion five years ago.

International economic relations continued to be an important priority and one that is using more resources as Australia becomes an important member of international bodies, particularly the G-20 and the Financial Stability Forum, which were both formed after the Asian crisis. During 2005/06, the Reserve Bank and the Treasury hosted two meetings for the G-20, and will host the annual G-20 Meeting of Finance Ministers and Central Bank Governors in November 2006 in Melbourne. The Reserve Bank also hosted the March 2006 meeting of the Financial Stability Forum in Sydney. Australia has been a prominent member of both bodies and plays a larger role there than in the older economic forums such as the IMF and OECD. The Reserve Bank continued to participate actively in the work of the Bank for International Settlements, including hosting a conference on reserves management in October 2005 and a conference of central bank auditors in December 2005, both held in Sydney.

In order to operate its regular services such as the wholesale payments system, transactional banking services for the Government and the issue of currency notes, the Reserve Bank regularly updates its systems. There has been a major upgrade of the RITS system, so that participants in the wholesale payments system can now use a more accessible browser-based interface. Work also proceeded with the construction of a business recovery site at Norwest Business Park in Sydney, which is expected to be operational in mid 2007. A new process to ensure that the quality of lower-denomination currency notes is maintained has been developed. It provides incentives to ensure that banks and armoured car companies return old notes, including from remote areas, for processing and replacement. In November 2005, the opportunity was taken to auction the Reserve Bank's holdings of gold coins. These had been accumulated during the Second World War and served no useful purpose on our balance sheet. They really belong in the hands of collectors, as the successful auction results showed.

Note Printing Australia produced its four billionth polymer note in April 2006. It has now printed 51 denominations for 18 countries. During the year, nine new denominations were launched on polymer by Note Printing Australia and other banknote printers for Romania, Papua New Guinea, Singapore and Vietnam. Securrency, the producer of polymer substrate, in which the Reserve Bank has a 50 per cent share, is operating at full capacity and its profits have exceeded budget for the past two years. It is in the process of constructing a new building at Craigieburn, Victoria, to more than double its capacity.

The completion of the 2005/06 financial year almost brings my term as Governor to a close, and this Annual Report is the last to which I will be contributing. It is thus a fitting vehicle for me to express my thanks to the staff of the Reserve Bank for the dedicated and professional job they have done. They have not only carried out their present responsibilities cheerfully and efficiently, but have actively sought to identify potential future problems and put in place systems to prevent them. I thank them, not only for making my job easier, but for the contribution they have made to the economic success of Australia over many years. I would also like to record my thanks for the support I have received from members of the Reserve Bank Board, who in every instance have put the national interest above any sectional interest.



IJ Macfarlane

Chairman, Reserve Bank Board
16 August 2006

Operations in Financial Markets

The main reason the Reserve Bank operates in financial markets is to implement its monetary policy decisions. It also, however, undertakes a large volume of transactions on behalf of clients, particularly in foreign exchange markets, and transacts on its own account to manage its holdings of financial assets.

Over recent years two forces have been shaping the way the Reserve Bank conducts its operations. First, its balance sheet has expanded substantially, mainly because of deposits placed by the Australian Government from the proceeds of its budget surpluses. Over the past four years, the balance sheet has increased by more than 75 per cent, to over \$100 billion, with the majority of the rise owing to larger Government deposits, including recently those of the Future Fund. Second, there has been a decline in outstandings of Commonwealth Government securities (CGS), the securities that had traditionally formed the staple of the Reserve Bank's market operations. To accommodate these two forces, the Reserve Bank has broadened the range of domestic securities in which it is prepared to deal and made more use of foreign exchange operations to manage domestic liquidity.

The result has been a substantial change in the composition of the balance sheet. Compared with four years ago, holdings of CGS (including under repo) have halved, to around \$7 billion, while holdings of other domestic securities have risen strongly. The largest rise in assets, however, has been in foreign exchange holdings. Including amounts held under swaps, holdings of foreign exchange have increased by about \$30 billion over the period, accounting for about three-quarters of the expansion of the balance sheet. This has reduced the pressure on domestic securities markets resulting from the contraction in government debt.

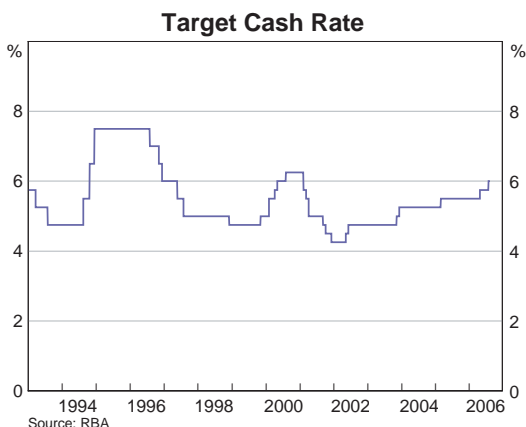
None of these developments has undermined the effectiveness of the Reserve Bank's operations. While there has been some increase in risk on the balance sheet, in terms of interest rate, exchange rate and credit exposures, it remains very well covered by the Reserve Bank's capital position. Moreover, much of the recent expansion of the balance sheet is likely to prove temporary as the Future Fund withdraws deposits to invest in other assets.

Domestic Market Operations

Monetary Policy Implementation

Decisions about the stance of monetary policy in Australia are expressed in terms of a target for the cash rate. This is the interest rate payable on overnight, unsecured loans between banks. Its relevance for policy is that it is an important determinant of other wholesale and retail interest rates, which, in turn, affect the level of economic activity and inflation. The Reserve Bank implements its policy decisions by undertaking transactions with financial market participants on a daily basis to ensure the actual level of the cash rate remains close to the target.

The target for the cash rate was increased by 25 basis points at the May 2006 and August 2006 Board meetings; these rises lifted the cash rate to 6.0 per cent. This was part



of a gradual tightening cycle that began in 2002. The background to policy changes is provided through the media releases announcing each change, and subsequently in the quarterly *Statement on Monetary Policy* and in appearances by the Governor before the House of Representatives Standing Committee on Economics, Finance and Public Administration.

To ensure that the cash rate remains as close as possible to the target, the Reserve Bank undertakes daily operations in the market to adjust the aggregate amount of funds held in commercial banks' Exchange Settlement (ES) accounts at the Reserve Bank. Adjusting the supply of ES funds provides control over the cash rate because banks have a clearly defined demand for these funds. They are the means used by banks to settle their payment obligations with one another (and with the Reserve Bank), and so banks must maintain sufficient holdings to meet expected obligations.

To ensure that the cash rate remains as close as possible to the target, the Reserve Bank undertakes daily operations in the market to adjust the aggregate amount of funds held in commercial banks' Exchange Settlement (ES) accounts at the Reserve Bank.

Over recent years, banks in total have sought to hold around \$750 million in ES accounts. If the supply were to fall below this level for any sustained period, some commercial banks would find themselves holding insufficient balances and would look to restore their holdings by bidding more aggressively for funds in the money market, putting upward pressure on the cash rate. Conversely, because these funds earn interest at slightly below market rates, if supply were to rise above that needed for payment obligations, banks would seek to reduce their unwanted holdings by offering funds in the market, thereby putting downward pressure on market interest rates.

This system of market operations is well understood by market participants and is efficient in maintaining control over the cash rate. Day-to-day volatility in the Australian cash rate is low by international standards.

Standing Facility for Overnight Repurchase Agreements		
	Number of Times Used	Total Value of Drawings (\$ million)
2000/01	18	2 611
2001/02	11	673
2002/03	14	1 673
2003/04	24	2 159
2004/05	11	1 394
2005/06	10	436

Open market operations are conducted each morning. On rare occasions, a second round of operations may be undertaken later in the day to offset large unexpected flows or sudden shifts in demand for ES balances. In 2005/06, there was just one second-round operation.

To supplement the daily market operations undertaken by the Reserve Bank, banks also have a standing facility under which they

can borrow funds overnight from the Reserve Bank on a secured basis, at their discretion but at 25 basis points above the cash rate target. Banks typically use this facility when there are technical factors that prevent them from sourcing funds from the market. In 2005/06, the facility was accessed on 10 occasions, about the same as in the previous year, while the average size of overnight loans declined to less than \$50 million.

Total turnover in domestic securities for market operations in 2005/06 was around \$420 billion, a little higher than in the previous year. The bulk of these operations were repurchase agreements ('repos'), which involved the purchase of securities with an agreement to re-sell at a set future date and at a set price. The high use of repos largely reflects the flexibility that they offer for managing liquidity flows, since their maturity can be tailored to meet expected flows. Outright purchases and sales of securities remained modest.

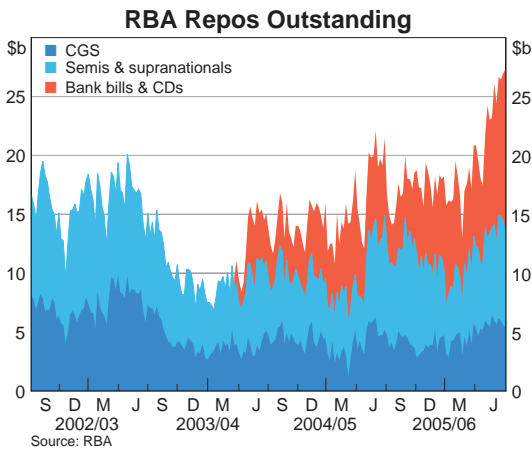
Domestic operations were augmented with foreign exchange swaps. These involve the exchange of one currency for another with an agreement to reverse the transaction at an agreed exchange rate and on an agreed date. In terms of managing domestic liquidity flows, they have similar effects to domestic repos, in that they can be used to add or subtract Australian dollars from the banking sector. The difference is that they do so in exchange for foreign currency rather than domestic securities. Turnover in foreign exchange swaps involving the Australian dollar rose substantially during the year, to over \$150 billion (see below for more details).

As noted above, the Reserve Bank has changed its dealing arrangements in recent years to allow for the reduced amount of CGS on issue. These changes have broadened the range of securities in which the Reserve Bank is prepared to deal. The most recent changes were made in early 2004, when the range of eligible securities was widened to include domestic bank instruments and a broader range of foreign government and supranational paper. The benefits of this change have become even more apparent in the past year, given the further strong growth in the Reserve Bank's balance sheet. The total repo book rose to \$26 billion by June 2006, up from around \$17 billion a year earlier. Most of the overall rise was in repos collateralised by bank bills and certificates of deposit (CDs), which almost trebled to \$14 billion. Repos in CGS have declined over recent years.

Open Market Operations						
(\$ billion)						
	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
Repurchase agreements ^(a)						
– Purchases	376	423	304	272	391	409
– Sales	17	16	17	11	10	6
Outright purchases ^(b)	5	1	3	5	5	4
Total operations in domestic securities	398	440	324	287	405	419
Foreign exchange swaps ^(a)	90	90	90	139	106	157
Total	488	530	414	426	511	576

(a) First leg of transaction.

(b) CGS only until 2002/03. Thereafter includes State and Territory government securities.



In addition to the repo operations noted above, the Reserve Bank continued to rebuild its outright holdings of domestic securities through secondary market purchases of longer-dated securities issued by the State and Territory borrowing authorities (semis). As in the previous year, small parcels (around \$100 million) were purchased at regular intervals throughout the year. In total, nine operations involving longer-dated securities were undertaken, bringing

the value of semis in the domestic portfolio to around \$1.6 billion. These operations have been undertaken to offset to some degree the decline in outright holdings of longer-dated CGS.

Securities Lending

The Reserve Bank maintains a securities lending facility through which it is prepared to lend to market participants any domestic securities that it holds on an outright basis on its balance sheet. This assists the flow of stock through the market and helps market participants meet their settlement obligations. In addition to these operations, which involve its own holdings of securities, the Reserve Bank operates a stock lending facility on behalf of the Australian Office of Financial Management (AOFM). This facility allows participants to obtain access to any line of Treasury bonds, but at a penalty relative to market prices for stock lending.

Both the value and volume of securities lending transactions have risen significantly in recent years. In part this is a response to the tightening supply of government securities, which has increased the demand by market makers to borrow stock to meet settlement obligations. In 2005/06, the value of stock lent from the Reserve Bank's portfolio rose by 70 per cent to over \$20 billion, after having more than doubled in the previous year. Loans are, however, generally only for short periods and the average amount of stock on loan at any one time was about \$500 million. Earnings on these transactions rose to around \$890 000. Stock lending

Stock Lending by the RBA			
	Number of Transactions	Amount Lent (face value, \$ billion)	Net Income (\$ million)
2000/01	75	1.2	0.05
2001/02	119	3.1	0.27
2002/03	32	0.9	0.13
2003/04	185	5.0	0.50
2004/05	264	11.9	0.56
2005/06	460	20.3	0.89

transactions on behalf of the AOFM were relatively small in comparison, at around \$1.2 billion, reflecting the 'last resort' nature of that facility.

Foreign Exchange Operations

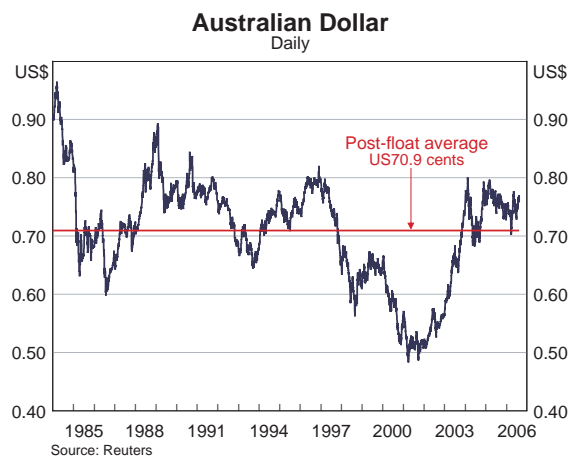
The Reserve Bank's foreign exchange operations in 2005/06 centred around two main tasks. The first was to meet the foreign exchange needs of the Australian Government and other clients. Over the course of the year, \$4.7 billion of foreign exchange was sold to the Government, an amount broadly in line with that in the previous year. This foreign exchange is needed by the Government to cover overseas costs, such as defence expenditure, embassy running costs and foreign aid. The Reserve Bank covered these sales by buying foreign exchange in the market. This is normal practice unless the exchange rate is unusually low, in which case some of the Government's foreign exchange needs may, on occasion, be met from foreign currency reserves.

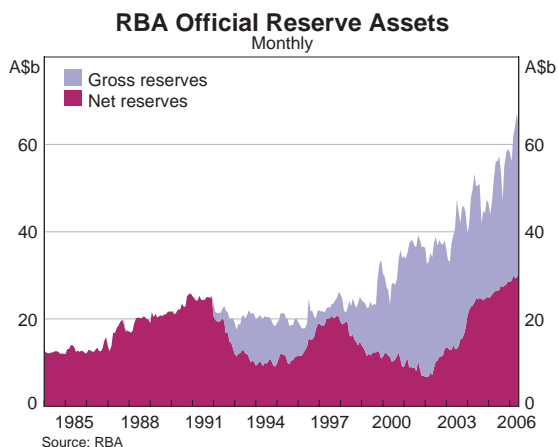
The second task was to assist in domestic liquidity management through foreign exchange swaps. As noted above, the increase in Government deposits at the Reserve Bank over the past year withdrew Australian dollars from the money market. One of the ways in which the Reserve Bank replenished these was to buy an increased amount of foreign exchange under swap agreements. (These transactions involve the Reserve Bank receiving foreign exchange from its counterpart and paying Australian dollars.)

Over the course of 2005/06, the Reserve Bank's holdings of foreign exchange under swaps increased from \$30 billion to \$34 billion. Swaps generally have a relatively short maturity, typically between two and three months. As such, the increased holdings of swaps led to a substantial increase in turnover, to \$157 billion.

The Reserve Bank did not undertake any foreign exchange operations in 2005/06 intended specifically to influence the exchange rate of the Australian dollar. Such transactions, known as intervention, are typically undertaken when the exchange rate has moved a long way from its normal level, and in a manner that is inconsistent with Australia's economic conditions. With the Australian dollar moving in a relatively narrow range during the year, at a level a little above its long-run average, the Reserve Bank saw no need to try to influence the exchange rate. The Reserve Bank has not intervened in the foreign exchange market since 2001.

The Reserve Bank also scaled back its reserves replenishment operations during the past year. After the period of intervention from 1997 to 2001, when the Reserve Bank sold reserves holdings to support the Australian dollar, a process of rebuilding reserves was begun once the exchange rate had recovered. While the primary aim of these operations has been to ensure that reserves holdings are adequate, consideration has also been given





to cost. Because the cost of buying foreign exchange decreases as the Australian dollar rises, purchases have been skewed towards periods of greatest strength in the exchange rate. Including earnings, the addition to reserves peaked at \$10.9 billion during 2003/04, when the Australian dollar rose sharply to around US80 cents. Since then, with the exchange rate declining from its earlier peaks and reserves at relatively comfortable levels, additions to reserves were scaled

back. In 2004/05, they amounted to \$3.8 billion and, in the year just ended, to \$2.3 billion.

At the end of June, net official reserves stood at \$30 billion, up from \$26 billion at the end of the previous financial year. In addition to purchases noted above, the rise reflected some valuation gains resulting from a fall in the exchange rate of the Australian dollar against the currencies in which reserves are held. This level of reserves holdings is adequate to meet Australia's needs. Nonetheless, it accounts for only about one-third of the Reserve Bank's assets, so there is scope to add further to holdings if the exchange rate were to rise to a level where this was advantageous. Taking into account also the \$34 billion held under swaps, total official reserve assets at June 2006 were \$64 billion, an increase of \$8 billion over the year.

Reserves Management

Australia's official reserve assets are held and managed by the Reserve Bank. They consist mainly of holdings of government securities and bank deposits in a range of foreign currencies. Given that these assets may be required at relatively short notice to fund intervention, priority in investing them is given to liquidity and security. Within these constraints, the funds are managed with the aim of maximising returns.

The assets are managed against a benchmark that defines risk/return characteristics acceptable to the Reserve Bank. A key feature of this benchmark is asset and currency composition. The United States and Europe both have equal weight, at 45 per cent each, while Japan has a weight of 10 per cent. The other key feature of the benchmark is the duration (or weighted average maturity) of investments. This is set at 30 months for each portfolio,

The Benchmark Portfolio			
	US	Europe	Japan
Asset allocation (% of total)	45	45	10
Currency allocation (% of total)	45	45	10
Duration (months)	30	30	30

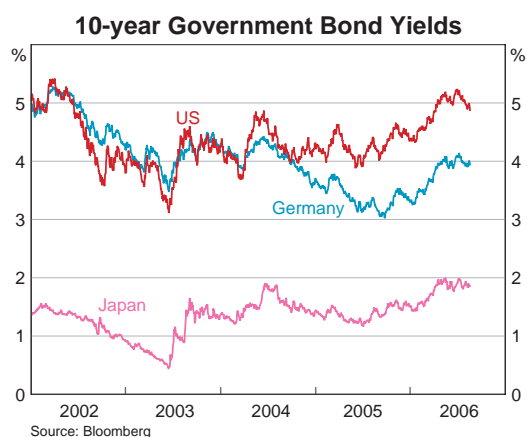
with the maximum term to maturity of any security being 10.5 years. In addition to these broad characteristics, the benchmark defines the types of assets that can be held, particularly in relation to credit risk. Changes to the benchmark are infrequent. The last major change occurred in February 2002, when the weight applied to Japanese investments was reduced from 30 per cent, with increased weight given to the other currencies, particularly the euro.

In managing the foreign assets, the portfolio managers are constrained to a relatively narrow range around the benchmark. However, they have some discretion to move away from benchmark to take advantage of cash management strategies and short-term market anomalies. Some tolerance for deviation from benchmark is also necessary given the operational practicalities of managing a large and diverse portfolio that is constantly changing in size. Rigid adherence to the benchmark in such circumstances would result in a significant amount of high-frequency, and largely offsetting, trading to fine-tune portfolio composition.

With market yields rising in all the major countries, the past year was a difficult one for fixed income investments, which make up the bulk of the reserves holdings. Capital losses on bonds kept returns low in each of the three countries in which investments are held. In fact, as shown below, the return on investments in Japan was negative, at -0.9 per cent. In Europe, the return was 0.1 per cent, while in the US it was 1.2 per cent. These returns were below average, though not dissimilar to those in 2003/04, also a year of rising bond yields.

Rates of Return in Local Currency by Portfolio			
(per cent)			
	US	Europe	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
2003/04	0.0	1.9	0.0
2004/05	4.1	5.8	1.1
2005/06	1.2	0.1	-0.9

Aggregating returns across the different regions requires the use of a common yardstick. The one the Reserve Bank uses is the SDR, a composite of the world's major currencies. On this basis, the total return on the reserves portfolio in 2005/06 was 1.2 per cent. This was below the average return achieved over the longer run, but again not very different from 2003/04.



The benchmark portfolio would have returned 1.0 per cent. The decisions taken by portfolio managers contributed another \$55 million, or 17 basis points, to actual returns for the year. This contribution was similar to the average of recent years. About two-thirds of this contribution came from portfolio managers taking positions that deviated from benchmark, while the rest came from lending securities. Of the returns that came from deviating from benchmark, the major contribution came from maintaining the actual portfolio duration a little short of benchmark. This was a favourable strategy in a rising interest rate environment.

Actual and Benchmark Returns			
	Rates of Return in SDR (per cent)		Value of Difference
	Actual	Benchmark	(A\$ million)
2000/01	11.0	10.8	74
2001/02	3.9	3.7	63
2002/03	6.7	6.4	77
2003/04	0.5	0.3	67
2004/05	4.7	4.5	38
2005/06	1.2	1.0	55

A small proportion of foreign currency reserves continues to be invested in the two Asian Bond Funds. These funds comprise portfolios of debt issued by a number of Asian sovereign and quasi-sovereign borrowers – one is a fund that invests in their US dollar-denominated debt and the other is a fund that invests in their local-currency debt. The US dollar-denominated fund (ABF1) returned -1.0 per cent in 2005/06. This was less than the return of 1.2 per cent on the return on the Reserve Bank's holdings of US securities and deposits, because of the rise in spreads late in the year on some of the debt held in the Fund. The return on the local-currency denominated fund (ABF2) was significantly higher, at 5.7 per cent, because of favourable exchange rate movements.

As part of official reserve assets, the Reserve Bank holds around 80 tonnes of gold, valued at about \$2.2 billion at the end of June. In past years, all this gold was on loan to gold dealers, on a fully collateralised basis. Over the past year, however, demand for gold loans fell sharply and interest rates on such loans fell to zero for maturities out to one year and only 28 basis points for maturities out to five years. In this environment, the Reserve Bank has not been prepared to make any new loans, and repayments reduced the amount of gold on loan to 53 tonnes at the end of June. Returns from gold lending for 2005/06 declined only marginally, however, as income was sustained by ongoing receipts from loans entered into in earlier years at higher interest rates; total interest income on gold loans for the year was \$13.4 million, compared with \$15.5 million in 2004/05.

International Financial Co-operation

In order to carry out its responsibilities, the Reserve Bank needs to interact with counterparts in other countries and international organisations. This is done in a variety of ways. The Reserve Bank is a member of various international organisations or groups, such as the G-20, the Financial Stability Forum (FSF), the Bank for International Settlements (BIS) and the Executives' Meeting of East Asian and Pacific central banks (EMEAP). It also participates, in association with the Australian Treasury, in the work of the International Monetary Fund (IMF) and the Organisation for Economic Co-operation and Development (OECD), and maintains strong bilateral relationships with a range of other central banks.

The Reserve Bank keeps other arms of the Australian Government informed of its international work through the International Economic Policy Group. This body co-ordinates the work by various Australian Government agencies in international economic issues. It is chaired by the Department of the Prime Minister and Cabinet, and includes, in addition to the Reserve Bank, representatives from the Australian Treasury, Department of Foreign Affairs and Trade, Office of National Assessments and AusAID.

Two major features of the Reserve Bank's international work in the past year were its responsibilities in helping Australia chair the G-20 in 2006 (the Reserve Bank and the Australian Treasury work jointly in this Group) and the commencement of an extensive bilateral exchange program with Bank Indonesia as part of the Australian Government's response to the tsunami of December 2004. More detail on these and other international relations activities is provided below.

Group of Twenty (G-20)

The G-20 is an international grouping of systemically important countries that has been meeting since 1999 to share experiences and opinions on matters of international economic and financial significance. The list of member countries is shown below.

G-20 Member Countries			
Argentina	France	Japan	South Africa
Australia	Germany	Korea	Turkey
Brazil	India	Mexico	United Kingdom
Canada	Indonesia	Russia	United States
China	Italy	Saudi Arabia	European Union ^(a)

(a) Represented by the rotating European Council Presidency and the European Central Bank

Australia is the Chair of the G-20 Group for 2006. The G-20 is traditionally co-hosted by ministers of finance/treasurers and central bank governors. To provide appropriate support for the Reserve Bank's share of this effort, resources have been devoted to G-20 matters in several parts of the organisation. A dedicated G-20 Unit within the International Department provides support for the participation of the Governor, Deputy Governor and other senior officials in



Treasurer Peter Costello and Governor Ian Macfarlane represented Australia at the G-20 Meeting held in Beijing in November 2005. From left to right: Jin Renqing, Minister of Finance, China; Caio Koch-Weser, State Secretary, Ministry of Finance, Germany; Peter Costello; Hu Jintao, President of China; Axel Weber, President, Deutsche Bundesbank; Ian Macfarlane; Zhou Xiaochuan, Governor, People's Bank of China.

G-20 meetings, and works closely with counterparts in the Australian Treasury in developing Australia's general position on matters relevant to the G-20. The Reserve Bank's Information and Systems & Technology Departments provide the hardware, technical support and management for the G-20 website. The Economic Group hosted one of the three G-20 Workshops for 2006, on the financial market implications of population ageing.

The theme of the G-20 meetings in 2006 is 'Building and Sustaining Prosperity'. One of the key issues being discussed is reform of the IMF and World Bank. The G-20 has played an important role in providing a platform for discussion between the major industrialised economies and the systemically important emerging market economies on this issue. Its work has contributed to the emergence of a broad consensus on the need for a greater voice within the IMF for emerging market and developing countries. The IMF is now developing a plan for governance reform to be considered by IMF members at the annual meetings in September 2006 in Singapore, aimed at an adjustment to quotas in line with important changes in the role of countries in the world economy.

Other key issues for discussion by the G-20 during 2006 include risks to the ongoing global economic expansion; the impact of demographic change; aid effectiveness; and the state of global energy and minerals markets. While a number of these areas for discussion are carried over from one year to the next, the addition of global energy and minerals markets to the G-20's

agenda reflects the unique position that the Group (which comprises both major suppliers and users of resources) has in considering the broader effects of changing natural resource markets and the implications for economic growth and development.

G-20 Finance Ministers and Governors will meet in November 2006 in Melbourne. In preparation for this, G-20 Deputies met in March in Adelaide and will meet again in October in Sydney. In addition, three technical workshops have been held in 2006 to allow a more detailed analysis of key issues. The first, focused on reform of the IMF and World Bank, was held in Tokyo in February; the second, held in Canada in June, focused on the implications of developments in natural resource markets; and, as mentioned above, the third, hosted by the Reserve Bank in Sydney in July, focused on the impact of demographic changes on financial markets.

G-20 Meetings in 2006		
Date	Event	Location
February	G-20 Workshop on Reform of Bretton Woods Institutions	Tokyo
March	Meeting of G-20 Finance and Central Bank Deputies	Adelaide
June	G-20 Energy and Resources Seminar	Banff
July	G-20 Workshop on Demography and Financial Markets	Sydney
October	Meeting of G-20 Finance and Central Bank Deputies	Sydney
November	Meeting of G-20 Finance Ministers and Central Bank Governors	Melbourne

Financial Stability Forum (FSF)

The FSF was formed in 1999 and has a mandate to strengthen global financial systems and improve the stability of international financial markets. Importantly, the FSF aims to improve co-ordination and information exchange among international agencies responsible for financial stability. Members include senior representatives from the central banks, finance ministries and supervisory agencies of the G-7 countries, and central bank governors of the European Central Bank and four countries whose financial markets are of global significance (Australia, Hong Kong, the Netherlands and Singapore). Other participants include international financial institutions, such as the BIS and the IMF, and other forums, including the Basel Committee on Banking Supervision and the Committee on the Global Financial System.

One of the meetings of the full FSF this year was held in Sydney, back to back with an Asia-Pacific regional meeting. Issues reviewed at the meetings included the continuation of relatively benign conditions in financial markets and the global economy, and the response of the financial system to a number of corporate credit disturbances in recent years. A particular focus was the potential for factors such as high levels of household indebtedness, the ‘search for yield’ in global markets, counterparty risk management practices and the rapid growth in credit derivatives to have an adverse affect on the stability of financial markets.

Membership of the Financial Stability Forum	
Australia	Japan
Canada	Netherlands
France	Singapore
Germany	United Kingdom
Hong Kong SAR	United States
Italy	



The Financial Stability Forum held its 15th plenary meeting and also met with financial authorities from the Asia-Pacific region in Sydney in March. Governor Ian Macfarlane is shown in discussions, as the chairman of the FSF meetings, former Vice Chairman of the Board of the Federal Reserve System, Roger Ferguson, Jr, looks on.



The FSF, as a co-ordinating body, has been a driving force behind improvements to the functioning of the global financial system and its infrastructure. Its ongoing work has revolved around the robustness of international standard-setting processes, counterparty and liquidity risk management practices, the role of hedge funds, and international accounting and auditing requirements. One issue that emerged in the context of ongoing work on business continuity planning was the implications of an avian flu pandemic. The FSF has also maintained an interest in the activities of offshore financial centres, with a particular emphasis on ensuring that the centres meet acceptable standards of international co-operation.

Executives' Meeting of East Asian and Pacific Central Banks (EMEAP)

During 2005/06, the Reserve Bank continued to be heavily involved in EMEAP, the main vehicle for co-operation among central banks and monetary authorities in the Asia-Pacific region. EMEAP Governors met on two occasions during the year. At the formal annual Governors' meeting, which took place in New Zealand in May 2006, discussions focused on macroeconomic management in the context of internal and external imbalances and the precautions central banks are taking in the event of an avian flu pandemic. EMEAP Governors also took the opportunity to meet with representatives of the Eurosystem central banks, where they shared views on the challenges each region faces in achieving balanced economic growth, and approaches to

regional surveillance and financial arrangements.

The two meetings of EMEAP Deputies that take place each year direct and oversee the work of EMEAP's working groups, covering financial markets, banking supervision, and payments and settlement issues. Recently, the Deputies' meetings have taken on a more intensive surveillance role, focusing on key challenges to monetary and financial stability in the region.

EMEAP Member Countries	
Australia	Malaysia
China	New Zealand
Hong Kong SAR	Philippines
Indonesia	Singapore
Japan	Thailand
Korea	

Recently, the Deputies' meetings have taken on a more intensive surveillance role, focusing on key challenges to monetary and financial stability in the region.

The Head of the Reserve Bank's Payments Policy Department was the chair of the Working Group on Payments and Settlement Systems during 2005/06. The work of that Group focused on two main areas. The first involved an investigation of whether there was evidence that arrangements for settlement of bonds in the EMEAP markets were impeding the development of bond markets in the region. This involved an assessment of settlement arrangements in each country against the Recommendations for Securities Settlement Systems of the BIS, as well as a study of how cross-border bond trades within the region were actually settled. Members concluded that settlement arrangements for cross-border bond trades within the region did not appear to be constraining the market. The second major topic of discussion was participation of EMEAP central banks in oversight arrangements for SWIFT, the messaging system used to send settlement instructions for many of the world's financial market transactions.

The Working Group on Banking Supervision continued to focus mainly on Basel II in 2005/06. It met with the Basel Committee on Bank Supervision to discuss the latter's review of Core Principles, effective supervision of financial conglomerates, consolidated supervision of international banking groups, and prudential issues arising from the new accounting standards and Basel II. Emphasis was also placed on promoting effective co-operation between macro-surveillance and banking supervision, and sharing early warning systems for identifying sources of vulnerabilities and risks. To facilitate this co-operation, the Working Group established a number of interest groups during the year, including one chaired by the Reserve Bank on stress-testing practices.

The Working Group on Financial Markets continued to focus on issues relating to the Asian Bond Funds during 2005/06 (see the 2005 Annual Report for more detail on the ABF). The main focus was to review the lessons learnt from the initiative. A number of factors potentially hindering the development of bond markets in the region were identified; efforts to address these impediments will be the focus of the work of this Group in future. The Group also meets twice yearly with representatives of central banks from the other major foreign exchange markets to discuss developments in international financial markets.

Bank for International Settlements (BIS) and Associated Committees

During 2005/06, the Reserve Bank continued its involvement with the BIS through active participation in the BIS bi-monthly meetings of central bank governors and associated BIS committees involving senior officials of member central banks. At the governor level, these

meetings discussed developments in the global macroeconomic situation, as well as structural developments in areas of particular relevance to central banks, including inflation, exchange rates and financial sector stability. The Governor was a member of the BIS Central Bank Governance Group, which discusses a range of issues relating to the management of central banks. The BIS Asian Consultative Council, of which the Governor is also a member, focuses its discussions on financial and monetary developments in Asia and provides direction for the work of the BIS in Asia.

The Assistant Governor, Financial Markets sits on two of the committees associated with the BIS – the Committee on the Global Financial System (CGFS) and the Markets Committee. The CGFS discusses risks and vulnerabilities in the global financial system, as well as structural developments in financial markets. The discussion in the Markets Committee focuses on matters related to foreign exchange and capital markets.

The Reserve Bank took part in two of the working groups commissioned by the CGFS during 2005/06. One of the working groups is examining the ways in which the development of local currency bond markets can contribute to financial stability. The group is expected to improve the quality of information on emerging economy bond markets, especially at the sectoral level. A second working group is analysing how asset allocation decisions are made by institutional investors. The Reserve Bank was also represented on the CGFS Working Group on Housing Finance, which analysed developments affecting the supply of, and demand for, housing finance. The report of this group, which was published by the BIS in January 2006, highlighted important similarities and differences that have helped shape the evolution of national housing finance systems.

The BIS and the Reserve Bank jointly hosted a conference on reserves management in Sydney in October 2005. The conference provided the opportunity for foreign reserves managers from 25 countries to exchange views and experiences on reserves management policies, objectives and strategies. Reserve Bank staff also presented a paper on the development of Australia's corporate bond market at a conference on developing corporate bond markets in Asia, which the BIS jointly hosted with the People's Bank of China in November 2005. In December, the Reserve Bank hosted a BIS Asia-Pacific Heads of Audit conference in Sydney.

International Monetary Fund (IMF)

An important element of the Reserve Bank's work with the IMF during the past year involved the assessment of the Australian financial sector undertaken by the IMF through its Financial Sector Assessment Program (FSAP). FSAP assessments seek to identify the strengths and vulnerabilities in countries' financial systems and evaluate how key sources of risk are being managed. More than 100 countries have been assessed since the IMF began the FSAP program in 1999.

The FSAP process includes analysis of economy-wide indicators of financial soundness and compliance with international standards relating to banking supervision, securities regulation, insurance supervision and systemically important payment systems. As part of this process, the Reserve Bank, APRA and ASIC compiled detailed self-assessments against the above standards, and along with the Australian Treasury, provided a range of other relevant background material to the IMF. The IMF staff and external experts then held extensive discussions with the

Australian authorities and a range of participants in the financial system. Several exercises were also conducted to examine vulnerabilities in the financial system.

Another aspect of the IMF's work in which the Reserve Bank has taken an interest over the past year is the strategic review the IMF has begun of its operations, especially relating to its surveillance work. This is a key area of the IMF's crises prevention work.

The Reserve Bank also participated in a number of the initiatives undertaken by the IMF during 2005/06 to strengthen the latter's engagement with Asia. The Deputy Governor and the Assistant Governor, Financial Markets participated in two seminars jointly hosted by the IMF and the Monetary Authority of Singapore, which examined issues surrounding regional financial sector integration. The Deputy Governor also met with the IMF Managing Director during his visit to Australia in June 2006.

South Pacific Central Bank Governors

Each year the central bank Governors of the six Pacific Island nations that have their own currencies (Fiji, Papua New Guinea, Samoa, Solomon Islands, Tonga and Vanuatu) meet with their counterparts from Australia and New Zealand. This year's meeting took place in Vanuatu in December 2005. It reviewed international economic developments, with particular emphasis on the effect on the island nations, and discussed the management of foreign exchange reserves.

Bilateral Relations and Assistance

The Reserve Bank has a long history of providing technical assistance to other central banks, particularly to those in the Asia-Pacific region. This was stepped up in 2005/06 as part of the Australian Government's assistance program to Indonesia following the tsunami of December 2004. With the help of funding under the Government Partnership Fund, the Reserve Bank was able to provide technical assistance and training to a significant number of Bank Indonesia staff. Further details of the exchange program that has been established between the two organisations are in the box on page 20.

Recent Annual Reports have noted a change from giving assistance by means of long-term attachments to using short-term visits. Modern communications using electronic means are now allowing, in some cases, the provision of assistance without travelling at all. This method was used to help the Reserve Bank of Vanuatu review its audit and risk management procedures.

During 2005/06, a member of the Reserve Bank's staff worked with the IMF on the monetary policy framework in Papua New Guinea, while another continued on extended leave to serve as an economist at the National Reserve Bank of Tonga under an AusAID contract. Reserve Bank staff also participated in an IMF review of the compliance of countries with international standards against money laundering and the financing of terrorism. This review was completed in September 2005 and submitted to the Executive Boards of both the IMF and the World Bank.

The Reserve Bank provided presenters during the year for a number of conferences and seminars conducted by multilateral institutions, other central banks and academic institutions. The HC Coombs Centre for Financial Studies (the Reserve Bank's training college) was made available for a week-long seminar organised by the Association of Financial Supervisors of Pacific Countries, and for the APEC Future Leaders' Conference.

As has been common in recent years, during 2005/06 the Reserve Bank received many visitors from overseas central banks who wish to study how it undertakes particular areas of work. This year there were visits from the central banks of Bhutan, Cambodia, the People's Republic of China, Nepal, Thailand, Tonga and Uganda.

Government Partnership Fund (GPF)

During 2005/06, the Reserve Bank received funding under the GPF for an exchange program designed to assist Bank Indonesia (BI) strengthen its monetary policy-making capacity and credibility under its inflation targeting framework. The program is aimed at capacity building in BI in the areas of economic and financial management. It has two main components. The first has involved the attachment of groups of BI staff to the Reserve Bank for a period of three months each. A total of 15 secondees have been placed in the Reserve Bank's Economic Analysis, Domestic Markets, Financial System and International Departments, where they have gained in-depth knowledge of how the Reserve Bank undertakes tasks relevant to their work in BI.

A second element of the program seeks to reinforce the skills gained by the secondees and assist BI in the adoption of these skills. It has involved visits by senior managers of the Reserve Bank to Jakarta for around one week on each occasion, to have meetings with counterparts in BI to discuss a range of topics. These include the development of the foreign exchange market and management of reserves; the operation of regional offices and integration of liaison information into monetary policy determination; surveillance of the financial system; and the interbank money market and securities lending.



Members of the third attachment of staff from Bank Indonesia attend an informal presentation on risk management practices by Keith Drayton, Senior Manager, Financial Markets Group.

Business Services

The Reserve Bank provides a range of services to the community, the most important of which are:

- the provision of banking services to the Australian Government for the core public accounts operated by the Department of Finance and Administration, and other transactional banking services to a number of government agencies;
- the operation of Australia's high-value payments and interbank settlement systems; and
- the supply of Australian currency notes.

In addition to these core services, some banking services are also provided to central banks abroad and international agencies, and registry services are provided to the Australian Government.

These activities are carried out by 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 for currency services, through the National Note Processing and Distribution Centre (NNPDC) at Craigieburn in Victoria.

The transactional banking and registry services provided by the Reserve Bank to Australian Government agencies are operated on a commercial basis. These activities are run as individual businesses under competitive neutrality guidelines, which require full cost recovery, including earning an appropriate rate of return on notional capital, through fees and charges paid by the users of these services.

Banking

Banking services are provided to the Australian Government and to other customers, including around 46 overseas official institutions and central banks.

The Reserve Bank provides a facility to the Australian Government that is used to manage a group of bank accounts, known as the Official Public Account (OPA) Group, the aggregate balance of which represents the Government's daily cash position. This facility is operated on behalf of the Government by the Department of Finance and Administration, and includes the provision of a term-deposit facility for the investment of surplus funds, the sweeping of balances to and from agencies' accounts held with transactional bankers, and access to a strictly limited overdraft facility. To assist in monetary policy and liquidity management, this service also includes the electronic collection of forecasting data and reporting on high-value transactions from agencies and transactional bankers.

The Reserve Bank also provides transactional banking facilities to Australian Government agencies. These services are provided only to a specific range of customers, which tend to have banking requirements that are similar to each other but different from those of most other users of banking products. Because of its particular focus, the Reserve Bank is able to provide

facilities tailored to the specific requirements of this group. These facilities include features such as extremely high standards of system reliability and availability, and the flexibility to adapt quickly when changes in government policy require consequent changes in systems or processes. The Reserve Bank also has dedicated internal IT resources and business analysts involved in researching and developing new banking solutions specifically for the needs of government. Under the Australian Government's competitive neutrality and procurement policies, the Reserve Bank is required to compete with other potential providers when making these services available to customers.

Transactional banking services offered by the Reserve Bank include bank account facilities and the processing of transactions such as deposits, cheques, bulk direct entry, and high-value payments. Access to these services is usually by way of ReserveLink, the Reserve Bank's electronic desktop banking package, or by way of a direct connection over leased communications lines. An internet-based delivery system known as RBANet allows agencies to initiate account and transaction enquiries, perform statistical analysis of transactions activity at aggregate and account levels, and manage the status of unrepresented cheques. The major services provided to government agencies are described below.

The Government Direct Entry Service (GDES) receives and processes bulk electronic direct credit and direct debit transactions from government agencies and distributes these to financial institutions. This service makes use of an extensive communications network and warehousing capabilities, and is the main vehicle used for transactional banking activities by government customers. GDES transactions include welfare, Medicare, salary and vendor payments. During 2005/06, 257.8 million GDES transactions were processed.

Overseas banking services enable customers electronically to request overseas payments to be made via cheque, electronic funds transfer (wires) or direct entry. This service provides government agencies with a secure, timely and cost-effective delivery mechanism for regular overseas payments. The largest group of such payments consists of direct entry payments initiated by Centrelink to recipients of Australian Government pensions who live abroad. The Reserve Bank's agent bank sends these payments directly to recipients' bank accounts in local currencies using the relevant country's automated clearing house arrangements. This overseas direct entry service is available in 24 countries.

Document printing services enable customers electronically to request the Reserve Bank to issue cheques and electronic documents on their behalf. For cheques, the service includes the production, enveloping and mailing of the cheque together with an attached remittance advice. For electronic payments, the service provides for the delivery (by post, email or facsimile) of a remittance advice, with the actual payment occurring via direct entry.

Cheque reconciliation and verification services consist of a full cheque reconciliation and cheque repository service for government agencies as well as a verification system to detect whether or not a cheque has been fraudulently altered. The verification service, developed by the Reserve Bank, provides customers with high-resolution images of cheques presented for payment (both front and back) and allows the issuing agency to confirm that the details of each cheque match details of the cheque when it was originally issued. This system enables the Reserve Bank to detect changes to cheque information quickly, thereby protecting itself and its

customers from losses arising from fraudulent alteration of cheques. The system has proven to be highly beneficial to government agencies because it substantially minimises their exposure to cheque fraud.

Payment collection services allow government agencies to receive payments from clients using major credit cards or the BPay system over the telephone or internet, or over the counter using cash, cheques and EFTPOS payments. The volume of over-the-counter collections through these channels continued to increase significantly during 2005/06.

Earnings after tax in 2005/06 for the Reserve Bank's transactional banking services were \$2.9 million, compared with \$3.4 million in the previous year.

Registry

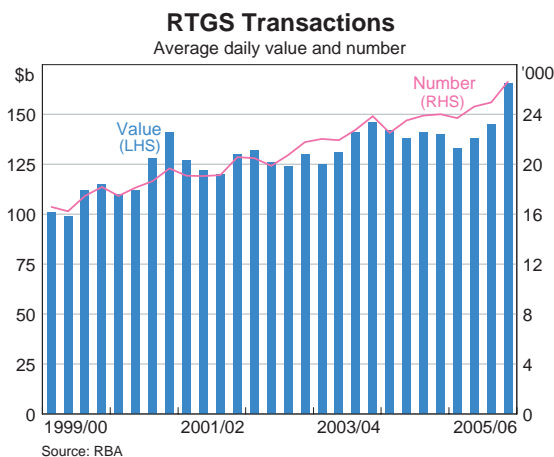
The Reserve Bank provides registry services to the Australian Government and a number of official foreign institutions which have Australian dollar debt programs. Services provided to all clients include the issue, transfer and registration of securities, the maintenance of ownership records, the distribution of interest payments and the redemption of securities at maturity. Additional services that are specific to the Commonwealth Registry include management and encashment of physical securities; maintenance of records relating to unclaimed CGS monies; provision of reports to the AOFM summarising transactions arising from its CGS lending facility; undertaking historical searches; and the provision of a small-investor facility, which enables retail investors to access CGS. Information relating to the small-investor facility, including indicative buying/selling prices, is available on the Reserve Bank's website.

With most large institutions holding and settling their transactions in CGS electronically outside the Reserve Bank's registry system, the level of traditional paper-based registry activity is extremely low and consists mainly of small retail holdings. Earnings after tax for the CGS registry business in 2005/06 were \$0.1 million, the same as in the previous year.

RTGS and Other Settlement Services

The Reserve Bank provides the real-time interbank payment and settlement service for the Australian financial market through its Reserve Bank Information and Transfer System (RITS).

About 90 per cent of the value of all payments in Australia is settled on a real-time gross settlement (RTGS) basis through the RITS system. This includes the settlement of wholesale debt and money market transactions, a range of time-critical customer payments, and Australian dollar foreign exchange dealings (including those foreign exchange trades settled by CLS Bank for which a net settlement is made each day in RITS).



In 2005/06, the average number of RTGS settlements rose by 6.3 per cent to around 25 000 each day. The total value of transactions in the year was on average around \$145 billion daily, equivalent to an average individual transaction size of \$5.8 million.

In addition to RTGS payments, RITS settles two batches of netted interbank payments each day. One relates to low-value payments (cheque clearings, direct entry credits and debits, and retail electronic payments originating in systems such as EFTPOS), which are cleared overnight and settled at 9:00 am. The other settles net positions for equity transactions on the Australian Stock Exchange, which are first cleared through the Exchange's electronic settlement system CHES before the net payments are settled over RITS.

The Reserve Bank has recently developed an improved Batch Settlement Facility, which will be implemented in the coming year. Under the new facility, the Reserve Bank will authorise entities to act as a Batch Administrator for particular streams of payments. These entities will then be able to submit batches of netted payments to RITS at any time during the business day. The facility is expected to be implemented for the CHES batch in the second half of 2006, and is expected eventually to be used for electronic conveyancing and settlement of property transactions.

Settlement services are also provided for currency note lodgements and withdrawals by commercial banks, and for transactions for Reserve Bank customers, including the Australian Government and overseas central banks and official institutions. The Reserve Bank also uses RITS and related systems to settle its own financial market transactions in domestic securities and foreign exchange markets, including market operations for the implementation of monetary policy.

The Reserve Bank introduced a new browser-based interface for RITS during 2005/06. The new interface provides benefits to RITS users in the form of improved access to information on payments being settled through RITS and improved efficiency in the management of payments that are awaiting settlement. It also incorporates significant security improvements, and will enhance the ability of RITS members to manage access by their staff. The new interface was implemented for external users in June 2006, after having been tested through several months of use by internal Reserve Bank users. All remaining external RITS users are expected to migrate their activities to the new interface by the end of 2006.

Note Issue

The Reserve Bank's note issue activities cover three main areas:

- the issue and redemption of currency notes, including organising the production of new notes and making arrangements with commercial banks for the distribution of notes;
- maintaining the quality of notes in circulation, including quality control for new notes, making arrangements with commercial banks for sorting of notes, machine processing and evaluation of notes returned from circulation, and the destruction of notes no longer fit for further use; and
- research into and development of note designs and security features, and research into counterfeiting activity.

Notes on Issue

During 2005/06, the value of Australian notes on issue rose by \$2.4 billion, or 6.9 per cent, to \$38.1 billion. This is about the same rate of growth as the average rate of growth for the note issue since 2000, although the growth rates have been volatile from year to year, reflecting changes in distribution arrangements after 2001. Among the different denominations, the \$50 continues to account for the largest number of notes on issue as well as the largest value; in June 2006, it accounted for over 47 per cent of the value of all notes on issue.

At End June	Value of Notes on Issue (\$ million)						Total ^(a)	Increase (per cent)
	\$5	\$10	\$20	\$50	\$100			
2000	397	646	1 917	11 188	11 240	25 434	8.0	
2001	431	662	2 014	12 055	11 961	27 168	6.8	
2002	530	791	2 789	14 718	13 057	31 930	17.5	
2003	515	759	2 510	14 918	13 426	32 173	0.8	
2004	533	791	2 533	15 941	14 224	34 022	5.7	
2005	539	837	2 584	16 740	14 924	35 624	4.7	
2006	572	857	2 690	18 044	15 903	38 066	6.9	

(a) Includes \$1 and \$2 notes remaining on issue.

Note Quality

The Reserve Bank aims to have a high quality of currency notes in circulation, to ensure that notes remain fit for use by the general community (including in the growing number of note accepting and dispensing machines in the community) and that counterfeit notes are able to be detected readily. Achievement of this goal requires that notes are sorted for quality by those institutions involved in the distribution process, with the unfit notes returned to the Reserve Bank's NNPDC for destruction and replacement. Note-sorting performance, and its impact on note quality, is monitored at the NNPDC through a program of evaluating sampling notes taken from notes in approved cash centres across Australia.

Over the past year, the Reserve Bank has worked with a number of commercial banks and armoured car companies to develop a new framework for ensuring an appropriate quality of notes in general circulation. This work identified that the note quality standard sought by the Reserve Bank is higher than that which the commercial banks require for their own commercial purposes, especially for the lower denomination notes. In order to achieve the standard sought by the Reserve Bank, commercial banks would have to invest in improved note-sorting infrastructure either by purchasing additional sorting equipment or procuring note-sorting services from external providers. The Reserve Bank and the commercial banks have agreed to resolve the differences in standards by applying a system of incentive payments to commercial banks if notes exceed the commercial bank standard; the incentive payments are set at a level consistent with the investment which would be required to achieve that outcome. Notes will be sampled by the Reserve Bank from cash centres and incentive payments will be based on the quality of these sampled notes. Incentive payments will be made to the commercial banks when

these sampled notes exceed the commercial bank quality standard, and payments made by the commercial banks to the Reserve Bank when sampled notes fall below that standard.

The new arrangements are due to commence in the final quarter of 2006. In the meantime, an operational trial is underway, monitored by a working group comprising representatives from the Reserve Bank and the commercial banks. The Reserve Bank is also preparing to sample notes from the wider community to confirm that the improved outsourcing of unfit notes by the commercial banks and the armoured car companies is reflected in an improved level of quality of notes in general circulation.

Some notes become accidentally damaged in circulation, beyond the normal levels of wear and tear, and become unsuitable for sorting using processing equipment. The Reserve Bank has a policy of paying value for these severely damaged notes, depending on the amount of the note which remains recognisable and can be authenticated. Commercial banks can assess damaged notes and pay the assessed value for them, but all damaged notes are returned to the NNPDC for final assessment and destruction. Under this policy, most damaged notes receive full value, but where a large piece of a note is missing, and the different pieces of the note could be presented to the Reserve Bank at different times, only the appropriate partial value is paid on each piece. During 2005/06, the NNPDC assessed nearly 28 000 note claims, with a total value of \$3.5 million.

Distribution

The commercial banks act as the conduit for the issue and withdrawal of currency notes from circulation. The commercial banks hold working stocks of surplus notes and coin in approved cash centres (ACCs) located throughout Australia and draw on these stocks when they need additional notes and coin to meet customer demand. The commercial banks deal directly and actively with each other in order to manage short-term surpluses and deficits in their working stocks. They also draw notes from the NNPDC to meet demand when they cannot meet this demand from their own stocks or from other commercial banks, especially at the times of seasonal peak demand for cash associated with Christmas and Easter. Commercial banks' holdings of surplus working stocks in ACCs have increased over the past year by about 11 per cent.

Armoured car companies transport notes to and from the NNPDC on behalf of the commercial banks. Some notes are returned to the NNPDC because they are unfit; these are processed through high-speed sorting equipment to confirm their quality and authenticity, and the unfit notes are destroyed. Other notes are returned to the NNPDC as part of the Reserve Bank's quality sampling programs and are processed in a similar way, with fit notes packaged for reissue and unfit notes destroyed. Notes that are fit but surplus to requirements can also be returned to the NNPDC at specified times following the Christmas and Easter peaks in demand; these notes are not processed at the NNPDC, but are reissued to the commercial banks at the first opportunity to satisfy orders.

During 2005/06, 265 million notes with a value of \$8.0 billion were returned to the NNPDC, representing a 3 per cent increase on the previous year. Of these, 234 million notes were returned either as unfit notes or notes from sampling programs, and required processing by the NNPDC. The remaining 31 million notes were surplus fit notes.

Notes deemed fit for reissue represented 52 per cent of notes processed during 2005/06, up from 45 per cent in the previous year. Encouragingly, the increased emphasis by the Reserve Bank on improving the general quality of notes in circulation over the past two years has been reflected in a rise in the proportion of notes from sampling programs that are found to be fit for reissue.

The Reserve Bank issued 315 million notes with a value of \$10.4 billion from the NNPDC in 2005/06, an increase of 10 per cent from the previous year. Of these, 147 million were previously circulated notes that were reissued after processing, where necessary, by the NNPDC, and 168 million were new notes.

As well as meeting the cost of producing new notes, the Reserve Bank bears the costs associated with the return to the NNPDC of unfit notes and notes required for quality and authenticity assessment. The Reserve Bank also pays commercial banks for interest forgone on their surplus working stocks of notes and coin held in ACCs, up to a specified amount. All other costs associated with the distribution of cash are met by others, including commercial banks, specialist cash handlers, retailers and the general public.

New Note Orders

An increase in the issue of new notes from the NNPDC, and an increase in the level of reserve stocks deemed appropriate for the Reserve Bank to hold, led to an increase in purchases of new notes from Note Printing Australia.

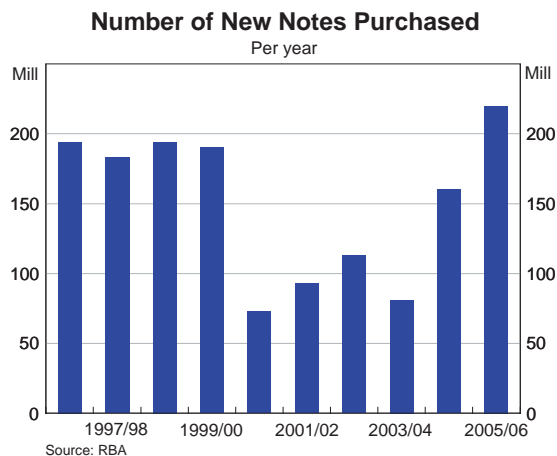
The Reserve Bank took delivery of a total of 220 million new notes in 2005/06, across most denominations, up from 160 million in the previous year, an increase of 38 per cent. There were no purchases of new \$100 notes, as has been the case for several years, as the Reserve Bank continues to run down the stock of \$100 notes acquired as a contingency for Y2K.

Counterfeiting Activity

Counterfeiting activity in Australia remains low. In 2005/06, a total of

about 5 100 counterfeit notes were passed, with a face value of around \$263 000, up from about 4 300 in the previous year. Measured against the number of notes in circulation, counterfeit notes rose slightly to six per million notes in circulation from five per million in the previous year. These rates of counterfeiting are very low compared with the experience in other industrialised countries.

In 2005/06, the \$50 was the most counterfeited denomination, accounting for about three-quarters of the total. Almost all were reproduced on paper rather than polymer, and as the quality was generally poor, they were quickly and easily detected. About 90 per cent of the counterfeit notes were detected by the public, and the remaining 10 per cent during



authentication at the NNPDC (representing about two counterfeit notes in every million notes processed by the NNPDC).

One notable development in May 2006 was the interception, by local authorities working in conjunction with Interpol and the Australian Federal Police, of a criminal operation in Colombia attempting to counterfeit the Australian \$100 note. The authorities seized a printing press, computer and printing materials, including partially printed counterfeit notes. These partially printed counterfeit notes were printed on plastic film, but not on genuine polymer substrate. The seized material would have been sufficient to have counterfeited notes with a face value of around \$5 million if they had been completed. No finished counterfeit notes were discovered, and there is no evidence to suggest that the counterfeiters had succeeded in completing any counterfeit notes or that any counterfeit notes had reached Australia or been passed.

The seizure in Colombia highlights the ongoing threat posed by counterfeiting. As part of its anti-counterfeiting strategy, the Reserve Bank maintains an active research and development program into note design and security features. The Reserve Bank's aim is to improve the security of polymer notes continually, making counterfeiting more difficult, more time-consuming and more costly for would-be counterfeiters, and easier for the public to detect. The Reserve Bank also works closely with the Australian Federal Police, and other central banks and international agencies, in monitoring developments in counterfeiting activity.

Note Printing Australia and Securrency

Note Printing Australia

Note Printing Australia Limited (NPA), based at Craigieburn in Victoria, is a wholly owned subsidiary of the Reserve Bank, which produces currency notes for Australia and export and was the first printer in the world to issue a complete circulating currency note series on polymer substrate. With Securrency Pty Ltd, which supplies print-ready polymer substrate, it has led the way in establishing the polymer technology as a viable alternative to paper.

During 2005/06, NPA produced 220 million notes for the Reserve Bank and 161 million export notes, continuing the high level of production established the previous year. Among the export deliveries were orders for Bank Negara Malaysia, the Reserve Bank of New Zealand, the Bank of Papua New Guinea and Nepal Rastra Bank. NPA produced its four billionth polymer note in April 2006, one measure of the success of the polymer technology. Another measure is that a number of other currency note printers have now taken up the polymer technology, in many cases assisted by technology transfer from NPA.

The outlook is for another strong year in 2006/07, with an order for 265 million notes from the Reserve Bank, and confirmed export orders of 188 million notes for countries in Asia, South America and the Pacific. Two export customers have recently entered long-term supply agreements with NPA.

New investment in 2005/06 has tightened process controls, increased productivity and improved print quality. An additional note-sorting machine raised capacity in the finishing area. The control environment was improved by the implementation of new IT infrastructure and management systems.

As the Reserve Bank undertook a program to improve the quality of notes in circulation, the National Note Processing and Distribution Centre, operated by NPA under contract from the Reserve Bank to reissue or withdraw circulating Australian notes, processed a significantly higher volume of currency notes than in recent years, achieving higher rates of productivity in the process.

NPA continued to work closely with Securrency in research and development, marketing and customer support for international business. The activities of the two companies in export markets complement each other. NPA has now printed 51 denominations for 18 countries, including Australia. Securrency has supplied polymer to printers overseas for a further 18 denominations in six countries. In all, 23 countries, covering all continents, have issued polymer currency notes. Australia, New Zealand and Romania have converted all their denominations to polymer, while Vietnam, Brunei and Papua New Guinea are approaching full conversion.

In addition to currency notes, NPA prints other security documents, including Australia's passports. During 2005/06, 1.8 million Australian passports were printed and assembled for

Export Orders for New Polymer Notes ^(a)

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 ^(b)	2 Kina	Circulating
1996	Brunei Darussalam	1, 5, 10 Dollar	Circulating
1996	Thailand	50 Baht	Special Issue Circulating
		500 Baht	Commemorative
1997	Thailand ^(b)	50 Baht	Circulating
1997	Western Samoa	2 Tala	Circulating
1998	Sri Lanka	200 Rupee	Commemorative
1998	Malaysia	50 Ringgit	Commemorative
1999	New Zealand	5, 10, 20, 100 Dollar	Circulating
1999	Papua New Guinea	50 Kina	Circulating
1999	Romania	2 000 Lei	Commemorative/Circulating
1999	Indonesia ^(b)	100 000 Rupiah	Circulating
1999	Northern Ireland ^(c)	5 Pound	Commemorative/Circulating
1999	Taiwan ^(c)	5 Dollar	Special Issue Circulating
2000	New Zealand	10 Dollar Millennium Note	Commemorative
		50 Dollar	Circulating
2000	Romania ^(b)	10 000 Lei	Circulating
2000	Romania ^(b)	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
2000	Brazil ^(c)	10 Reais	Commemorative/Circulating
2001	Kuwait	1 Dinar	Commemorative
2001	Solomon Islands	2 Dollar	Special Issue Circulating
2001	China ^(c)	100 Yuan	Commemorative
2001	Vietnam ^(c)	50 Dong	Commemorative
2001	Romania ^(c)	50 000, 100 000 Lei	Circulating
2002	Mexico ^(b)	20 Peso	Circulating
2002	Nepal	10 Rupee	Circulating
2003	Papua New Guinea	20 Kina	Commemorative
2003	Vietnam	50 000 Dong	Circulating
2003	Vietnam ^(c)	50 000, 500 000 Dong	Circulating
2003	Zambia ^(c)	500, 1 000 Kwacha	Circulating
2003	Romania ^(c)	1 000 000 Lei	Circulating
2004	Singapore	10 Dollar	Commemorative/Circulating
2004	Brunei Darussalam	50, 100 Dollar	Circulating
2004	Chile	2 000 Pesos	Circulating
2004	Malaysia	5 Ringgit	Circulating
2004	Vietnam ^(c)	100 000 Dong	Circulating
2005	Romania ^(c)	1, 5, 10, 50, 100, 500 Lei	Circulating
2005	Papua New Guinea	100 Kina	Circulating
2006	Singapore ^(c)	2 Dollar	Circulating
2006	Vietnam ^(c)	20 000 Dong	Circulating

(a) Excludes repeat orders

Denominations shown were printed by Note Printing Australia, except for:

(b) Printed by NPA and an overseas printer

(c) Printed by an overseas printer

For both (b) and (c), Securrency exported polymer substrate for printing the denominations shown.

Special issue circulating notes are printed for general circulation and often feature an overprint to commemorate a special event. Commemorative notes are designed and printed to commemorate a one-off occasion (and are usually manufactured in low volumes and not necessarily circulated widely).

the Department of Foreign Affairs and Trade. Almost all of these were the new electronic-chip passports, which were officially launched in October 2005. NPA was awarded a gold medal for innovation at the 23rd National Print Awards for the electronic passport.

In recent years, NPA has widened the range of security products it offers, based on the polymer note-printing technology, including by producing academic transcripts for a number of universities.

NPA's Board operates under a charter from the Reserve Bank Board and comprises Graeme Thompson, Chairman (a former Deputy Governor of the Reserve Bank), Richard Warburton AO (a former non-executive member of the Reserve Bank Board), Les Austin (a former Assistant Governor of the Reserve Bank), Mark Bethwaite (former Chief Executive of Australian Business Ltd) and Frank Campbell (an Assistant Governor of the Reserve Bank). The Chief Executive of NPA is Chris Ogilvy.

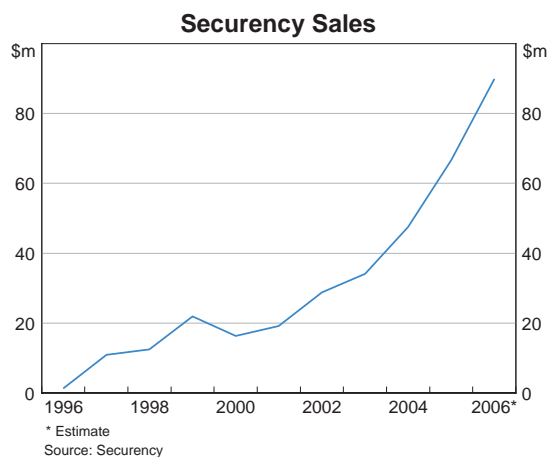
Security

Securrency Pty Ltd is a joint venture between the Reserve Bank and Innovia Films, a global supplier of polypropylene films. Securrency sells to NPA, and other currency note printers overseas, high-security polymer substrates that it produces by applying unique coatings and security features to the specialised films supplied by Innovia. It currently supplies three types of substrate: Guardian® to high-security printers for currency notes; Sentinel® for other high-security documents, such as land titles and academic transcripts; and Sentrii® for secure cards.

Securrency achieved record output during 2005/06 and expects to achieve even stronger results in 2006/07. Repeat orders from several countries indicate increasing international acceptance of the polymer technology, which has combined lower long-term cost with lower rates of counterfeit. All orders in recent years have been for circulating notes, as opposed to commemorative or special issue notes, which were quite common in the early years of the application of the technology.

In 2005/06, Securrency produced substrate for a range of denominations in Australia, Malaysia, Mexico, Nepal, New Zealand, Papua New Guinea, Romania, Singapore, Vietnam and Zambia. About 90 per cent of Securrency's revenue comes from exports.

Nine new denominations were launched on Guardian® during the year, including a new redenominated series for the National Bank of Romania (NBR) (six denominations), Papua New Guinea's new 100 kina, Singapore's new \$2 note and Vietnam's 20 000 dong. The Romanian series is significant as the first series to be fully redenominated on polymer; the NBR will issue an additional denomination, the 200 lei, on





Graeme Thompson, Chairman, right, and Myles Curtis, Managing Director, left, assess progress during construction of Security's plant expansion.

polymer later in 2006. Banco de Mexico has announced that it will issue its 50 peso and a new 20 peso note on polymer, while the State Bank of Vietnam announced that it will convert all its denominations to polymer. The Central Bank of Nigeria recently placed orders for its first polymer denomination – a redesigned 20 naira to be issued in 2007. An innovative optically variable security feature called G Switch® was launched on the new 100 kina for Papua New Guinea and will be on a number of other notes to be issued in 2006.

Security is currently more than doubling its manufacturing capacity at Craigieburn, with a new facility to be commissioned later in 2006 to accommodate the rapid growth in demand for secure polymer substrate around the world. The new plant will enable Security to improve its service to customers while also providing scope to expand its research and development program. It will also be the blueprint for further expansion internationally in the coming few years.

Security has successfully marketed polymer substrate for Sentinel® secure documents and Sentrrii® secure card substrate, receiving orders for substrate for Taiwan Land Titles and to produce the South Australian Driver's Licence.

Security's Board comprises three directors appointed by the Reserve Bank, three appointed by its joint-venture partner, and the company's Managing Director, Myles Curtis, as a non-voting member. Security's offices and plant are located at Craigieburn, on the same site as NPA and adjacent to the Innovia plant that supplies it.

The Reserve Bank in the Community

Accountability

The Reserve Bank is accountable to Parliament. This report complies with Section 9 of the *Commonwealth Authorities and Companies Act 1997*, which requires an annual report to be tabled in both Houses of Parliament. Parliamentary accountability has been increased since 1996 through twice-yearly appearances before the House of Representatives Standing Committee on Economics, Finance and Public Administration. In 2005/06, the Governor and senior officers appeared at hearings of the Committee in Melbourne in August and in Canberra in February; the next hearing of the Committee is scheduled to be held in Sydney in August 2006. The hearings in 2005/06 covered a wide range of issues, including the domestic and international economic outlook, the resources boom and Australia's terms of trade, inflation, household sector developments, payments system reform, central bank governance and, of course, monetary policy.

The *Statement on Monetary Policy*, published quarterly, provides an analysis of the state of the economy, the outlook for inflation and the reasons for recent Reserve Bank Board decisions on interest rates. These statements inform the financial markets, the media and the wider community about the Reserve Bank's thinking on monetary policy and provide a basis for the Parliamentary Committee's questioning.

Communication

In addition to the formal requirements, Reserve Bank accountability is fostered also by regular communication with the financial markets and public more generally. During 2005/06, the Governor, Deputy Governor and senior officers gave speeches on topics such as the economic conjuncture and outlook, reform of the payments system, financial co-operation in Asia, global imbalances, the financial implications of ageing, and risk and the macroeconomy.

The Reserve Bank *Bulletin* is a monthly record of media releases and comprehensive statistics, plus articles on numerous topics; in the past year, these included household sector developments, trends in savings and investment, Australia's foreign assets and liabilities, banking fees and measuring house prices. In addition, the *Bulletin* reproduces most of the speeches made by senior staff.

The *Financial Stability Review* is published in March and September each year and gives a detailed assessment of the overall condition of Australia's financial system. It also provides analysis of specific issues, including, in the past year, residential mortgage-backed securities, banks' foreign currency lending practices and developments in the low-doc loan market.

Research work undertaken by staff is published in the Research Discussion Paper (RDP) series. In 2005/06, 13 RDPs were published. A wide variety of topics were covered, including the determinants of manufactured exports in the Australian states, the measurement

of housing prices, the determinants of corporate investment, and the relationship between credit and the macroeconomy. Although this work is primarily of interest to professional economists, non-technical findings of some of the papers are published in the *Bulletin* to be available to a wider audience. In addition to these publications, some staff have also had work published externally. This has included a paper on the effectiveness of central bank intervention in foreign exchange markets, published in the *Journal of International Economics*, and a paper on the external vulnerability of economies, published in *The Journal of Policy Reform*. Much of this research work is on issues relevant to monetary policy, although the views expressed are those of the authors and do not necessarily reflect the views of the Reserve Bank. These publications are aimed at promoting discussion and debate among researchers in the field.

The Reserve Bank's annual two-day economic research conference was combined with a G-20 workshop in Sydney, jointly hosted with the Australian Treasury and titled 'Demography and Financial Markets'. This workshop brought together academics, officials from the Reserve Bank and the Australian Treasury and their counterparts from the participating G-20 nations. As with previous Reserve Bank conferences, which began in 1989, the papers presented at the workshop will be published in a volume later in the year.

The Reserve Bank publishes all this information in both electronic and hardcopy formats. Demand for hardcopy publications has been declining as use of the website has grown strongly.

The Reserve Bank continues to convene its Small Business Advisory Panel. This panel was established in 1993 and meets annually to discuss issues relating to the provision of finance for small businesses. Membership of the Panel is drawn from a wide range of industries across the country. The Panel continues to represent a valuable source of information on the financial conditions faced by small businesses.

Activities of the Regional Offices

An important dimension of the Reserve Bank's presence in the community is its Regional Offices. Located across the country,¹ these have two main roles. One is economic intelligence gathering, with economists in the Regional Offices seeking timely information about business conditions; this economic intelligence feeds into the monthly assessments of the economy provided to the Reserve Bank Board and other core work of the Reserve Bank. A second role is representation, where the presence of Reserve Bank staff in regional locations facilitates greater communication between the Reserve Bank and the wider community.

The liaison function of the Regional Offices sees staff interact with a broad cross-section of the community. The Reserve Bank has cultivated a pool of over 1 500 contacts with whom liaison is regularly conducted, and a total of nearly 5 000 interviews have been conducted since the inception of the program. While the bulk of these contacts are firms, a valuable part of the program is liaison with industry associations and government agencies. In the normal course of liaison, Reserve Bank staff meet with around 100 contacts per month. With the program

¹ There are Regional Offices in Queensland, South Australia, Victoria and Western Australia. The Victorian Office covers Tasmania, the South Australian Office covers the Northern Territory and staff in Head Office cover New South Wales and the Australian Capital Territory.

having reached a mature stage, relationships with many contacts are now well established, enhancing the dialogue between the Reserve Bank and the community and the quality of information obtained.

In addition to their interaction with businesses and other agencies, Regional Office staff are the first point of contact with the Reserve Bank for the general public in their States, fielding a large number of enquiries about the role of the Reserve Bank, economic statistics and monetary policy decisions. Regional Office staff also give presentations to the public in their capital cities and increasingly in provincial centres. Over the past year, presentations have been given in the Northern Territory, various provincial cities in Queensland and Victoria, Albany and the goldfields of Western Australia, and Mount Gambier in South Australia. These presentations have been to industry bodies and community groups, and many have been to teachers' associations and students (from both high schools and universities). They have generally been about the framework for monetary policy or current economic conditions. Other Reserve Bank staff from Head Office have visited the regions and given talks on published research work.

The Reserve Bank's presence in the community has been further raised by the hosting of functions in the Regional Offices. The Offices on occasion host Reserve Bank Board meetings, and briefings on the *Statement on Monetary Policy* have become a regular occurrence in each State capital. These briefings are given by senior managers, who communicate the main themes of the *Statement* to liaison contacts and engage in discussion with participants.



Karen Hooper, Senior Representative in the Reserve Bank's Queensland Regional Office, overlooking an industrial facility at Auckland Point in Gladstone, site of the largest multi-commodity port in Queensland.

Museum of Australian Currency Notes

The Museum, which opened in March 2005, exhibits the story of Australia's currency notes against the background of the nation's broader history. After an introductory stage on developments before Federation, which includes Australia's first gold coins (see below), visitors can review the various series of notes produced since the first Australian notes in 1913–1915. The final stage in the Museum focuses on Australia's polymer currency notes, including information on their design, security, recycling and other features. Polymer note technology has placed Australia at the forefront of currency note development and visitors can see examples of the many polymer notes that have been issued by other countries.

As well as viewing the original notes, visitors can learn about the men and women represented on the notes over the years, about the artwork used in their design and about some of the key historical episodes in Australian history through the Museum's displays of archival film, photographs and documents.

Since March 2005, about 11 000 people have visited the Museum. Most of the information in the Museum is on the Reserve Bank's website, where visitors can also take a virtual tour of the Museum. Around 150 000 visitors have so far experienced the Museum online, half of those from other countries.

Disposal of Gold Coins

The Reserve Bank held for many years a large quantity of gold coins, accumulated prior to 1976 when Australian law required that the public exchange gold coins for Australian currency. The total value of these coins was minor, at less than one-tenth of 1 per cent of the Reserve Bank's assets.

The Reserve Bank, which is responsible for the issue of currency notes but not coins, decided that it did not need to continue to hold this large quantity of coins. Some coins identified as having historical value were transferred to the Royal Australian Mint's National Coin Collection. Those coins with no numismatic value – worth only their weight in gold metal – were melted and sold as gold bullion, while those with small numismatic value were sold at tender to coin dealers in a number of bulk lots. Some 5 850 coins were assessed as having significant numismatic value; these were Australian half-sovereigns and sovereigns, Adelaide pounds and some foreign coins. They were sold by public auction, together with 800 silver and copper-based coins also held by the Reserve Bank.

The auction was conducted during late November 2005 in the Old Treasury Building, Melbourne. The auction was well attended, bidding was strong and all lots were sold. The auction raised \$4.7 million, well in excess of the market value of \$3.1 million estimated prior to the auction.

The Reserve Bank retained a small number of gold coins for display in the pre-Federation stage of its Museum of Australian Currency Notes.



The Reserve Bank sold the remainder of its holdings of gold coins at an auction organised by Downies Australian Coin Auctions in November.

Financial Assistance for Economic and Financial Research and Education

The Reserve Bank provides assistance for a variety of research and related activities that are closely aligned with its core functions. Ongoing funding has been 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 Workplace Research Centre (formerly the Australian Centre for Industrial Relations Research and Training) at the University of Sydney. During the year, the Reserve Bank joined with other central banks to support the establishment of the *International Journal of Central Banking*, the primary objectives of which are to disseminate the best policy-relevant and applied research on central banking and to promote communication among researchers both inside and outside central banks.

Scholarships under the Elite Executive Honours Scholarship Program, organised by Axis Australia, the government agency charged with positioning Australia as a global financial services centre, were again supported during 2005/06. This year, two scholarships funded by the Reserve Bank under this program were for study at the University of Queensland and the University of New South Wales. In conjunction with APRA, the Reserve Bank has continued sponsorship of the Brian Gray Scholarship Program, initiated in 2002 in memory of a former senior officer of the Reserve Bank and APRA; two scholarships were awarded under this program for 2006, for honours year studies at the Australian National University and the University of Sydney.

The Reserve Bank's financial assistance to Australian universities each year includes contributions towards the costs of their organising conferences in economics and closely related fields. In 2005/06, these conferences included the annual Conference for PhD Students in Economics and Business, held this year at the University of Western Australia, the Economic Society of Australia's 34th Conference of Economists, held at the University of Melbourne, the 11th Melbourne Money and Finance Conference, held at the University of Melbourne, and the University of New South Wales' 18th Australasian Finance and Banking Conference.

In conjunction with other central banks, the Reserve Bank agreed to continue its support of the International Accounting Standards Committee Foundation following completion last year of the initial five-year support plan. The Reserve Bank 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 Activities

During the year, the Reserve Bank maintained the level of its financial support for charitable organisations, contributing a total of \$20 000 to 16 Australian charities that seek to address



In July 2006, the Deputy Governor, Glenn Stevens, addressed the Anika Foundation and Australian Business Economists on the conduct of monetary policy.

a broad range of medical problems and disabilities. In addition, the Reserve Bank made its fourth annual contribution of \$50 000 to the Financial Markets Foundation for Children, of which the Governor is Chairman; along with a number of other major Australian financial institutions, the Reserve Bank has committed to support the Foundation to this extent for a further six years. In July 2006, in its first public event to raise funds, the Deputy Governor addressed the Anika Foundation; the Foundation was established in 2005 to raise funds to support research into adolescent depression and suicide.

Statutory Obligations

Equal Employment Opportunity (EEO)

As required under the *Equal Employment Opportunity (Commonwealth Authorities) Act 1987*, the Reserve Bank reports to the Australian Parliament each year on its EEO program. The Equity and Diversity Annual Report 2005 was tabled on 15 September 2005 and incorporates initiatives under the Reserve Bank's disability action plan consistent with the Commonwealth Disability Strategy.

The prime focus for the Reserve Bank in 2005 was its commitment to working parents, particularly women returning to work from parental leave, through the establishment of a joint-venture childcare facility in the CBD. The facility provides 20 places for pre-school-age children of staff.

Health and Safety, Compensation and Rehabilitation

The Reserve Bank is required, in terms of Section 74 of the *Occupational Health and Safety (Commonwealth Employment) Act 1991 (OH&S Act)* and the conditions of its licence as a Licensee 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 Reserve Bank.

The Reserve Bank's licence to self-insure and manage claims for workers' compensation remains current to 30 June 2007, as is the Bank's agreement with Australia Post to undertake reconsiderations of determinations issued by Reserve Bank delegates. Both the number of OH&S incidents reported (65) and claims determined (17) were lower than in 2004/05; as in previous years, most related to travel or lunchtime sport. No requests for reconsideration of the Reserve Bank's workers' compensation determinations were received during the period. In terms of Section 68 of the *OH&S Act*, two incidents were notified to Comcare as 'dangerous occurrences'; both have been fully investigated and preventative action taken against recurrences.

The Reserve Bank has robust policies and mature systems in OH&S, claims management and rehabilitation, with a strong record of performance. These were confirmed by independent audits during the period – two in OH&S (Head Office and the Perth Regional Office) and one each in claims management and rehabilitation. In addition, Comcare undertook verification OH&S audits at Canberra Branch and the Brisbane Regional Office. All audits found the Reserve Bank to be fully compliant with the respective legislation and the Reserve Bank's conditions of licence. The Reserve Bank's performance as measured by audits and Comcare Performance Indicators was reviewed in the annual Licensee Improvement Program Report provided to Comcare at the end of March 2006. That report also reflected the Reserve Bank's commitment to continuous improvement in OH&S during 2006/07.

Freedom of Information

Section 8 statement

Organisation and functions: The Reserve Bank 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 *Commonwealth Authorities and Companies Act 1997*, the *Payment Systems (Regulation) Act 1998*, the *Payment Systems and Netting Act 1998*, the *Corporations Act 2001* and the *Financial Services Reform Act 2001*, and in Regulations made under those Acts. An overview of the structure of the Reserve Bank is provided in the organisational chart that 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 Reserve Bank *Bulletin*. These publications, as well as

other information about the Reserve Bank, are also available on the Reserve Bank's 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.

The right of access to documents in the possession of Australian Government agencies in terms of the *Freedom of Information Act 1982 (FOI Act)* applies to the Reserve Bank. However, the Reserve Bank is an exempt agency under the *FOI Act* in respect of documents concerning banking operations (including individual open market operations and foreign exchange dealings) and exchange control matters.

Facilities for access and Freedom of Information procedures: Enquiries under the *FOI Act*, including requests for access to documents, should be directed to the Secretary of the Reserve Bank. 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

One request, from a solicitor, for access to documents under the *FOI Act* about an individual thought to have been an employee of the Reserve Bank, was received in 2005/06. A request, from a media organisation, for access to documents under the *FOI Act* that was received in 2004/05 was finalised early in the year. Both requests were denied on account of the Reserve Bank not having any relevant documents.

The estimated number of staff hours spent dealing with all aspects of FOI requests in 2005/06 was around 11 hours, of which about half related to the request that was received during the year. The total cost to the Reserve Bank of administering the *FOI Act* in 2005/06 was estimated to have been \$2 492.

Management of the Reserve Bank

Operating Costs

More than half of the Reserve Bank's operating costs are incurred in the core policy areas of monetary policy and financial system stability. The remainder is spread quite evenly across note issue, settlements and banking. Nearly 60 per cent of costs are staff costs.

The Reserve Bank's operating costs rose by about 8 per cent in 2005/06, with some major projects in the core areas of responsibility contributing almost half of the increase. For example, the project to modernise RITS continued, with banks planning to adopt the new system interface by the end of 2006. The new system will enhance user access, and provide greater security and better backup functions. The new features of RITS will ensure that the real-time interbank gross settlement system in Australia remains abreast of world best practice. Further development of RITS systems is likely over the next few years. New activities to improve the quality of currency notes in circulation raised outlays directly associated with currency distribution, and led to higher depreciation on new note-handling equipment and spending on research activities, as improved systems for currency note evaluation were developed. This project takes advantage of the durability of polymer note technology, which provides the opportunity to maintain generally high-quality notes in circulation at low long-term cost. This, in turn, helps contain the threat of counterfeit notes.

Although also raising operating costs, once commissioned in mid 2007, the business resumption site (BRS) will ensure that the Reserve Bank's critical functions will continue to operate if access to Head Office systems or accommodation is lost. In particular, the facility will provide continuity for RITS, banking operations for the Australian Government – such as those for making pension and health care payments – and the Reserve Bank's market operations. This project will strengthen the financial system infrastructure in Australia and is in line with steps being taken by banks and central banks around the world to cope with disruption to their activities. The fact that the Reserve Bank assumed management of the facility used by NPA at Craigieburn also raised the Bank's direct costs in 2005/06, although it resulted in lower overall costs on a consolidated basis, as it led to savings in staff costs at NPA. Over time, further cost

Operating Costs ^(a)									
(\$ million)									
	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
Staff costs	77.7	69.1	68.7	67.7	73.9	77.8	85.5	91.4	100.5
Other costs	47.2	49.1	56.1	54.1	58.4	62.7	58.6	68.8	73.1
Underlying operating costs	124.9	118.2	124.8	121.8	132.3	140.5	144.1	160.2	173.6
Cost of redundancies	20.7	18.4	9.3	2.6	3.4	2.6	0.2	0.2	0.2

(a) Costs associated with the ongoing operation of the Reserve Bank, excluding NPA.

reductions are expected as the Reserve Bank applies its procurement practices to servicing the NPA site. These services are provided to NPA on a cost-recovery basis.

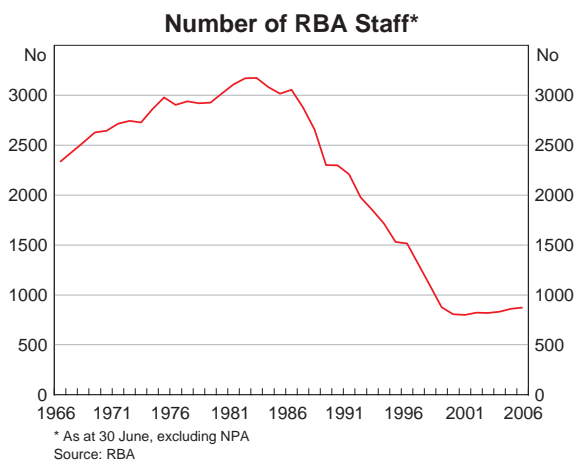
The rise in staff costs in 2005/06 reflected an annual increase in base salaries of 4 per cent in November 2005, plus some performance payments. Average staff levels in 2005/06 were about 2 per cent higher than those in the previous year. In policy areas, this reflected the annual program of recruiting graduates of suitable quality in disciplines related to the Reserve Bank's policy responsibilities and the appointment of a couple of more senior economists with overseas experience. Small staffing increases were associated with the work on currency note quality, while staff with specialist skills were appointed, usually on short-term contracts, to assist with designing IT systems for the BRS and other smaller projects. Staff costs were also affected by the decision early in 2006 to restore, on actuarial advice, contributions to the staff superannuation fund to a more normal long-term rate, after contributions had previously been made at significantly lower rates over a long period, also on actuarial advice.

Staff costs have been rising in recent years, but remain slightly below their peak level of 1990/91. The rise in staff numbers from the historically low point of 2001, when total staff was about a quarter of its peak in 1983, reflects a number of factors: RITS operations were relocated to the Reserve Bank from an external provider to ensure that resources would be applied to maintain the system at a high level of performance; the regional offices were established in Melbourne, Brisbane, Perth and Adelaide; the Reserve Bank's international responsibilities have expanded and been staffed accordingly; IT systems, including support for Internet facilities, have increased; and the risk management function has been established, with more staff also appointed in internal audit. Staff numbers have recently been boosted temporarily by short-term contractors working on projects. Annual salary increases, within successive enterprise bargaining agreements, have ranged between 3½ and 4 per cent since 2001. In real terms, staff costs remain a little more than half their peak in 1987.

Staffing

The Reserve Bank's responsibilities require high-calibre staff. Over half of the staff have degree qualifications and a fifth have post-graduate qualifications. A number of programs support the Reserve Bank's aim of recruiting professional staff of suitable quality. Honours graduates are sought through the Cadetship Scheme, which provides students of high potential in relevant disciplines with work experience at the start of their honours year. Financial support during that year is available if cadets are offered, and accept, a place on the next Graduate Development Program. Business Sponsorships have also been used during the year to attract a small number of experienced economists from overseas.

Financial support is provided to current staff for part-time study in disciplines related to their work; at the end of June 2006, 80 employees were studying part-time. For a few of the most capable staff, financial assistance is provided for full-time post-graduate study at universities in Australia and overseas; in the past year, nine staff received such assistance. Staff who are supported for full-time study are required to reimburse these costs if they resign either while studying or before completing an agreed period of work after returning from study.



A number of informal and formal training programs aim to develop workplace skills and management expertise. The performance appraisal process encourages supervisors and managers to plan appropriate training for their staff. Professional development is encouraged through secondments, either to the Reserve Bank's regional and overseas offices or to other organisations. During 2005/06, staff have worked at the BIS, the Bank of France, the Australian Treasury,

the Australian Taxation Office, ASIC and the Financial Services Authority in the UK. Staff are often seconded within the Reserve Bank to participate in projects of various kinds, which draw together skills from a range of disciplines, resulting in a better appreciation of the variety of challenges facing staff working in different areas.

Eighty per cent of staff in professional and managerial roles are employed on individual contracts, which provide flexibility to match remuneration with accountability and performance. At executive levels, these contracts are for five-year fixed terms and vacancies are advertised both within and outside the Reserve Bank. External remuneration benchmarking for staff is facilitated by a program of formal job evaluations, advice from remuneration consultants and participation in industry-based salary surveys.

The terms of employment for staff not employed on individual contracts continue to be determined by the current enterprise bargaining agreement (EBA). This agreement provided for an annual salary increase of 4 per cent in November 2005, and continues to provide greater scope than in the past to reward good performance, within the existing budget. It also provided for more efficient work practices in a number of areas while accommodating more flexible work arrangements, especially for staff with caring responsibilities. Staff on individual contracts received, on average, the same annual salary increase as staff covered by the EBA. The Reserve Bank is currently reviewing recent changes to workplace legislation and considering the appropriate industrial instruments for 2007 and beyond.

Benefits provided to staff are kept under review to ensure that they remain consistent with the contemporary needs of staff. Twelve parents currently use one or more of the 20 places available at the Reserve Bank's joint-venture childcare facility, established in the Sydney CBD in early 2005. Several others will take up positions in coming months.

The Reserve Bank continues to participate in the Australian Government's New Apprenticeship and Traineeship System, which provides training in a number of areas to young people who generally lack a widely recognised post-school qualification.

Facilities Management

The Reserve Bank owns property in locations in which it has a business need, including office accommodation in the CBDs of Sydney, Melbourne and Canberra and the site at Craigieburn, north of Melbourne, where NPA, the NNPDC and Securrency are located. Surplus space in the CBD premises is leased to tenants on commercial terms. With virtually this entire surplus remaining fully leased during the year, gross annual rental income amounted to \$6.3 million.

Following Parliamentary approval in June 2005, expressions of interest and tenders were called for the construction of the BRS in outer metropolitan Sydney. When completed, the site will provide accommodation for staff and IT systems to ensure continuity for the Reserve Bank's critical business functions if there is disruption to these activities at Head Office. The construction contract was awarded to Grindley Construction Pty Ltd in January 2006, with work commencing on site early in February. The project is on program for completion by the end of March 2007, within the overall project budget of \$38 million. The facility is planned to be ready for operations in July 2007, following commissioning of IT and communications systems. In addition, during the year work commenced to strengthen the Head Office IT and associated electrical infrastructure, compatible with systems planned for the BRS.

The Reserve Bank has established various policies and programs to promote best practice in the areas of environmental management systems and operations. These include the Reserve Bank's Energy Management Program, which has achieved a reduction in energy consumption in accord with Australian Government targets. Other environmental programs focus on recycling and efficient practices to reduce waste. The Reserve Bank's procurement policies are consistent with relevant environmental guidelines.



Frank Campbell, Assistant Governor (Corporate Services), second from left, discusses progress on construction of the business resumption site with, from left to right, Greg Graham, Richard Mayes and John Wightman, members of the Reserve Bank's project team.

Consultancies

In common with other large organisations, the Reserve Bank employs outside contractors or professional service providers to carry out specific tasks where necessary, and also, from time to time, uses consultants. A consultant investigates particular issues and then provides independent advice. In 2005/06, the following four consultancies were undertaken.

Consultancies^(a) 2005/06			
Name	Project	Cost (\$, excl GST)	Purpose
Castelain Pty Ltd	RITS application	35 000	Technical advice on implementation of IT security systems
Castelain Pty Ltd	Secure Internet transmission	49 078	Technical advice about connecting to Fedlink
Clayton Utz	EFTPOS Access Regime reforms	84 483	Legal advice on reform of the EFTPOS Access Regime
Hay Group Pty Ltd	RBA personnel	57 200	Market testing of remuneration of RBA staff

(a) Costing \$10 000 or more

Risk Management

Objectives and Governance Structure

The Reserve Bank is exposed to a range of risks in fulfilling its responsibilities. In financial terms, the largest risk stems from operations in the financial markets and the holding of assets needed to support those operations. Operational risks are also significant, given the large volume of banking services provided to clients and the sensitive nature of much of the material with which the Reserve Bank deals.

Responsibility for managing those risks rests with line management. This takes place within a framework overseen by the Risk Management Committee, comprising the Deputy Governor as Chairman; the Assistant Governors of Financial Markets, Business Services and Corporate Services; the Heads of Audit and Risk Management; and the Reserve Bank's General Counsel and Deputy Secretary. The primary responsibility of the Committee is to ensure that the full spectrum of non-policy risks is effectively managed across the organisation, particularly those which span more than one department. The Committee meets at least quarterly and keeps the Audit Committee informed of its activities; it reports annually to the Reserve Bank Board.

A small Risk Management Unit assists the Risk Management Committee in its work. Its main tasks are to advise departments and co-ordinate the risk management process across the organisation. The Unit maintains a close working relationship with, but remains separate from, the Audit Department.

The sections below describe the various risks, and the associated management practices, in more detail.

Balance Sheet Risks

The main risks are exchange rate risk, interest rate risk and credit risk. These risks are managed by the Financial Markets Group, within parameters and controls set by the Governor and the Reserve Bank Board. The main features of the control framework include limits on open positions and counterparty exposures, a well-defined benchmark for the foreign reserves portfolio, a clearly defined delegation structure and detailed procedures manuals. Compliance with the control framework is reported daily to senior management, including to the Assistant Governor, Financial Markets and Head of the Risk Management Unit.

Exchange Rate Risk

The foreign currency assets the Reserve Bank holds outright are exposed to exchange rate risk, as their value (when measured in Australian dollars) varies with movements in the exchange rate between the currencies in which the assets are denominated and the Australian dollar.²

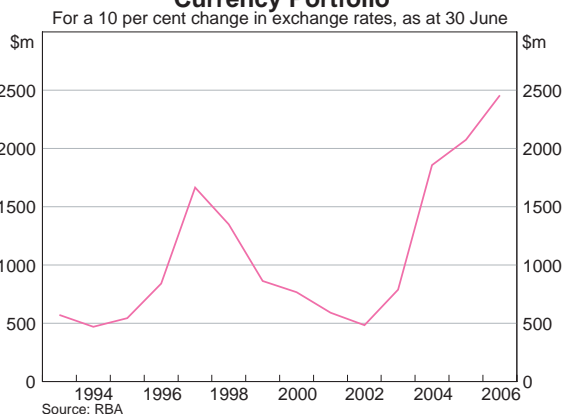
² This is not the case for foreign exchange held under swaps as the exchange rate at which the foreign exchange will be delivered is agreed at the start of the swap.

The level of foreign currency exposure is largely determined by intervention operations, which are decided on policy grounds, and cannot be separately managed. The exchange rate risk from holding a given level of foreign currency is, however, reduced by the diversification of foreign currency reserves across three currencies. Forty-five per cent of foreign currency reserves are held in US dollars, 45 per cent are held in euros and 10 per cent in Japanese yen.

In addition, intervention operations, when conducted successfully, work to reduce risk. This is because they result in the Reserve Bank selling foreign exchange when the Australian dollar is low, resulting in its holding less foreign currency when the Australian dollar is more likely to appreciate. Conversely when the Australian dollar is high, and is more likely to depreciate, the Reserve Bank will tend to hold more foreign currency.

As discussed in the chapter on ‘Operations in Financial Markets’, the Reserve Bank has replenished reserve assets over recent years. This has added to the level of exchange rate risk on the Reserve Bank’s balance sheet. On current holdings, a 10 per cent rise in the Australian dollar (on a weighted average basis against the three currencies in the portfolio) would result in valuation losses of around \$2.5 billion.

Exchange Rate Risk on RBA Foreign Currency Portfolio

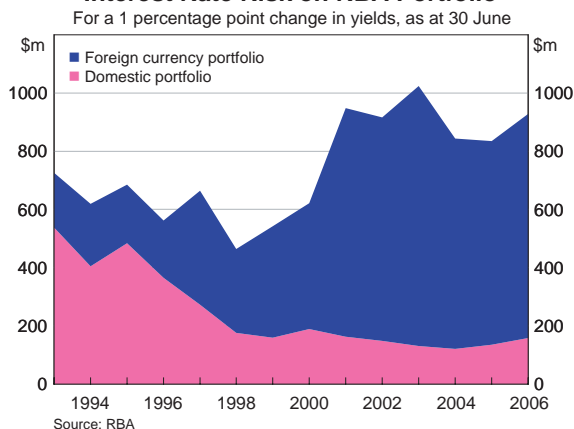


Interest Rate Risk

The Reserve Bank’s balance sheet is exposed to considerable interest rate risk because most of its assets are financial assets, such as domestic and foreign securities, which have a fixed income stream. Their value is therefore subject to movements in domestic and foreign market yields. Specifically, because of the fixed income stream, the value of these securities falls when market yields rise. Securities that have a longer maturity (or duration) contain a greater degree of interest rate risk, as the income stream is fixed for longer periods.

Over the past year, growth in the balance sheet has resulted in an increase in interest rate risk, although this was offset to some extent by a reduction in the average maturity of assets held. The maturity of assets was reduced in order to retain the flexibility to be able to meet the withdrawal of deposits by the Future Fund. Across the balance sheet, including domestic and foreign

Interest Rate Risk on RBA Portfolio



assets, the Reserve Bank would suffer a capital loss of about \$930 million if interest rates in Australia and abroad were to rise by 1 percentage point across the yield curve.

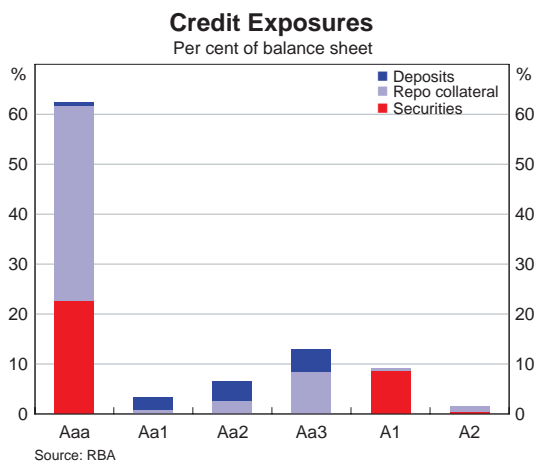
Credit Risk

Credit risk is the potential for financial loss arising from the default of a debtor or issuer. In contrast to exchange rate and interest rate risk, which the Reserve Bank is generally unable to avoid because of policy imperatives, credit risk is held to relatively low levels. This is because the Reserve Bank holds only highly rated securities. In the case of the domestic portfolio, only securities issued by either the Australian Government or the State and Territory borrowing authorities are held outright. The majority of these securities are rated Aaa. The foreign currency portfolio is invested primarily in securities issued by the US, German, French and Japanese governments. Some foreign reserves are also held as investments with the BIS, mostly in the form of direct claims on which there is very little risk of default. While funds invested in the Asian Bond Funds have an exposure to securities of lower credit rating than those otherwise held as foreign reserves, the amount invested is relatively small and the average credit rating is still well within the range of investment grade paper.

Some foreign assets are also held as deposits with commercial banks, and are therefore subject to the risk of default by these banks. There is also a default risk associated with carrying out transactions with market counterparties, since they may not be able to complete transactions entered into. Various steps are taken to minimise such risks: dealings are confined to highly creditworthy counterparties; foreign currency commercial bank deposits are placed only with banks that have a high credit rating (a short-term rating of P-1 and a long-term rating of Aa3 or above); and foreign exchange transactions are conducted only with counterparties rated P-1 (short term) and at least A3 (long term).

Credit risk arising from repurchase agreements and gold loans is much lower than for deposits, since these transactions are collateralised with either securities or cash. For this reason, the required credit standing for counterparties in these transactions is lower than for deposits and foreign exchange. Foreign repurchase agreements and gold lending transactions are conducted with counterparties rated P-2 and Baa1, or better. Other measures to control risks include requiring that the initial position be over-collateralised, that the collateral be revalued daily and that counterparties supply additional securities if the value of the securities falls below a required amount.

In the domestic portfolio, no minimum credit rating is explicitly assigned to counterparties as the operations are conducted for policy purposes. However, because dealing is restricted to RITS members, which



are primarily banks operating in Australia, the credit rating of domestic counterparties tends to be quite high.

For the foreign portfolio, in addition to assigning minimum credit ratings criteria, a limit on the absolute exposure to each counterparty is imposed in accordance with the institution's financial strength, credit rating and the size of its capital base. As the Reserve Bank may deal with a counterparty across a variety of financial products, the exposure to a given counterparty is measured so as to capture all transactions with that party. Counterparty limits are reviewed on a regular basis and adjusted immediately following changes to credit ratings.

Settlement risk (i.e. the risk that the counterparty may not be able to complete the deal) is mitigated in a number of ways. For outright and repurchase agreement transactions in domestic and foreign securities, settlement risk is eliminated by use of systems that are based on delivery-versus-payment – i.e. the simultaneous exchange of securities and cash. Settlement risk can be significant for foreign exchange transactions because the two currencies of the foreign exchange transaction are settled in different time zones, which may require the Reserve Bank to pay out funds well before it receives any funds in return. Because of this, in addition to restricting foreign exchange transactions to highly rated counterparties, a limit is imposed on the total value of foreign currency transactions settling with a counterparty on a given day.

Operational Risk

While all parts of the Reserve Bank are exposed to operational risks of varying degrees, the most significant are those associated with carrying out the market operations and supplying banking and settlement services to customers and to the market as a whole. Significant operational risks can also arise from the mishandling of sensitive information, which can cause financial loss and/or damage to the organisation's reputation.

Operational risk in financial market activities arises from the large volume of transactions undertaken in markets each day. Around 72 000 transactions were undertaken in 2005/06, with average daily settlement flows of around \$22 billion. These risks are managed by having systems and processes that are efficient and robust. To strengthen the control over operational risk, a new financial market trading and settlement system has been installed. Foreign operations were moved onto this platform during the 2004/05 financial year and domestic operations were moved onto it early in 2006. As a result, dealing functionality and risk controls for both the foreign and domestic operations are now on one integrated platform.

One of the most significant risks facing any financial institution is financial loss or reputational damage from unauthorised transactions by staff. A number of controls and processes are in place to minimise this risk. These include a clear decision-making hierarchy, with all staff involved in financial dealing having limits to their authority to take risk; controls in the computer systems to prevent unauthorised dealing; separation between staff who initiate transactions and those who settle them; an independent middle office to monitor compliance; and a strong internal audit function.

Some operations involve providing services to clients or market participants. For example, the Reserve Bank is the main banker for a number of government agencies, and processes on average about 280 million transactions a year, including all Australian Taxation Office, Medicare

Australia and Centrelink payments. It also provides real-time interbank payment and settlement services through RITS, which typically involve processing about 25 000 payment instructions per day, for an average daily value of \$145 billion. It is crucial that these operational risks be managed to ensure that the functions are carried out in an efficient manner and with complete reliability.

A major program to strengthen the Reserve Bank's back-up arrangements was advanced further during the year. Construction work on a new self-contained business resumption site in north-west Sydney commenced and it is expected that the new facility will be ready for use in 2007; more details are provided in the chapter on 'Management of the Reserve Bank'.

The Reserve Bank, in common with most other organisations, has also considered the key issues that might arise if an avian flu pandemic were to occur in Australia. Such an event raises quite different business-continuity issues since it would be staff – rather than facilities and/or systems – that become unavailable in an influenza pandemic. A key part of the strategy for dealing with an avian flu pandemic would be to have staff work from home to the maximum extent possible. Various measures were taken during the year to enhance this capacity.

Earnings and Distribution

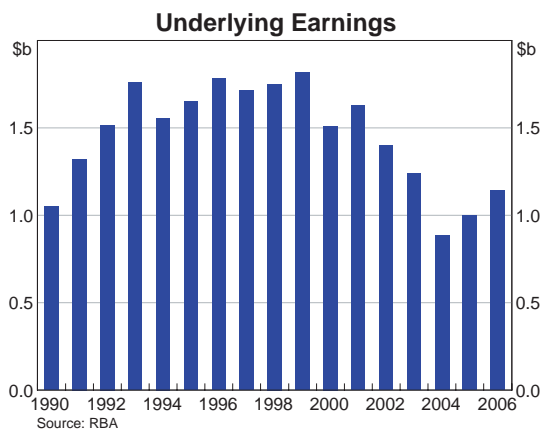
The Reserve Bank earns income from the portfolio of financial assets that it holds to undertake operations to implement monetary policy. These assets are invested primarily in securities denominated both in Australian dollars and in the foreign currencies in which Australia's international reserves are invested. The management of these assets is discussed in the chapter on 'Operations in Financial Markets', while a discussion of associated risks appears in the chapter on 'Risk Management'.

The Reserve Bank's assets provide two general sources of income – net interest income, and valuation gains or losses. Net interest income is the difference between the interest received on the portfolio of domestic and foreign assets and the interest paid on liabilities such as deposits. The Reserve Bank also earns relatively small amounts of other income from fees on the financial services it provides and rental income. The Reserve Bank's underlying earnings, which are fairly predictable, comprise net interest income plus fees and rent minus its operating costs. The underlying earnings are typically quite large because, while almost all of the Reserve Bank's assets earn interest, interest is not paid on a significant proportion of its liabilities, in particular currency in circulation and capital and reserves. Valuation gains occur when the prices of the assets it holds rise either because market interest rates fall or, for foreign assets, when the exchange rate of the Australian dollar depreciates; valuation losses occur when interest rates rise or the Australian dollar appreciates. Valuation gains and losses are realised only when assets are sold.

As the Reserve Bank prepares its financial reports on the basis of Australian equivalents to International Financial Reporting Standards (AIFRS), the Reserve Bank's accounting profits comprise earnings from all sources, including unrealised valuation gains and losses. The *Reserve Bank Act 1959*, however, specifies the components of profits that are available to be distributed as a dividend to the Reserve Bank's owner, the Australian Government.

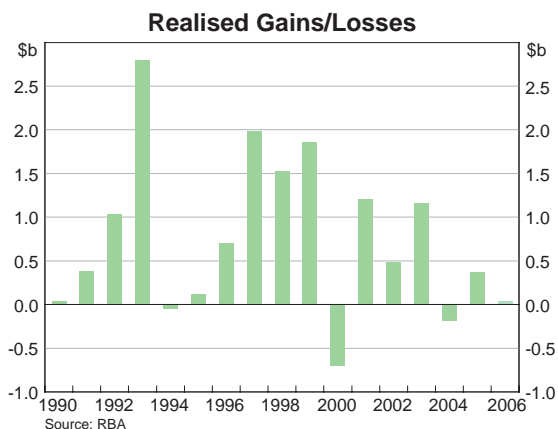
Distributable Earnings

Section 30 of the *Reserve Bank Act 1959* provides that earnings available for distribution comprise the Reserve Bank's underlying earnings plus any realised gains or losses. Unrealised valuation gains are not available to be distributed but are transferred to (or, in the case of losses, from) the Unrealised Profits Reserve. Balances in this reserve are held against the possibility of future valuation losses or are realised when assets are sold.



Looking at the results for 2005/06, underlying earnings totalled \$1 156 million, compared with \$997 million in the previous year. The increase in underlying earnings in 2005/06 reflects rises in short-term interest rates in Australia, the United States and Europe. In the past couple of years, underlying earnings have increased after a run of years during which they had fallen as short-term interest rates globally had moved to historically low levels.

Realised gains, the more volatile component of distributable earnings, amounted to \$21 million in 2005/06, compared with \$366 million in 2004/05. Gains of \$362 million



were realised from the sale of foreign exchange. However, losses of \$332 million were realised on holdings of foreign securities and there were losses of \$30 million on domestic assets. The loss on foreign investments reflected turnover in these assets, in the course of managing international reserves, at higher market yields (lower prices) than those at which they were purchased. Gains of \$21 million

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
2003/04	882	-188	694
2004/05	997	366	1 363
2005/06	1 156	21	1 177

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

were realised from the sale of gold coin that the Reserve Bank decided it no longer needed to hold.

Earnings available for distribution – the sum of underlying earnings and realised gains – amounted to \$1 177 million in 2005/06, compared with \$1 363 million in the previous year.

Reserves and Dividend

The Reserve Bank Reserve Fund (RBRF) is the Reserve Bank’s permanent general reserve. It is available to cover potential losses from a range of risks, especially the substantial market risks faced by the Reserve Bank. The RBRF is also available to cover losses from fraud, operational risks and other risks of the sort faced by most financial institutions. The RBRF has been funded over time by transfers from earnings available for distribution and is akin to capital.

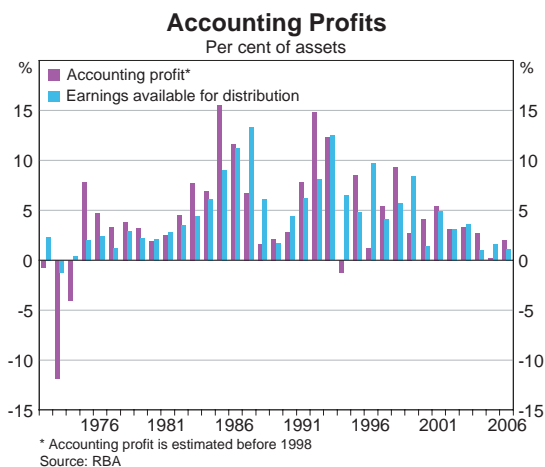
Consistent with the *Reserve Bank Act 1959*, after consultation with the Reserve Bank Board, the Treasurer determines the amount, if any, to be credited to the RBRF from earnings available for distribution. The balance of distributable earnings after any such transfers is payable as a dividend to the Australian Government. At 30 June 2006, the balance of the RBRF stood at \$6 286 million. This was an increase of \$1 million compared with the published accounts at the previous balance date, reflecting accounting adjustments associated with minor asset revaluations under AIFRS. As the Board regards the current balance in the RBRF as satisfactory, it did not approach the Treasurer for a transfer from profits in 2005/06. Consequently, all of the earnings available for distribution in 2005/06 will be paid as a dividend to the Australian Government.

Dividends are usually paid to the Government early in the financial year following that in which profits are earned. In some recent years, the Treasurer has decided to defer part of the dividend payable, spreading the payment over two years. Last year, the Treasurer deferred until 2006/07 the sum of \$300 million from the dividend due to be paid in 2005/06. None of the dividend payable in 2006/07 from profits in 2005/06 is to be deferred. Accordingly, a total amount of \$1 477 million will be paid to the Australian Government in August 2006 – as summarised in the table below. The total sum payable in August 2006 is \$94 million more than was paid in 2005.

Dividend Payment: August 2006	
(\$ million)	
Sum deferred from Earnings in 2004/05 (to be paid in 2006/07)	300
<i>Plus</i>	
Total Distributable Earnings from 2005/06 (payable in 2006/07)	1 177
Total Payment in 2006/07	1 477

In addition to the RBRF, the Reserve Bank maintains a number of other financial reserves. As noted, under the *Reserve Bank Act 1959* unrealised gains are not available to be distributed but are transferred to the Unrealised Profits Reserve, to absorb future valuation losses or to be realised when relevant assets are sold. On 30 June 2006, the balance in the Unrealised Profits Reserve was \$2 528 million. This approach, embedded in legislation, reflects sound practice

since it recognises the principle that unrealised gains should not be distributed, as this would erode the capacity to cope with subsequent unrealised losses. Experience shows that such losses do occur and are virtually inevitable because, as the Reserve Bank's operations are driven by policy considerations, it has no scope to control the market risks faced on domestic assets and only limited scope to do so in the case of foreign assets.



One effect of these arrangements is that earnings available for distribution, although they still fluctuate considerably, tend to follow a less volatile path than they would if earnings from all sources were required to be distributed – dividends tend to be lower than otherwise in years in which the Reserve Bank records unrealised gains and higher in years in which it records unrealised losses. The most important consideration, however,

Reserve Bank Payments to Government

(\$ million)

	Earnings Available for Distribution	Transfers to Reserves	Payments to the Australian Government				Total Payment
			Balance Available from Current Year's Profit	Interim Payment from Current Year's Profit	Payment from Previous Year's Profit	Payment Delayed from Previous Years	
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	694	–	694	–	1 300	–	1 300
2004/05	1 363	–	1 363	–	374	964	1 338
2005/06	1 177	–	1 177	–	1 063	320	1 383
2006/07	–	–	–	–	1 177	300	1 477

is that the arrangements mean that the Reserve Bank will usually have sufficient resources to absorb significant unrealised losses in years in which interest rates or the exchange rate move unfavourably. As it happens, transfers from the reserve (associated with unrealised losses) have occurred over a long run of years about as often as transfers to the reserve (associated with unrealised gains), although the current credit balance means that the value of total transfers to the Unrealised Profits Reserve has exceeded transfers from it.

The Reserve Bank also maintains asset revaluation reserves, the balances of which reflect the amount by which the market value of its holdings of gold and property exceed the prices at which they were purchased. At 30 June 2006, balances in these reserves totalled \$2 354 million, \$672 million higher than a year earlier, mainly reflecting the increase in the price of gold.

Accounting Profits

As noted above, since the basis of the Reserve Bank's financial disclosures is AIFRS, it discloses its accounting profits as profits from all sources, including unrealised gains and losses, in line with the Finance Minister's Orders, issued under the *Commonwealth Authorities and Companies Act 1997*. As the Reserve Bank recorded unrealised gains of \$933 million in 2005/06 in addition to distributable earnings of \$1 177 million, its accounting profits amounted to \$2 093 million after allowing for a transfer from an asset revaluation reserve associated with the sale of gold coin.

Financial Disclosure

The Reserve Bank's financial statements for 2005/06 were prepared for the first time in accordance with AIFRS. The Notes to the Accounts report the effects of adopting AIFRS on the financial statements, which are presented in the following pages.

Directors' Statement

In the opinion of the directors, the financial statements for the year ended 30 June 2006 give a true and fair view of the matters required by the Finance Minister's Orders 2005-2006 made under the *Commonwealth Authorities and Companies Act 1997*. These statements have been prepared from properly maintained financial records and are signed in accordance with a resolution of the directors.

A handwritten signature in black ink, appearing to read 'IJ Macfarlane', written in a cursive style.

IJ Macfarlane

Chairman, Reserve Bank Board
10 August 2006

BALANCE SHEET As at 30 June 2006**Reserve Bank of Australia and Controlled Entities**

	Note	2006 \$M	2005 \$M
ASSETS			
Cash and cash equivalents	6	575	1 008
Australian dollar securities	1(b), 16	30 306	20 899
Foreign exchange	1(b), 16	71 689	61 187
Gold	1(c), 16	2 151	1 493
Property, plant and equipment	1(d), 8	329	307
Loans, advances and other	7	397	377
Total Assets		105 447	85 271
LIABILITIES			
Deposits	1(b), 9	43 204	29 228
Distribution payable to Australian Government	1(f), 3	1 477	1 683
Other	10	11 493	9 133
Australian notes on issue	1(b), 16	38 065	35 624
Total Liabilities		94 239	75 668
Net Assets		11 208	9 603
Capital and Reserves			
Reserves:			
Unrealised profits reserves	1(e), 5	2 528	1 595
Asset revaluation reserves	1(e), 5	2 354	1 682
Reserve Bank Reserve Fund	1(e), 5	6 286	6 286
Capital		40	40
Total Capital and Reserves		11 208	9 603

INCOME STATEMENT For the year ended 30 June 2006
Reserve Bank of Australia and Controlled Entities

	Note	2006 \$M	2005 \$M
INCOME			
Interest revenue	2	3 477	2 392
Net gains/(losses) on securities and foreign exchange	2	935	(910)
Dividend revenue	2	5	4
Fees and commissions	2	18	19
Other revenue	2	63	57
Total Income		4 498	1 562
EXPENSES			
Interest expense	2	2 174	1 243
General administrative expenses	2	207	206
Other expenses	2	24	29
Total Expenses		2 405	1 478
Net Profit		2 093	84

STATEMENT OF DISTRIBUTION For the year ended 30 June 2006
Reserve Bank of Australia and Controlled Entities

	Note	2006 \$M	2005 \$M
Net Profit		2 093	84
Transfer (to)/from unrealised profits reserves	5	(933)	1 278
Transfer (to)/from Reserve Bank Reserve Fund	5	–	1
Transfer from asset revaluation reserves	5	17	–
Earnings available for distribution		1 177	1 363
<i>Distributed as follows:</i>			
Reserve Bank Reserve Fund	5	–	–
Payable to the Australian Government	3	1 177	1 363
		1 177	1 363

STATEMENT OF CHANGES IN CAPITAL AND RESERVES

For the year ended 30 June 2006

Reserve Bank of Australia and Controlled Entities

	Note	2006 \$M	2005 \$M
Opening balance of Capital and Reserves	5	9 603	10 891
<i>Plus:</i>			
Net Profit	2	2 093	84
Gain /(loss) on revaluation of gold	5	647	(6)
Gain/(loss) on revaluation of shares in international institutions	5	25	(16)
Gain/(loss) on revaluation of properties	5	17	13
Total revaluation gains/(losses)		689	(9)
Total income and expenses		2 782	75
<i>Less:</i>			
Transfer to the distribution payable to Australian Government	3	(1 177)	(1 363)
Closing balance of Capital and Reserves	5	11 208	9 603

CASH FLOW STATEMENT For the year ended 30 June 2006
Reserve Bank of Australia and Controlled Entities

This statement meets the requirements of AASB 107 – *Cash Flow Statements* and the Finance Minister’s Orders 2005-2006. In the RBA’s view, due to the nature of central banking activities, this statement does not shed 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.

	2006 Inflow/ (outflow) \$M	2005 Inflow/ (outflow) \$M
Cash flows from operating activities		
Interest received on investments	2 933	2 159
Interest received on loans, advances, and on net overnight settlements systems	50	43
Loan management reimbursement	1	1
Banking service fees received	19	18
Dividends received	5	4
Rents received	6	6
Net payments for and proceeds from sale of investments	(16 363)	(12 002)
Interest paid on deposit liabilities	(1 735)	(877)
Interest paid on currency note holdings of banks	(166)	(148)
Staff costs (including redundancy)	(128)	(115)
Premises and equipment	(28)	(26)
Other	(18)	(28)
Net cash provided by operating activities	(15 424)	(10 965)
Cash flows from investment activities		
Net expenditure on property, plant and equipment	(31)	(25)
Net cash used in investing activities	(31)	(25)
Cash flows from financing activities		
Profit payment to Australian Government	(1 383)	(1 338)
Net movement in deposit liabilities	13 976	11 102
Net movement in loans and advances	2	2
Net movement in notes on issue	2 441	1 602
Other	(14)	7
Net cash provided by financing activities	15 022	11 375
Net increase/(decrease) in cash	(433)	385
Cash at beginning of financial year	1 008	623
Cash at end of financial year	575	1 008

CASH FLOW STATEMENT (CONTINUED) For the year ended 30 June 2006
Reserve Bank of Australia and Controlled Entities

Reconciliation of cash	2006 \$M	2005 \$M
Cash	15	16
Overnight settlements systems	560	992
	575	1 008
Reconciliation of net cash provided by operating activities to Net Profits in terms of the <i>Reserve Bank Act 1959</i>	2006 \$M	2005 \$M
Net Profit	2 093	84
Increase/(decrease) in interest payable	(59)	42
Net loss/(gain) on overseas investments	826	(444)
Net loss/(gain) on Australian dollar securities	137	(31)
Net loss/(gain) on foreign currency	(1 898)	1 385
Decrease/(increase) in income accrued on investments	(148)	1
Depreciation of property	7	7
Depreciation of plant and equipment	15	10
Net payments for and proceeds from sale of investments	(16 363)	(12 002)
Other	(34)	(17)
Net cash provided by operating activities	(15 424)	(10 965)

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS 30 June 2006
Reserve Bank of Australia and Controlled Entities

Note 1 SUMMARY OF ACCOUNTING POLICIES

The Reserve Bank of Australia (RBA) reports its financial statements in accordance with the *Reserve Bank Act 1959* and the *Commonwealth Authorities and Companies (CAC) Act 1997*. In accordance with the Finance Minister's Orders (FMOs) 2005-2006, which are issued pursuant to the *CAC Act 1997*, the RBA has prepared its financial statements for the year ended 30 June 2006 under Australian equivalents to International Financial Reporting Standards (AIFRS), other accounting standards and accounting interpretations issued by the Australian Accounting Standards Board. This is the first time the RBA has prepared its financial statements under AIFRS. These financial statements comply fully with International Financial Reporting Standards. As the RBA is a financial institution, these financial statements have been prepared using AASB 130 – *Disclosures in the Financial Statements of Banks and Similar Financial Institutions*. The RBA has been granted an exemption from the requirements of the FMOs as detailed in Note 1(j). This exemption relates to a matter of disclosure and presentation which is of a minor nature and is adequately dealt with elsewhere in these financial statements.

These financial statements and attached notes are a general purpose financial report prepared in accordance with relevant AIFRS. Elections as to the accounting treatment under AIFRS made by the Bank are noted appropriately. All amounts are expressed in Australian dollars unless another currency is indicated. Under the FMOs, the RBA is classified as a for-profit public-sector entity for purposes of financial disclosure. Fair values are used for the RBA's major assets, including domestic and foreign marketable securities, gold and foreign currency, as well as for premises, plant and equipment. Revenue and expenses are brought to account on an accrual basis. All revenues, expenses and profits of the RBA are from ordinary activities.

(a) Consolidation and joint venture

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. 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. Note Printing Australia Limited's total assets, liabilities and capital as at 30 June 2006 were \$63.2 million, \$16.8 million and \$46.4 million respectively (\$57.9 million, \$15.7 million and \$42.2 million as at 30 June 2005).

The assets, liabilities and results of Note Printing Australia Limited have been consolidated with the parent entity accounts in accordance with AASB 127 – *Consolidated and Separate Financial Statements*. All internal transactions and balances have been eliminated on consolidation.

The RBA equity accounts for its investment in Securrency Pty Ltd in accordance with AASB 131 – *Interests in Joint Ventures*. The RBA's investment in Securrency Pty Ltd is included in Note 7.

(b) Financial instruments

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 RBA's financial instruments are its Australian dollar securities, foreign government securities, bank deposits, interest rate futures, foreign currency swap contracts, gold loans, cash and cash equivalents, notes on issue, deposit liabilities and its shareholding in the Bank for International Settlements. The RBA accounts for its financial instruments in accordance with AASB 139 – *Financial Instruments: Recognition and Measurement* and reports these instruments under AASB 132 – *Financial Instruments: Disclosure and Presentation*. The RBA has elected to apply the provisions of AASB 139 in preparing its opening balance sheet and the 2004/05 comparative balances under AIFRS.

The RBA brings its foreign and domestic securities transactions and foreign exchange transactions to account on a trade date basis; that is, it recognises the effects of purchases and sales of these securities in the Income Statement and the Balance Sheet on the date these transactions are arranged (not when the transactions are settled). Bank deposits and repurchase agreements are brought to account on settlement date.

Australian dollar securities

The RBA holds Commonwealth Treasury Fixed Coupon Bonds, Treasury Notes and Treasury Capital Indexed Bonds, and securities issued by the central borrowing authorities of State and Territory Governments. It also holds under repurchase agreements bank bills and certificates of deposit issued by banks licensed in Australia and Australian dollar denominated securities issued by foreign governments, foreign government agencies that have an explicit government guarantee and by certain highly-rated supranational organisations. Domestic securities, except those contracted for sale under repurchase agreements, are classified under AASB 139 as “at fair value through profit or loss”, as they are held for purposes of conducting monetary policy and may be sold or lent, typically for short terms, under repurchase agreements. In accordance with this standard, the securities are valued at market bid prices on balance date; realised and unrealised gains or losses are immediately taken to profit. Only realised gains are available for distribution in accordance with the *Reserve Bank Act 1959* (Note 1(f)). Interest earned on the securities is accrued over the term of the security and included as revenue in the Income Statement.

Commonwealth Treasury Fixed Coupon Bonds are coupon securities; the interest is received biannually at the coupon rate and the principal is received at maturity. 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.

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 highly rated international 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 the relevant market bid or offer exchange rate ruling on balance date in accordance with AASB 121 – *The Effects of Changes in Foreign Exchange Rates*. Realised and unrealised gains or losses on foreign currency are immediately taken to profit, but only realised gains are available for distribution in accordance with the *Reserve Bank Act 1959* (Note 1(f)). Interest revenue and revaluation gains and losses on foreign currency assets and interest expense on foreign currency liabilities are converted to Australian dollars using the relevant market bid or offer exchange rate on the date they are accrued or recognised, in accordance with AASB 121.

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; the principal of these securities is received at maturity. 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. Foreign securities, except those contracted for sale under repurchase agreements, are classified under AASB 139 as “at fair value through profit or loss”, as they are held for trading. In accordance with this standard, the securities are valued at market bid prices on balance date; realised and unrealised gains or losses are taken to profit. Only realised gains are available for distribution in accordance with the *Reserve Bank Act 1959* (Note 1(f)). Interest earned on securities is accrued over the term of the security as revenue in the Income Statement.

Foreign bank deposits

The RBA invests part of its foreign currency reserves in deposits with highly-rated international banks; it also maintains working accounts in foreign currencies. Deposits are classified as “loans and receivables” under AASB 139 and recorded at their face value, which is equivalent to their amortised cost using the effective interest method. Interest is accrued over the term of deposits and is received periodically or at maturity. Interest accrued but not paid is included in Accrued Interest (Note 16).

Foreign currency swaps

The RBA uses foreign currency swaps to assist daily domestic liquidity management and to manage its balance sheet holdings. A foreign 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 2006 (including those under swap contracts) have been valued at market exchange rates (Note 16).

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 positions are classified under AASB 139 as “at fair value through profit or loss”. In accordance with this standard, futures positions are marked to market on balance date at the relevant bid or offer price and valuation gains and losses taken to profit. Only realised gains are available for distribution in accordance with the *Reserve Bank Act 1959* (Note 1(f)).

Bank for International Settlements

Under AASB 139 the RBA's shareholding in the Bank for International Settlements (BIS) is classified as “available for sale” for accounting purposes. The shareholding is valued at fair value and revaluation gains and losses are transferred directly to the revaluation reserve for shares in international financial institutions (Note 5). The fair value reflects BIS' net asset value, less a discount of 30 per cent. Dividends are recognised as revenue in the Income Statement when declared.

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 classified under AASB 139 as “at fair value through profit or loss”, as they are held for trading, and reported on the Balance Sheet within the relevant investment portfolio. In accordance with this standard, the securities are valued at market bid prices on balance date and realised and unrealised gains or losses on Australian dollar securities are immediately taken to profit. Only realised gains are available for distribution in accordance with the *Reserve Bank Act 1959* (Note 1(f)). The counterpart obligation to repurchase the securities is reported in Other Liabilities (Note 10) at amortised cost; the difference between the sale and purchase price is accrued over the term of the agreement and recognised as interest expense.

Securities purchased and contracted for sale under repurchase agreements are classified under AASB 139 as “loans and receivables” and valued at amortised cost. The difference between the purchase and sale price is accrued over the term of the agreement and recognised as interest revenue.

Cash invested in securities purchased and contracted for sale under repurchase agreements is secured to 102 per cent of the market value of the securities. The proceeds of securities sold and contracted for purchase under repurchase agreements equates to the market value of these securities.

Deposit liabilities

Deposits include deposits at call and term deposits. Deposits are classified as financial liabilities under AASB 139. Deposit balances are shown at their amortised cost, which is equivalent to 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 (Note 10). Details of deposits are included in Note 9.

Australian notes on issue

Notes on issue are recorded at face value. Prior to 2004/05, the RBA periodically adjusted its liability for note series that ceased to be issued, to reflect the likelihood that the remaining notes

on issue from these series would not be presented for redemption because they were judged to have been destroyed or were otherwise unavailable for presentation. Under this policy, notes totaling \$133 million were written down and the gains included in accounting profits. As these notes were written down prior to 1 January 2005, the RBA has not had to re-recognise the liability for the notes under AIFRS. If the written-down notes are subsequently presented, the RBA will reinstate the liability for these notes and charge an expense against profits.

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.

(c) 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 balance date. Revaluation gains and losses on gold are transferred to the gold revaluation reserve. The RBA lends gold to financial institutions participating in the gold market. As outlined in Note 1(b), gold loans are a financial instrument and the RBA accounts for these loans in accordance with AASB 139 and reports the loans under AASB 132. Gold loans are secured to 110 per cent of their market value by Australian dollar denominated collateral. Interest on gold loans is accounted for on an accrual basis.

(d) Property, plant and equipment

Formal valuations of all the RBA's Australian properties are conducted annually; RBA properties overseas are formally valued on a triennial basis. Australian properties are valued by officers of the Australian Valuation Office and overseas properties are valued by local independent valuers. The most recent valuation of overseas properties was at 30 June 2004. In accordance with AASB 116 – *Property, Plant and Equipment*, properties are valued at market value, which reflects observable prices and are based on the assumption that assets would be exchanged between knowledgeable, willing parties at arm's length. Due to its specialised nature, the value of the Craigieburn property has been determined on the basis of vacant possession. Valuation gains and losses are transferred to the Property Revaluation Reserve. These valuations have been incorporated in the accounts. Annual depreciation is based on market values and assessments of useful remaining life.

Plant and equipment is recognised on a fair value basis; valuation gains and losses are treated in accordance with AASB 116. Plant and equipment is valued by independent valuers on a triennial basis. The most recent independent valuation was on 30 June 2005. Annual depreciation is based on fair values and the RBA's assessments of useful remaining life. Computer software is accounted for in accordance with AASB 138 – *Intangible Assets*. Software is recognised at cost less accumulated amortisation, which is calculated at rates based on the estimated useful life of the relevant assets. Amortisation expense for computer software is included in Other Expenses in Note 2.

The useful lives used for each class of asset are:

	Years
Buildings	16-50
Fitout and furniture	5-20
Computer equipment	
– hardware	4-5
– software	4-7
Office equipment	4-5
Motor vehicles	4-5
Plant	4-20

Details of annual net expenditure, revaluation adjustments and depreciation of buildings, and plant and equipment are included in Note 8; details of computer software are included in Note 7.

(e) Reserves

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 (refer Note 1(f)).

The balance of asset revaluation reserves in the balance sheet reflect differences between the fair value of a number of the RBA's assets, mainly non-traded assets (gold; property, plant and equipment; and shares in international financial institutions), and their cost. Balances in these reserves represent unrealised gains on assets which are not distributable until the gains are realised through the sale of the relevant asset.

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

Unrealised gains and losses on the surplus of the staff superannuation funds are also recognised in the Income Statement in accordance with the 'corridor' approach under AASB 119 – *Employee Benefits*. These amounts are reflected in the Reserve for Unrealised Profits on Superannuation.

(f) Profits

Profits of the RBA are dealt with in terms of Section 30 of the *Reserve Bank Act 1959* 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.

(g) Provisions

The RBA maintains provisions for accrued annual leave in accordance with AASB 119 – *Employee Benefits*, calculated on salaries expected to prevail when leave is anticipated to be taken 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 consistent with AASB 119. 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.

(h) Superannuation funds

The RBA includes in its balance sheet an asset representing the surpluses in its defined benefit superannuation funds in accordance with the 'corridor' approach under AASB 119 – *Employee Benefits*; the counterpart to this asset is the Reserve for Unrealised Profits on Superannuation. Details of the superannuation funds and superannuation expenses are included in Note 14.

(i) Rounding

Amounts in the financial statements are rounded to the nearest million dollars unless otherwise stated.

(j) Exemptions

The RBA has been granted an exemption from the following requirements of the FMOs:

Requirement	Description	Detail of exemption
Appendix A	Form of Balance Sheet and Income Statement.	The Balance Sheet is presented according to AASB 130 and details of revenues and expenses are disclosed in Note 2.

(k) Transition to Australian equivalents to International Financial Reporting Standards

Authorities of the Australian Government reporting under the *CAC Act 1997* have adopted AIFRS for reporting periods beginning on or after 1 January 2005. AIFRS has affected a number of areas in the RBA's financial statements. The new standards have had little impact on balance sheet footings, but involved a range of changes to disclosure in the notes to the RBA's financial statements. The main effects of the new standards on the opening balance sheet and the financial statements for 2004/05 are discussed below.

Superannuation

Under AIFRS, the RBA recognises in its balance sheet an asset representing the surpluses in the RBA's defined benefit superannuation schemes, the Officers' Superannuation Fund and the UK Pension Scheme; the counterpart to this asset is a new accounting reserve, the Reserve for Unrealised Profits on Superannuation. The RBA recognised all previous cumulative actuarial gains and losses in the opening fair value of the superannuation asset. The value of this asset in the opening balance sheet is \$57 million (\$55 million as at 30 June 2005); this amount is included in Loans, advances and other assets. Subsequently, the RBA has valued the superannuation asset in accordance with the 'corridor' approach under AASB 119 – *Employee Benefits*. Prior to AIFRS, surpluses from the defined benefit schemes were not recorded on the balance sheet, but disclosed in the notes to the RBA's financial statements.

Under the new approach, superannuation expense charged to the Income Statement includes the RBA's contributions, service costs, interest costs, less the actuarially assumed return on fund assets and any amortisation of actuarial gains and losses which exceed the corridor (10 per cent of the superannuation funds' assets or liabilities, whichever is greater). Under previous standards, superannuation expense comprised only the RBA's contributions to these superannuation schemes. Accordingly, the RBA's superannuation expense in 2004/05 under AIFRS was \$2 million higher than in the financial statements published for 2004/05.

Financial instruments

The RBA brings its foreign and domestic securities transactions and foreign exchange transactions to account under AIFRS on a trade date basis – that is, it recognises the effects of these transactions, both in the Income Statement and the Balance Sheet, on the date on which these transactions are arranged, not when the transactions are settled. Under previous arrangements, these transactions were recognised on the balance sheet at settlement date. Bank deposits and repurchase agreements continue to be brought to account on settlement date. In addition, all securities are valued at bid prices, while all foreign currency assets and liabilities and futures contracts are valued at relevant bid or offer rates. Domestic securities, futures contracts and foreign currency assets and liabilities were previously valued using mid rates.

As a result of these changes:

- foreign currency assets and liabilities in the opening balance sheet under AIFRS were \$106 million and \$127 million higher compared with previous standards (and \$259 million and \$267 million higher at 30 June 2005);
- accounting profits in 2004/05 were \$13 million higher than under previous standards; and
- the Reserve for Unrealised Profits on Investments in the opening balance sheet was \$21 million lower (\$8 million lower as at 30 June 2005).

Interest receivable of \$39 million on repurchase agreements and foreign bank deposits was reported as a separate asset under AIFRS in the RBA's opening balance sheet, rather than included in the asset value as was the treatment under previous standards. The amount of interest receivable reclassified in the balance sheet as at 30 June 2005 was \$99 million. This has had a small compositional effect on the RBA's balance sheet.

Gold

The RBA values gold at the bid price under AIFRS, whereas it previously valued this asset using the mid price. This has had the effect of reducing the value of gold in the opening balance sheet by \$0.2 million and by \$0.9 million as at 30 June 2005. The counterpart adjustments are reflected in lower balances in the gold revaluation reserve at these dates under the new standards.

Property, plant and equipment

In accordance with AIFRS, the RBA has established individual asset revaluation reserves for each property and item of plant and equipment. Under previous accounting standards, the RBA revalued individual properties as a single class of assets and all plant and equipment assets as a separate aggregate class of assets. Consequently, the balance of asset revaluation reserves in the opening balance sheet and at 30 June 2005 was \$3 million lower than under previous standards. There was no material impact on profits for 2004/05. These adjustments have their counterparts in the Reserve Bank Reserve Fund, the equivalent of the RBA's 'equity'.

Securrency

The value of the RBA's investment in Securrency in the opening balance was determined from the share of Securrency's equity as at 1 July 2004, as measured under AIFRS, owned by the RBA.

Profits

Accounting profits for 2004/05 determined in accordance with AIFRS were \$10 million higher than in the financial statements published for 2004/05. The adoption of AIFRS has had no impact on measured earnings available for distribution to the Australian Government in 2004/05.

Cash flows

The adjustments did not materially affect the RBA Cash Flow Statement.

The effects of the adjustments outlined above on the RBA's opening balance sheet, its balance sheet as at 30 June 2005 and the Income Statement for 2004/05 are summarised in the following tables. These effects are the same as the estimates the RBA disclosed in the notes to its published accounts for 2004/05 as part of the transition to the new arrangements; that is, the RBA has not had to revise its earlier estimates.

	Previous Accounting Standards \$M	AIFRS \$M	Difference \$M
RBA Opening Balance Sheet			
as at 1 July 2004			
Assets			
Cash and cash equivalents	623	623	-
Australian dollar securities	18 317	18 316	(1)
Foreign exchange	52 051	52 157	106
Gold	1 492	1 492	-
Property, plant and equipment	293	289	(4)
Loans, advances and other	297	358	61
Total Assets	73 073	73 235	162
Liabilities			
Deposits	18 126	18 126	-
Distribution payable to Australian Government	1 658	1 658	-
Other	8 411	8 538	127
Australian notes on issue	34 022	34 022	-
Total Liabilities	62 217	62 344	127
Net Assets	10 856	10 891	35
Capital and Reserves			
Reserves:			
Unrealised Profits on Investments	2 837	2 816	(21)
Unrealised Profits on Superannuation	-	57	57
Asset revaluation reserves	1 694	1 691	(3)
Reserve Bank Reserve Fund	6 285	6 287	2
Capital	40	40	-
Total Capital and Reserves	10 856	10 891	35

	Previous Accounting Standards \$M	AIFRS \$M	Difference \$M
RBA Balance Sheet			
as at 30 June 2005			
Assets			
Cash and cash equivalents	1 008	1 008	–
Australian dollar securities	20 900	20 899	(1)
Foreign exchange	60 928	61 187	259
Gold	1 494	1 493	(1)
Property, plant and equipment	313	307	(6)
Loans, advances and other	316	377	61
Total Assets	84 959	85 271	312
Liabilities			
Deposits	29 228	29 228	–
Distribution payable to Australian Government	1 683	1 683	–
Other	8 866	9 133	267
Australian notes on issue	35 624	35 624	–
Total Liabilities	75 401	75 668	267
Net Assets	9 558	9 603	45
Capital and Reserves			
Reserves:			
Unrealised Profits on Investments	1 548	1 540	(8)
Unrealised Profits on Superannuation	–	55	55
Asset revaluation reserves	1 685	1 682	(3)
Reserve Bank Reserve Fund	6 285	6 286	1
Capital	40	40	–
Total Capital and Reserves	9 558	9 603	45

	Previous Accounting Standards \$M	AIFRS \$M	Difference \$M
RBA Income Statement for the year ended 30 June 2005			
Income			
Interest revenue	2 392	2 392	–
Net gains/(losses) on securities and foreign exchange	(923)	(910)	13
Dividend revenue	4	4	–
Fees and commissions	19	19	–
Other revenue	57	57	–
Total Income	1 549	1 562	13
Expenses			
Interest expense	1 243	1 243	–
General administrative expenses	206	206	–
Other expenses	26	29	3
Total Expenses	1 475	1 478	3
Net Profit	74	84	10
Net revaluation adjustments in asset revaluation reserves	(9)	(9)	–
Net profit plus net revaluation adjustments in asset revaluation reserves	65	75	10

	Note	2006 \$M	2005 \$M
Note 2 NET PROFITS			
<i>Interest revenue</i>			
Overseas investments	1(b), 4	2 092	1 265
Australian dollar securities	1(b), 4	1 322	1 069
Overnight settlements	4	49	42
Gold loans	1(c), 4	13	15
Loans, advances and other	4	1	1
		3 477	2 392
<i>Net gains/(losses) on securities and foreign exchange</i>			
Overseas investments	1(b)	(826)	444
Australian dollar securities	1(b)	(137)	31
Foreign currency	1(b)	1 898	(1 385)
		935	(910)
<i>Dividend revenue</i>			
Earnings on shares in Bank for International Settlements	1(b)	5	4
<i>Fees and commissions</i>			
Banking services fees received		18	19
<i>Other revenue</i>			
Reimbursement by Australian Government for loan management and registry expenses		1	1
Rental of Bank premises		6	6
Sales of note products		30	35
Other		26	15
		63	57
Total		4 498	1 562
Less:			
<i>Interest expense</i>			
Deposit liabilities	1(b), 4	1 676	919
Currency note holdings of banks	1(b), 4	165	148
Repurchase agreements	1(b), 4	333	176
		2 174	1 243
<i>General administrative expenses</i>			
Staff costs		111	119
Superannuation costs	1(h), 14	13	8
Special redundancy/retirement payments		–	1
Depreciation of property	1(d), 8	7	7
Depreciation of plant and equipment	1(d), 8	15	10
Premises and equipment	1(d)	28	26

	Note	2006 \$M	2005 \$M
Note 2 (CONTINUED)			
Materials used in note production		22	21
Travel		3	2
Consultants' fees, legal fees and payments to contractors		2	6
Other		6	6
		207	206
<i>Other expenses</i>			
Agency business reimbursement		3	3
Subsidiary income tax		–	–
Cash distribution expenses		8	6
Write down of plant and equipment	1(d)	–	–
Other		13	20
		24	29
Total		2 405	1 478
Net Profit		2 093	84

Staff costs in 2005/06 include a reduction in expense of \$4.9 million associated with the decrease in the balance of the Provision for post-employment benefits (expense of \$10.6 million in 2004/05) (refer Note 10). Post-employment health care costs of \$4.7 million are included in Staff costs (\$9.3 million in 2004/05).

The RBA's aggregate research and development expenditure recognised as an expense in 2005/06 was \$0.6 million (\$0.5 million in 2004/05); this is included in Other Expenses.

Note 3 DISTRIBUTION PAYABLE TO AUSTRALIAN GOVERNMENT

Section 30 of the *Reserve Bank Act 1959* 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 after consultation with the Board, shall be paid to the Australian Government (see Note 1(f)). Also under Section 30, unrealised profits are not available for distribution and are transferred to the unrealised profits reserves where they are available to absorb future valuation losses or are realised when relevant assets are sold.

	2006 \$M	2005 \$M
Opening balance	1 683	1 658
Distribution to Australian Government	(1 383)	(1 338)
Transfer from Statement of Distribution	1 177	1363
As at 30 June	1 477	1 683

Of the \$1 363 million payable to the Australian Government out of profits in 2004/05, \$1 063 million was paid in August 2005, and \$300 million will be paid in August 2006. Earnings available for distribution of \$1 177 million from 2005/06 will also be distributed in August 2006. Accordingly, all of the balance of \$1 477 million of the distribution payable account as at 30 June 2006 will be distributed to the Australian Government in August 2006.

	Average balance	Interest	Average annual interest rate
	\$M	\$M	%

Note 4 INTEREST REVENUE AND INTEREST EXPENSE

Analysis for the year ended 30 June 2006

Interest revenue

Overseas investments	62 665	2 092	3.3
Australian dollar securities	23 157	1 322	5.7
Overnight settlements	928	49	5.3
Gold loans	1 799	13	0.7
Loans, advances and other	20	1	3.4
	<u>88 569</u>	<u>3 477</u>	<u>3.9</u>

Interest expense

Banks' Exchange Settlement balances	782	41	5.3
Deposits from governments	29 255	1 628	5.6
Deposits from overseas institutions	1 482	7	0.5
Currency note holdings of banks	2 971	165	5.6
Overseas repurchase agreements	8 088	291	3.6
Domestic repurchase agreements	780	42	5.4
Other deposits	15	–	1.6
	<u>43 373</u>	<u>2 174</u>	<u>5.0</u>

Analysis for the year ended 30 June 2005

Interest revenue total	<u>70 626</u>	<u>2 392</u>	<u>3.4</u>
Interest expense total	<u>27 385</u>	<u>1 243</u>	<u>4.5</u>

Interest revenue for 2005/06 includes \$2 588 million calculated using the effective interest method for financial assets not at fair value through profit and loss (\$1 488 million in 2004/05). Interest expense for 2005/06 includes \$2 174 million calculated using the effective interest method for financial liabilities not at fair value through profit and loss (\$1 243 million in 2004/05).

	2006 \$M	2005 \$M
Note 5 CAPITAL AND RESERVES		
Changes in the RBA's Capital and Reserves are shown below.		
Asset revaluation reserves		
Gold (Note 1(e))		
Opening balance	1 361	1 367
Net revaluation adjustments	647	(6)
Transfers (to)/from Statement of Distribution	(17)	–
As at 30 June	1 991	1 361
Shares in international financial institutions (Note 7)		
Opening balance	198	214
Net revaluation adjustments	25	(16)
As at 30 June	223	198
Bank properties, plant and equipment (Notes 1(d), 8)		
Opening balance	123	110
Net revaluation adjustments	17	13
As at 30 June	140	123
Total asset revaluation reserves (Note 1(d))		
Opening balance	1 682	1 691
Net revaluation adjustments	689	(9)
Transfers (to)/from Statement of Distribution	(17)	–
As at 30 June	2 354	1 682
Unrealised profits reserves		
Reserve for Unrealised Profits on Investments (Note 1(e))		
Opening balance	1 540	2 816
Net transfers (to)/from Statement of Distribution	936	(1 276)
As at 30 June	2 476	1 540
Reserve for Unrealised Profits on Superannuation (Note 1(h))		
Opening balance	55	57
Net transfers (to)/from Statement of Distribution	(3)	(2)
As at 30 June	52	55
Total Unrealised profits reserves		
Opening balance	1 595	2 873
Net transfers (to)/from Statement of Distribution	933	(1 278)
As at 30 June	2 528	1 595
Reserve Bank Reserve Fund (Note 1(e))		
Opening balance	6 286	6 287
Transfers (to)/from Statement of Distribution	–	(1)
As at 30 June	6 286	6 286
Capital		
Opening and closing balance	40	40

Note 6 CASH AND CASH EQUIVALENTS

This includes net amounts of \$560 million owed to the RBA for overnight clearances of financial transactions through the clearing houses; an amount of \$992 million was owed to the RBA at 30 June 2005.

	Note	2006 \$M	2005 \$M
Note 7 LOANS, ADVANCES AND OTHER ASSETS			
Shareholding in Bank for International Settlements	1(b)	267	241
Superannuation asset	1(h)	52	55
Officers' Home Advances		20	21
Gold coin		–	19
Investment in Securrency	1(a)	21	14
Computer software	1(d)	6	6
Other		31	21
As at 30 June		397	377

The Reserve Bank of Australia has a 50 per cent share in Securrency Pty Ltd, which is incorporated in Victoria, Australia, and whose principal activity is the marketing and manufacture of polymer substrate. The capital of Securrency as at 30 June 2006 was \$36.5 million. The carrying value of the RBA's investment in Securrency as at 30 June 2006 was \$21.2 million (\$13.6 million at 30 June 2005). Securrency has a 31 December balance date. The RBA's share of Securrency's profit before income tax in 2005/06 was \$8.3 million (\$2.4 million in 2004/05); its share of Securrency's income tax expense in 2005/06 was \$0.7 million (nil in 2004/05). Securrency's current and non-current assets as at 30 June 2006 were \$27.0 million and \$29.7 million respectively (\$29.0 million and \$19.4 million as at 30 June 2005). Current and non-current liabilities on 30 June 2006 were \$13.6 million and \$0.7 million (\$10.7 million and \$10.6 million on 30 June 2005). Securrency's revenue and expenses for 2005/06 were \$77.3 million and \$60.7 million (\$55.6 million and \$50.7 million in 2004/05). The RBA provides facilities to Securrency under operating leases. In 2005/06, the RBA also provided a finance lease to Securrency for \$5.6 million in relation to the construction of a new building on the Bank's land at Craigieburn. The finance lease was partly drawn down in July 2006. The lease was provided on commercial terms and at arm's length; it has a term of 10 years.

During 2005/06, the RBA acquired \$1.4 million of computer software (\$2.1 million in 2004/05) and amortised \$1.4 million (\$1.0 million in 2004/05). At 30 June 2006 the gross book value of the RBA's computer software amounted to \$9.9 million and accumulated amortisation on this software was \$4.1 million (\$8.6 million and \$2.8 million respectively at 30 June 2005). The RBA had contractual commitments of \$0.4 million as at 30 June 2006 for the acquisition of computer software (\$0.1 million at 30 June 2005).

As at 30 June 2006, other assets included receivables of \$21.9 million, of which \$18.0 million is current (at 30 June 2005 other assets included receivables of \$15.8 million, of which \$12.2 million was current).

	Land	Buildings	Plant and Equipment	Total
	\$M	\$M	\$M	\$M
Note 8 PROPERTY, PLANT AND EQUIPMENT				
Gross Book Value as at 30 June 2005	101	140	105	346
Accumulated depreciation	–	–	(39)	(39)
Net Book Value	101	140	66	307
Additions	–	17	14	31
Depreciation expense	–	(7)	(15)	(22)
Net revaluation increment/(decrement)	8	5	–	13
Disposals	–	–	–	–
Net additions to net book value	8	15	(1)	22
Gross Book Value as at 30 June 2006	109	155	83	347
Accumulated depreciation	–	–	(18)	(18)
Net Book Value	109	155	65	329

The net book value of buildings as at 30 June 2006 includes expenditure of \$13.4 million on work in progress which has been capitalised in the carrying amount of these assets (\$2.2 million as at 30 June 2005). Additions include expenditure of \$18.0 million on work in progress that was capitalised during 2005/06 (\$2.6 million in 2004/05). As at 30 June 2006, the RBA had contractual commitments of \$27.0 million to acquire buildings, plant and equipment (\$0.5 million at 30 June 2005).

	2006 \$M	2005 \$M
Note 9 DEPOSITS		
Banks' Exchange Settlement balances	1 285	1 257
Australian Government	40 055	26 890
State Governments	3	4
Foreign governments, foreign institutions and international organisations	1 847	1 062
Other depositors	14	15
As at 30 June	43 204	29 228

	2006 \$M	2005 \$M
Note 10 OTHER LIABILITIES		
Provisions (Note 1(g))		
Provision for accrued annual leave	11	10
Provision for long service leave	24	23
Provision for post-employment benefits	58	63
Provision for workers' compensation	1	1
	94	97
Other		
Amounts outstanding under repurchase agreements (contract price) (Note 1(b))	9 923	8 262
Interest accrued on deposits	130	189
Other	1 346	585
	11 399	9 036
Total Other Liabilities as at 30 June	11 493	9 133

During 2005/06, annual leave of \$8.4 million was accrued by staff, while \$7.9 million of accrued leave was used. Staff accrued and used long service leave of \$3.2 million and \$2.2 million respectively in 2005/06; the provision for long service leave also decreased by \$0.6 million due to the increase in the interest rate used to discount future cash flows. The RBA provided an additional \$1.6 million for post-retirement benefits in 2005/06, while benefits of \$2.0 million were paid out of the provision; an increase in the discount rate further reduced the provision by \$4.5 million. The balance of the provision for post-employment benefits will change if assumptions regarding the length of staff service, the longevity of retired staff, increases in medical costs and the discount rate vary.

Note 11 CONTINGENT LIABILITIES AND OTHER ITEMS NOT INCLUDED IN THE BALANCE SHEET

The RBA has a contingent liability, amounting to \$71.1 million at 30 June 2006 (\$68.8 million at 30 June 2005), 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.

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 KEY MANAGEMENT PERSONNEL

AASB 124 – *Related Party Disclosures* requires disclosure of information relating to aggregate compensation of key management personnel. The key management personnel of the RBA are members of the RBA Board, members of the Payments System Board and senior staff who have responsibility for planning, directing and controlling the activities of the RBA; this group comprises 20 in total (19 in 2004/05), including the Governor and Deputy Governor, 8 non-executive RBA Board members, 5 non-executive Payments System Board members and 5 senior staff. Fees of the non-executive members of the Reserve Bank Board and the Payments Systems Board are determined by the Remuneration Tribunal. A committee of non-executive Board members reviews annually the remuneration of the Governor and Deputy Governor in terms of Section 24A of the *Reserve Bank Act 1959*. The Governors determine the remuneration of other key executives.

The remuneration of the RBA's key management personnel was as follows:

	2006	2005
	\$	\$
Short-term employee benefits	3 275 238	3 135 212
Post-employment benefits	589 359	564 260
Other long-term benefits	120 999	103 560
Share based payments	–	–
Termination benefits	–	–
Total Compensation	3 985 596	3 803 032

Short-term benefits include cash salary, and in the case of staff, annual leave, motor vehicle benefits, car parking, health benefits and the fringe benefits tax paid or payable on these benefits. Post-employment benefits include superannuation benefits and, in the case of staff, health benefits. Other long-term benefits include long service leave. The components of remuneration are reported on an accruals basis.

As at 30 June 2006 and 30 June 2005 there were no loans by the RBA to key management personnel.

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, \$170 180 (\$179 547 in 2004/05) was paid for non-executive members of the Board of NPA Limited who are not employees of the RBA or members of the Bank Board.

Note 13 REMUNERATION OF AUDITOR

Fees paid or payable to the statutory auditor (Auditor-General of the Commonwealth of Australia) for audit services (excluding GST) totalled \$227 000 in 2005/06 (\$196 000 in 2004/05); this includes audit services in relation to the RBA's subsidiary Note Printing Australia. These fees are included in Consultants' Fees, Legal Fees and Payments to Contractors in Note 2. In addition, fees for work related to the RBA's accounting policies and financial statements under AIFRS in 2004/05 are estimated at \$71 000 (excluding GST).

Note 14 SUPERANNUATION FUNDS

Two superannuation funds are operated pursuant to the *Reserve Bank Act 1959*: 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 the RBA's financial statements. Payment of the funds' current and future benefits is funded by member and RBA contributions and the funds' existing asset bases. The RBA's superannuation expense in relation to the OSF and the UK Pension Scheme is included in accounting profits and shown 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 2005/06.

The OSF is a hybrid fund. Most members receive a Bank-funded defined benefit in accordance with the rules of the fund; other member benefits include unitised defined contribution accumulation balances, which comprise the RBA's productivity and superannuation guarantee contributions and members' personal contributions, plus earnings on these contributions. The OSF is classified as a single-employer plan for the purposes of AASB 119 – *Employee Benefits*. The UK Pension Scheme is a defined benefit scheme.

Funding valuation

Full independent actuarial valuations of the OSF and UK Pension Scheme are conducted every three years to determine funding for these schemes. The most recent funding valuation of the OSF was at 30 June 2005 and for the UK Pension Scheme at 1 July 2004. At the most recent valuations, the actuaries indicated that, on the basis of accrued benefits, both funds were in surplus and that the funds were in a satisfactory financial position.

The OSF triennial funding valuation as at 30 June 2005 was based on the Aggregate Funding method, consistent with the accounting standard for superannuation funds, AAS 25 – *Financial Reporting by Superannuation Plans*. Under this standard, the accrued benefits of the OSF were determined as the present value of the future benefits payable to members (allowing for future salary increases), discounted using the expected rate of return on the assets held to fund these benefits. At the time of the triennial review, the surplus of the OSF on this measure was \$64 million, as the assets of the OSF of \$614 million exceeded the accrued benefits of \$550 million. Subsequent to the triennial review, the OSF surplus measured on the basis of AAS 25 as at 30 June 2006 amounted to \$81 million (assets of \$656 million less accrued benefits of \$575 million).

Consistent with the actuary's funding recommendation, the Bank contributed to the OSF from January 2006 at a rate of 15 per cent of salaries, which represents a return to a more normal long-term funding rate after a period of a decade or more in which funding had occurred at significantly less than the long-term rate, also on actuarial advice. In recent years, the RBA's contribution to the OSF amounted to 6 per cent. The main financial assumptions in the triennial valuation were that the annual post-tax rate of return on assets for benefits of active members was 6.25 per cent and 6.75 per cent (pre-tax) for assets for current pensions, annual salary increases of 4.0 per cent and annual pension increases of 3.5 per cent.

The triennial funding valuation for the UK Pension Scheme was based on the Attained Age method. The surplus of the UK Pension Scheme as at 30 June 2006, measured in accordance with AAS 25, was \$3 million (assets of \$24 million compared with accrued benefits of \$21 million).

Accounting valuation

For financial statement purposes, the financial positions of the superannuation schemes are valued in accordance with AASB 119. Under AASB 119, accrued benefits are determined by discounting future benefits payable to current fund members at the yield on government bonds of similar maturity on the reporting date. The approach under AASB 119, in contrast with the results of the actuary's triennial valuations noted above, does not take into account that the assets held by the superannuation schemes to fund future benefits have generally earned a higher rate of return on average than government bonds.

The principal actuarial assumptions for the AASB 119 valuation used in the case of the OSF were a discount rate of 6.0 per cent (5.1 per cent in 2004/05), future salary increases of 4.0 per cent (3.5 per cent in 2004/05), future pension increases of 3.5 per cent (3.25 per cent in 2004/05) and an assumed return on plan assets of 7.0 per cent (6.5 per cent in 2004/05). The actual return on plan assets of the OSF for the 2005/06 financial year was 12.1 per cent (12.8 per cent in 2004/05). The assumptions used for the UK Pension Scheme were a discount rate of 5.25 per cent (5.0 per cent in 2004/05), future salary increases of 5.0 per cent (4.75 per cent in 2004/05), future pension increases of 3.0 per cent (2.75 per cent in 2004/05) and an assumed return on plan assets of 4.75 per cent (4.5 per cent in 2004/05). The actual return on plan assets of the UK Pension Scheme for the 2005/06 financial year was 4.2 per cent (10.4 per cent in 2004/05). The expected overall rates of returns are based on the actuaries' models of returns for major asset classes and reflect the historic rates of return and volatility for each class and correlations across asset classes.

Details of the Funds are as shown on the following pages. In the case of the OSF, these details relate only to the defined benefit component of the fund; defined contribution accumulation balances, on which the Bank has no actuarial risk, are excluded. This has no effect on the measurement of the surpluses in the OSF. At 30 June 2006 accumulation balances in the OSF totalled \$113.3 million (\$97.0 million as at 30 June 2005).

Asset Distribution as at 30 June (% of fund assets)	OSF		UK Pension Scheme	
	2006	2005	2006	2005
Cash and short-term securities	9.2	14.0	–	–
Fixed interest securities	16.1	17.0	–	–
Indexed securities	3.5	7.6	94.0	95.1
Domestic shares	28.6	21.3	6.0	4.9
Foreign shares	7.0	5.3	–	–
Property				
Direct	8.9	9.2	–	–
Indirect	18.9	18.9	–	–
Private equity and alternative investments	7.8	6.7	–	–
Total	100	100	100	100

Note 14 CONTINUED

	OSF		UK Scheme		Total	
	2006 \$M	2005 \$M	2006 \$M	2005 \$M	2006 \$M	2005 \$M
<i>Opening balances:</i>						
Net market value of assets	614	563	23	25	637	587
Accrued benefits	(607)	(510)	(19)	(20)	(626)	(530)
Surplus	7	52	4	4	11	57
Actuarial losses not included in balance sheet under Corridor	43	–	–	–	43	–
Opening superannuation asset	50	52	4	4	55	57
Change in net market value of assets	42	51	1	(1)	43	50
Change in accrued benefits	(47)	(96)	(1)	1	(47)	(95)
Change in actuarial losses not included in balance sheet under Corridor	2	43	–	–	2	43
Total change in superannuation asset	(3)	(2)	–	–	(3)	(2)
<i>Closing balances:</i>						
Net market value of assets	656	614	24	23	680	637
Accrued benefits	(653)	(607)	(20)	(19)	(673)	(626)
Surplus	3	7	4	4	7	11
Actuarial losses not included in balance sheet under Corridor	45	43	–	–	45	43
Closing superannuation asset	48	50	4	4	52	55
Actuarially assumed return on plan assets	37	36	1	1	38	37
Benefit payments	(26)	(26)	(1)	(1)	(27)	(27)
Actuarial gains on assets	24	38	–	1	24	39
Contributions from RBA to defined benefit schemes	8	4	–	–	8	4
Contributions tax	(1)	(1)	–	–	(1)	(1)
Exchange rate gains/(losses)	–	–	1	(2)	1	(2)
Change in net market value of assets	42	51	1	(1)	43	50
Current service cost	(21)	(16)	–	–	(21)	(16)
Interest cost	(27)	(27)	(1)	(1)	(28)	(28)
Benefit payments	26	26	1	1	27	27
Contributions tax	1	1	–	–	1	1
Experience adjustments on benefits	(14)	(11)	–	–	(14)	(11)
Effects of changes in benefit actuarial assumptions	(12)	(69)	–	(1)	(12)	(70)
Exchange rate gains/(losses)	–	–	(1)	2	(1)	2
Change in accrued benefits	(47)	(96)	(1)	1	(47)	(95)

Note 14 CONTINUED	OSF		UK Scheme		Total	
	2006 \$M	2005 \$M	2006 \$M	2005 \$M	2006 \$M	2005 \$M
Actuarial (gains)/losses on assets	(24)	(38)	–	(1)	(24)	(39)
Experience adjustments on benefits	14	11	–	–	14	11
Effects of changes in benefit actuarial assumptions	12	69	–	1	12	70
Amortisation of actuarial gains/losses	–	–	–	–	–	–
Change in actuarial losses not included in balance sheet under Corridor	2	43	–	–	2	43
Superannuation expense included in Income Statement						
Current service cost	21	16	–	–	21	16
Interest cost	27	27	1	1	28	28
Assumed return on plan assets	(37)	(36)	(1)	(1)	(38)	(37)
Amortisation of actuarial gains/losses under Corridor	–	–	–	–	–	–
Productivity and superannuation guarantee contributions	2	2	–	–	2	2
Total superannuation expense	13	8	–	–	13	8

The components of this table may not add due to rounding.

Note 15 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 16.

Note 16 FINANCIAL INSTRUMENTS

Australian Accounting Standard AASB 132 – *Financial Instruments: Disclosure and Presentation* requires disclosure of information relating to financial instruments; their significance and performance; accounting policies; terms and conditions; fair values and risk information. The Risk Management chapter in this report provides additional information on the RBA's management of financial risks.

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 Australian dollar securities, foreign government securities, interest rate futures, foreign currency swap contracts and its shareholding in the Bank for International Settlements are carried in the balance sheet (and shown in this note) at fair value. The RBA's bank deposits, cash and cash equivalents, notes on issue and deposit liabilities are carried in the balance sheet (and shown in this note) at face value, which is equivalent to their amortised cost using the effective interest method; this approximates fair value.

Financial risk of financial instruments embodies market risk (currency risk and interest rate risk); credit risk; liquidity risk and cash flow risk.

The interest rate risk and credit risk tables are based on the RBA's contracted portfolio as reported in the RBA's balance sheet.

Foreign exchange risk

Foreign exchange risk is the risk that the value of a financial instrument will fluctuate due to changes in exchange rates. The RBA's net foreign currency exposure as at 30 June 2006 was \$28.1 billion (\$23.8 billion as at 30 June 2005).

Interest rate risk

Interest rate risk is the risk that the fair value of a financial instrument will fluctuate due to changes in market interest rates. The following table shows the RBA's balance sheet restated in compliance with AASB 132.

Note 16 (CONTINUED)

Interest rate risk As at 30 June 2006

	Balance sheet total \$M	Floating interest rate \$M	Repricing period \$M				Not bearing interest \$M	Weighted average coupon rate %	Weighted average effective rate %
			0 to 3 months	3 to 12 months	1 to 5 years	Over 5 years			
Assets									
Gold loans	1 434	–	105	238	1 055	–	36	1.38	1.38
Gold holdings	717	–	–	–	–	–	717	n/a	n/a
Sub-total	2 151								
Foreign exchange									
Balances with central banks	676	673	–	–	–	–	3	4.49	4.49
Securities sold under repurchase agreements	9 650	–	–	1 432	3 780	4 438	–	3.69	4.91
Securities purchased under repurchase agreements	29 121	–	29 121	–	–	–	–	4.63	4.63
Other securities	19 581	267	10 648	1 562	3 762	2 957	385	2.16	2.24
Deposits	12 310	28	12 279	–	–	–	3	4.40	4.40
Accrued interest – foreign exchange	351	–	–	–	–	–	351	n/a	n/a
Sub-total	71 689								
Australian dollar securities									
Securities sold under repurchase agreements	172	–	–	112	60	–	–	7.26	5.86
Securities purchased under repurchase agreements	26 195	–	26 195	–	–	–	–	5.77	5.77
Other securities	3 824	–	–	243	2 195	1 386	–	6.66	5.82
Accrued interest – Australian dollar securities	115	–	–	–	–	–	115	n/a	n/a
Sub-total	30 306								
Property, plant & equipment	329	–	–	–	–	–	329	n/a	n/a
Cash and cash equivalents	575	560	–	–	–	–	15	5.75	5.75
Loans and advances	20	20	–	–	–	–	–	3.79	3.79
Other	377	–	–	–	–	–	377	n/a	n/a
Total assets	105 447	1 548	78 348	3 587	10 852	8 781	2 331	3.87	3.95
Liabilities									
Australian notes on issue	38 065	2 543	–	–	–	–	35 522	0.38	0.38
Deposits	43 204	3 177	35 935	2 400	–	–	1 692	5.78	5.78
Distribution payable to Australian Government	1 477	–	–	–	–	–	1 477	n/a	n/a
Other	11 493	–	10 467	–	–	–	1 026	4.26	4.26
Total liabilities	94 239	5 720	46 402	2 400	–	–	39 717	3.33	3.33
Capital and reserves	11 208								
Total balance sheet	105 447								
Off balance sheet items									
Interest rate futures	2 594	–	–	–	–	–	2 594	n/a	n/a

Note 16 (CONTINUED)

Interest rate risk As at 30 June 2005

	Balance sheet total \$M	Floating interest rate \$M	Repricing period \$M				Not bearing interest \$M	Weighted average coupon rate %	Weighted average effective rate %
			0 to 3 months	3 to 12 months	1 to 5 years	Over 5 years			
Total assets	85 271	1 626	59 010	3 207	12 097	7 204	2 127	3.83	3.60
Total liabilities	75 668	5 184	32 912	1 354	-	-	36 218	4.82	4.41
Capital and reserves	9 603								
Total balance sheet	85 271								
Off balance sheet items	65	-	-	-	-	65	-	n/a	n/a

Other liabilities include amounts outstanding under sale repurchase agreements.

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.

Sensitivity to risks

The sensitivity of the fair value of the RBA's financial assets to fluctuations in the exchange rate and interest rates is shown below.

	Change in fair value \$M
Impact on:	
Net foreign exchange holdings of:	
A rise of 10 per cent in the value of the A\$	2 456
An increase of 1 percentage point in yield curves overseas	769
Australian dollar securities of:	
An increase of 1 percentage point in the yield curve in Australia	159

Concentration of foreign exchange

The Bank's net holdings of foreign exchange were distributed as follows as at 30 June:

	% of foreign exchange as at 2006	% of foreign exchange as at 2005
US dollar	45	45
Euro	45	45
Japanese yen	10	10
Total foreign exchange	100	100

Fair value of financial instruments

AASB 130 requires that the fair value of financial assets and liabilities be disclosed according to their accounting classification under AASB 139.

	2006 \$M	2005 \$M
Assets		
At fair value through Profit or Loss	33 493	25 355
Loans and receivables	69 956	57 969
Available-for-sale	842	1 249
Total financial assets as at 30 June	104 291	84 573
Non-financial assets	1 156	698
Total assets as at 30 June	105 447	85 271
Liabilities		
At fair value through Profit or Loss	1 310	555
Not at fair value through Profit or Loss	91 323	73 302
Non-financial liabilities	1 606	1 811
Total liabilities as at 30 June	94 239	75 668

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 not 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 low.

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

1. *Foreign exchange swaps* – As at 30 June 2006 the RBA was under contract to purchase \$16.2 billion of foreign currency and sell \$49.5 billion of foreign currency. As of that date there was an unrealised net loss of \$261 million on these swap positions included in net profit. 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 2006 the amount of credit risk on interest rate futures contracts was approximately \$3.4 million (\$0.3 million at 30 June 2005). As at 30 June 2006 there was an unrealised loss brought to account on those contracts of \$1.6 million (\$0.1 million unrealised gain at 30 June 2005).

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(b).

Credit risk

	Risk rating of security issuer*	Risk rating of counterparties*	% of total assets as at 2006	% of total assets as at 2005
Domestic Government Securities				
Holdings – Commonwealth Government securities	AAA	n/a	2.1	2.9
Holdings – Semi Government securities	AAA	n/a	1.5	1.1
	AA	n/a	0.0	0.3
Securities sold under repurchase agreements	AAA	AA	0.1	0.5
	AAA	A	0.1	0.2
Securities held under repurchase agreements	AAA	AA	9.0	10.4
	AAA	A	0.7	1.6
	AAA	other	1.9	1.6
	AA	AA	11.5	3.6
	AA	A	0.2	1.6
	AA	other	0.0	0.0
	A	AA	1.4	0.3
	A	A	0.1	0.4
Foreign investments				
Holdings of securities	AAA	n/a	10.2	12.0
	A	n/a	8.8	3.4
Securities sold under repurchase agreements	AAA	AA	7.2	8.5
	AAA	A	1.7	0.6
	A	AA	0.2	0.0
	A	A	0.1	0.0
Securities held under repurchase agreements	AAA	AAA	0.2	0.0
	AAA	AA	25.1	32.0
	AAA	A	2.1	2.5
	A	AAA	0.0	0.0
	A	AA	0.1	0.0
	A	A	0.1	0.0
Deposits	n/a	AAA	0.6	1.1
	n/a	AA	11.1	10.7
	n/a	A	0.0	0.6
Other	n/a	AAA/other	0.3	0.3
Gold loans	n/a	AAA	0.1	0.1
	n/a	AA	0.7	0.7
	n/a	A	0.6	0.6
Other			2.2	2.4
			100	100

* Standard & Poor's equivalent ratings



Auditor-General for Australia



INDEPENDENT AUDIT REPORT

To the Treasurer

Matters relating to the Electronic Presentation of the Audited Financial Statements

This audit report relates to the financial statements published in both the annual report and on the website of the Reserve Bank of Australia (the Bank) and the consolidated entity for the year ended 30 June 2006. The Directors are responsible for the integrity of both the annual report and its web site.

The audit report refers only to the financial statements, schedules and notes named below. It does not provide an opinion on any other information which may have been hyperlinked to/from the audited financial statements.

If the users of this report are concerned with the inherent risks arising from electronic data communications they are advised to refer to the hard copy of the audited financial statements in the Bank's annual report.

Scope

The financial statements and Directors' responsibility

The financial statements comprise:

- Directors' Statement;
- Balance Sheet, Income Statement, Statement of Distribution, Statement of Changes in Capital and Reserves, and Cash Flow Statement; and
- Notes to and forming part of the Financial Statements

for both the Reserve Bank of Australia (the Bank) and the consolidated entity for the year ended 30 June 2006. The consolidated entity comprises both the Bank and the entities it controlled during that year.

The members of the Bank's Board are responsible for preparing the financial statements that give a true and fair view of the financial position and performance of the Bank and the consolidated entity, and that comply with Finance Minister's Orders made under the *Commonwealth Authorities and Companies Act 1997*, Australian Accounting Standards and

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Email ian.mcphee@anao.gov.au

other mandatory financial reporting requirements. The members of the Bank's Board are also responsible for the maintenance of adequate accounting records and internal controls that are designed to prevent and detect fraud and error, and for the accounting policies and accounting estimates inherent in the financial statements.

Audit Approach

I have conducted an independent audit of the financial statements in order to express an opinion on them to you. My audit has been conducted in accordance with the Australian National Audit Office Auditing Standards, which incorporate the Australian Auditing and Assurance Standards, in order to provide reasonable assurance as to whether the financial statements are free of material misstatement. The nature of an audit is influenced by factors such as the use of professional judgement, selective testing, the inherent limitations of internal control, and the availability of persuasive, rather than conclusive, evidence. Therefore, an audit cannot guarantee that all material misstatements have been detected.

While the effectiveness of management's internal controls over financial reporting was considered when determining the nature and extent of audit procedures, the audit was not designed to provide assurance on internal controls.

I have performed procedures to assess whether in all material respects the financial statements present fairly, in accordance with Finance Minister's Orders made under the *Commonwealth Authorities and Companies Act 1997*, Australian Accounting Standards and other mandatory financial reporting requirements, a view which is consistent with my understanding of the Bank's and the consolidated entity's financial position and of their performance as represented by the results of their operations, changes in equity and cash flows.

The audit opinion is formed on the basis of these procedures, which included:

- examining, on a test basis, information to provide evidence supporting the amounts and disclosures in the financial statements; and
- assessing the appropriateness of the accounting policies and disclosures used, and the reasonableness of significant accounting estimates made by the Board.

Independence

In conducting the audit, I have followed the independence requirements of the Australian National Audit Office, which incorporate the ethical requirements of the Australian accounting profession.

Audit Opinion

In my opinion, the financial statements of the Reserve Bank of Australia and the consolidated entity:

- (a) have been prepared in accordance with Finance Minister's Orders made under the *Commonwealth Authorities and Companies Act 1997*; and
- (b) give a true and fair view of the Reserve Bank of Australia's and the consolidated entity's financial position as at 30 June 2006 and of their performance for the year then ended, in accordance with:

- (i) the matters required by the Finance Minister's Orders; and
- (ii) applicable Accounting Standards in Australia and other mandatory financial reporting requirements.

A handwritten signature in blue ink, appearing to read 'Ian McPhee', with a long horizontal flourish extending to the right.

Ian McPhee
Auditor-General

Sydney
10 August 2006

Pro Forma Business Accounts

The following sets of accounts for each of the Reserve Bank'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	
	2004/05 \$ million	2005/06 \$ million	2004/05 \$ million	2005/06 \$ million
Revenue				
– Service fees	16.4	15.5	0.7	0.6
– Other revenue	3.1	4.5	0.1	0.1
Total	19.5	20.0	0.8	0.7
Expenditure				
– Direct costs	11.5	12.5	0.4	0.4
– Indirect costs	3.2	3.4	0.2	0.1
Total	14.7	15.9	0.6	0.5
Net profit/(loss)	4.8	4.1	0.2	0.2
Net profit/(loss) after taxes ^(a)	3.4	2.9	0.1	0.1
Assets^(b)				
– Domestic markets investments	340.4	337.0	1.4	1.3
– Other assets	9.5	7.7	0.1	0.0
Total	349.9	344.7	1.5	1.3
Liabilities^(b)				
– Capital & reserves	25.0	25.0	1.0	1.0
– Deposits	319.2	312.5		
– Other liabilities	5.7	7.2	0.5	0.3
Total	349.9	344.7	1.5	1.3
(a) In accordance with competitive neutrality guidelines, income tax expense has been calculated and transferred to the Commonwealth as a notional part of the Reserve Bank's annual profit distribution.				
(b) As at 30 June				

The Reserve Bank Board and Governance

The Role of the Reserve Bank Board

The *Reserve Bank Act 1959*, the enabling legislation, gives the Reserve Bank Board responsibility for monetary and banking policy, and the Reserve Bank's policy on all other matters, except for its payments system policy. The relationship of the Board and the government of the day is set out in Section 11 of the Act. 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 of the Governor, Deputy Governor and senior officers with the Treasurer shortly after each Board meeting.

The Act itself has not been changed since its initial proclamation with respect to the mandate for monetary policy, but procedures and practices have evolved over time in order to keep the Reserve Bank's policy-making process relevant to the changing environment and in parallel with developments abroad. In 1996, the responsible Minister, the Treasurer, and the Governor jointly signed the *Statement on the Conduct of Monetary Policy*, which confirmed the Reserve Bank'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 essentially 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.

Stability of the financial system is a longstanding responsibility of the Reserve Bank – a mandate reconfirmed by the Government when landmark changes to the Australian financial regulatory structure were introduced in 1998. At that time, responsibility for the supervision of banks was transferred to the new, integrated regulator, APRA. Twice a year, in March and September, the Reserve Bank publishes a separate *Financial Stability Review*, which contains its assessment of the state of the financial 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 Reserve Bank Board

The Reserve Bank Board comprises the Governor, who is Chairman, Deputy Governor, 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; there is currently one vacancy on the Board. Five members form a quorum for a meeting of the Board.

Meetings of the Reserve Bank Board

The *Reserve Bank Act 1959* does not stipulate the frequency of Reserve Bank Board meetings. For many years the Board's practice has been to meet 11 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 held in Melbourne, usually in the first half of the year, and from time to time the Board also meets in other Australian capitals; the Board held its September 2005 meeting in Adelaide.

Board Meetings in 2005/06 – Attendance by Members^(a)

IJ Macfarlane	11	(11)
GR Stevens	11	(11)
KR Henry ^(b)	9	(11)
JR Broadbent	11	(11)
RC Corbett ^(c)	4	(5)
RG Gerard ^(d)	4	(5)
FP Lowy ^(e)	3	(6)
DG McGauchie	10	(11)
WJ McKibbin	10	(11)
HM Morgan	11	(11)

(a) Figures in brackets show the number of meetings each member was eligible to attend.

(b) ML Parkinson attended two meetings in place of KR Henry, in terms of the provisions of Section 22 of the *Reserve Bank Act 1959*.

(c) Mr Corbett was appointed to the Board on 2 December 2005.

(d) Mr Gerard resigned from the Board on 2 December 2005.

(e) Mr Lowy's term as a member of the Board ended on 9 December 2005.

Conduct of Reserve Bank Board Members

On appointment to the Reserve Bank Board, each member is required under the *Reserve Bank Act 1959* to sign a declaration to maintain secrecy in relation to the affairs of the Board and the Reserve Bank. Further, members must by law meet the general obligations of directors of statutory authorities, as set out in the *Commonwealth Authorities and Companies Act 1997 (CAC Act)*. 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. As such, directors must:

- discharge their duties with care and diligence;
- act in good faith, and in the best interests of the Reserve Bank;
- not use their position to benefit themselves or any other person, or to cause detriment to the Reserve Bank or any person;
- not use any information obtained by virtue of their position to benefit themselves or any other person, or to cause detriment to the Reserve Bank or any person; and
- declare any material personal interest where a conflict arises with the interests of the Reserve Bank.

Over and above these legislated requirements, members recognise their responsibility for maintaining a reputation for integrity and propriety on the part of the Board and the Reserve Bank in all respects. Hence, they have adopted a Code of Conduct, which provides a number of

general principles as a guide for the conduct of individual members in fulfilling their duties and responsibilities as members of the Board; a copy of the Code is on the Reserve Bank's website.

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 Reserve Bank 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 NPA Board, as NPA's Audit Committee.

The Audit Committee is made up of the Deputy Governor, who is Chairman, a non-executive member of the Reserve Bank Board, Jillian Broadbent, and an external appointed member, George Bennett, company director and former National Executive Chairman of KPMG Peat Marwick. During 2005/06, the Committee met on four occasions; all members attended each of these meetings. At its July 2006 meeting, the Committee considered the draft financial statements for the year ended 30 June 2006 and agreed that the statements be presented to the Reserve Bank Board with its endorsement.

The two external members of the Audit Committee also meet with the external auditor in the absence of management from time to time.

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.

Reporting Obligations under the CAC Act

The Reserve Bank 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 Reserve Bank. As such, they are responsible for the preparation of the Annual Report and, at the meeting of the Board on 1 August 2006, they resolved that the Chairman sign the Report and Financial Statements as at 30 June 2006, 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 Reserve Bank and the Annual Report of the Payments System Board.

Remuneration

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

A committee of the non-executive Reserve Bank Board members, currently chaired by Donald McGauchie, reviews annually the remuneration of the Governor and Deputy Governor

in terms of Section 24A of the *Reserve Bank Act 1959*. In June 2006, the Committee decided to raise the salary of both the Governor and Deputy Governor by 4 per cent, effective 1 July 2006, the same increase as in the preceding several years.

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 Reserve Bank itself or any subsidiary of the Bank. 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 | End July 2006



Chairman: Ian Macfarlane AC

Governor since
18 September 1996
Present term expires
17 September 2006

Chairman – Payments System
Board

Chairman – Council of
Financial Regulators



Glenn Stevens

Deputy Governor since
21 December 2001
Present term expires
20 December 2008



Ken Henry

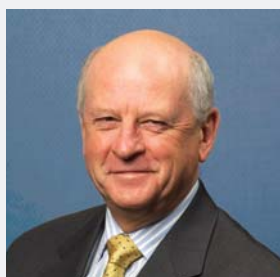
Secretary to the Treasury
Member since
27 April 2001



Jillian Broadbent AO

Member since 7 May 1998
Present term expires
6 May 2008

Director – Coca Cola Amatil
Limited
Director – Special Broadcasting
Service
Director – Woodside Petroleum
Limited



Roger Corbett AM

Member since 2 December 2005
Present term expires
1 December 2010

Chief Executive Officer and
Group Managing Director –
Woolworths Limited
Director – Fairfax Holdings
Limited
Director – CEIS Food Business
Forum



Donald McGauchie AO

Member since 30 March 2001
Present term expires
29 March 2011

Chairman – Telstra
Corporation Limited
Director – Nufarm Limited
Director – James Hardie
Industries NV



Warwick McKibbin

Member since 31 July 2001
Present term expires
30 July 2011

Executive Director – Centre for
Applied Macroeconomic Analysis

Professor of International
Economics – Research School
of Pacific & Asian Studies,
Australian National University

Professorial Fellow – Lowy Institute
for International Policy

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



Hugh Morgan AC

Member since 14 August 1996
Present term expires
28 July 2007

Principal – First
Charnock Pty Ltd

Chairman – BioDiem Ltd

Joint Chairman –
Commonwealth Business
Council

President – Australia Japan
Business Co-operation
Committee

Member – Lafarge
International Advisory Board

Tribute to Ian Macfarlane AC

Ian Macfarlane will retire from the Reserve Bank on 17 September 2006, after a ten-year term as Governor and Chairman of the Board. At its meeting on 1 August, the Reserve Bank Board passed the following resolution:

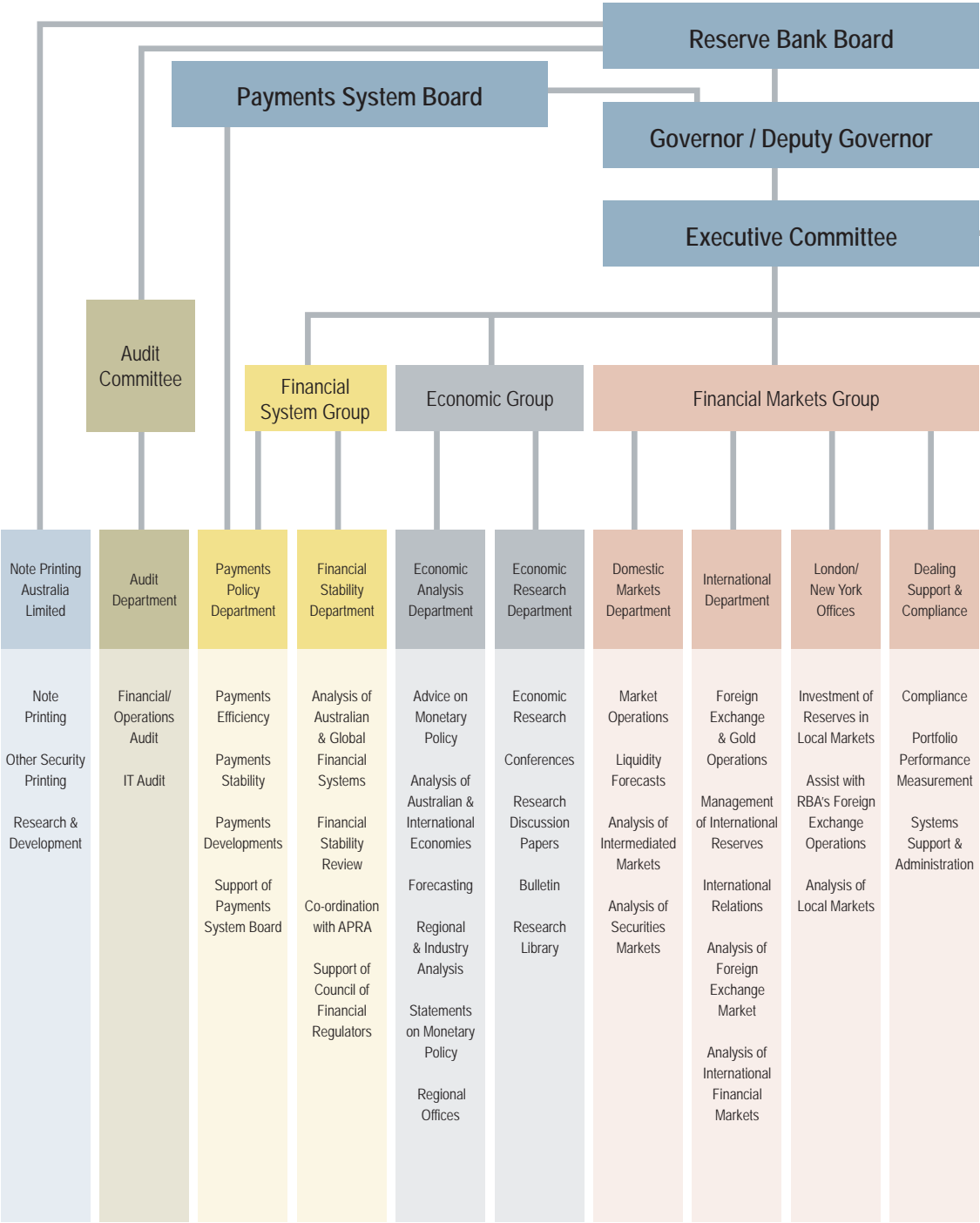
This Board pays tribute to the immense contribution to the conduct of Australian economic policy made by Ian Macfarlane. In a career spanning more than three decades, he has demonstrated not only an outstanding intellect, but exceptional judgement. Always willing to question the conventional wisdom, he has commonly been ahead of others in identifying and responding to new economic and financial developments. As Governor of the Reserve Bank in a period in which Australia has enjoyed remarkable economic stability and prosperity in the face of considerable challenges, his record is unsurpassed by any of his international peers. Thanks to his leadership, the Reserve Bank is well placed to meet future challenges. The Board and the Reserve Bank wish him well in his future pursuits.

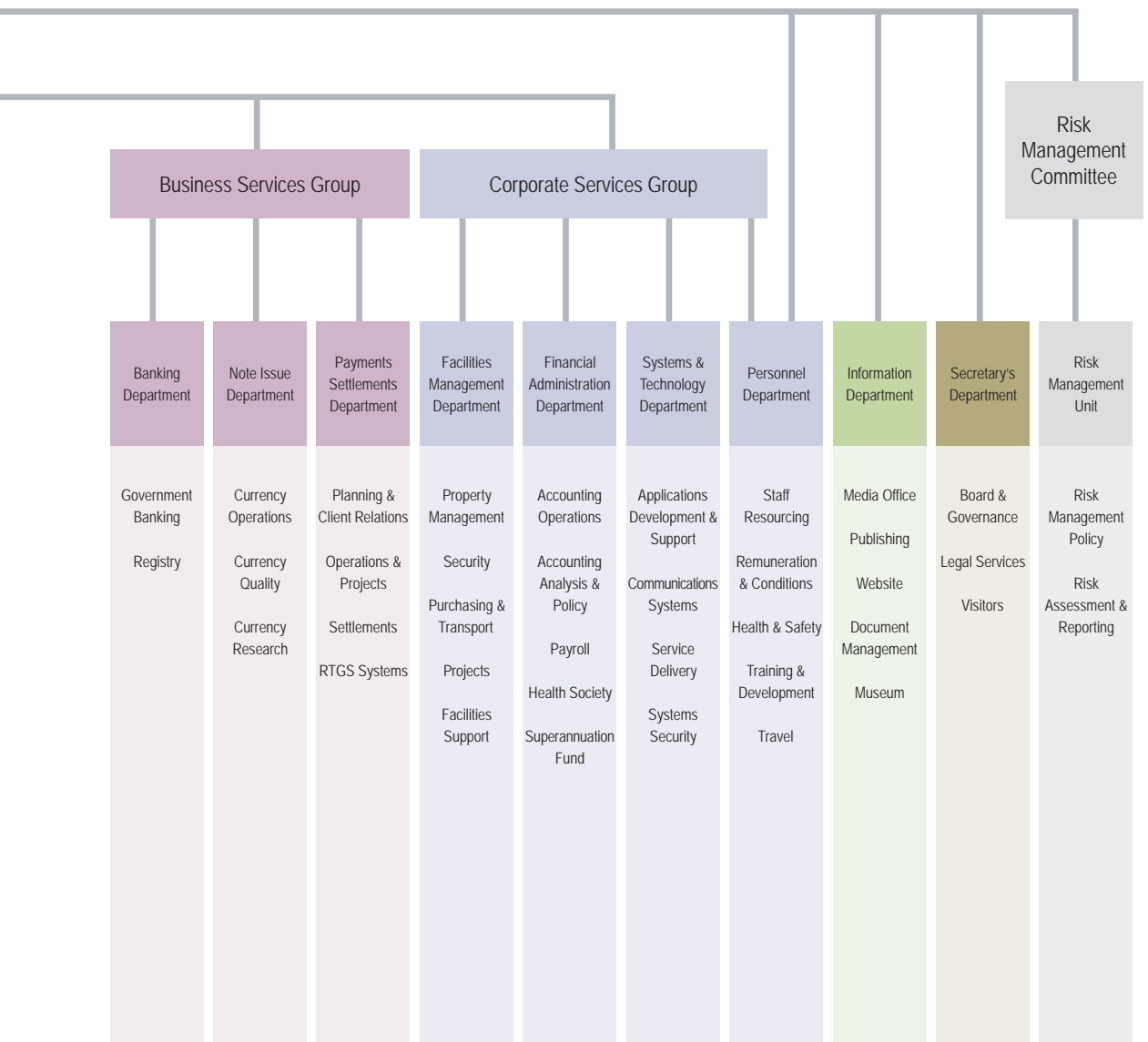


Members of the Reserve Bank Board and senior staff at the August 2006 Board meeting.



Organisational Chart | July 2006





Head Office Management | End July 2006

Governor: Ian Macfarlane
Deputy Governor: Glenn Stevens

Economic Group

Assistant Governor: Malcolm Edey

Economic Analysis Department

Head: Tony Richards
Deputy Heads: Luci Ellis
David Orsmond

Economic Research Department

Head: Christopher Kent

Financial Markets Group

Assistant Governor: Ric Battellino

Domestic Markets Department

Head: Chris Ryan
Chief Manager: John Broadbent

International Department

Head: Guy Debelle
Chief Managers: Ric Deverell
Mike Sinclair

Financial System Group

Assistant Governor: Philip Lowe

Payments Policy Department

Head: John Veale
Chief Manager: Michele Bullock

Financial Stability Department

Head: Keith Hall
Chief Managers: Chris Aylmer
Carl Schwartz

Business Services Group

Assistant Governor: Bob Rankin

Banking Department

Head: Greg Johnston

Note Issue Department

Head: Peter Carlin

Payments Settlements Department

Head: Nola McMillan

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

Secretary's Department

Secretary: David Emanuel
Deputy Secretary: Anthony Dickman

Audit Department

Head: Paul Apps

Information Department

Head: Paul Barry

Personnel Department

Head: Graham Rawstron

Risk Management Unit

Head: Peter Stebbing

Contact Details

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Regional & Industry Analysis

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Senior Representative Officer:
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Fax: (07) 3002 6110

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Western Australia

Senior Representative Officer:
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Perth 6000
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Fax: (08) 9323 3210

Canberra Branch

Manager: Scott Kennedy
20-22 London Circuit
Canberra 2600
Telephone: (02) 6201 4800
Fax: (02) 6201 4875

Overseas Offices

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Chief Representative: Geoff Board
Deputy Chief Representative: Vicki Newman
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London EC2R 6AQ
Telephone: 44 20 7600 2244
Fax: 44 20 7710 3500

New York

Chief Representative: James Whitelaw
Deputy Chief Representative: Matthew Boge
505 Fifth Avenue
New York, NY 10017
Telephone: 1 212 566 8466
Fax: 1 212 566 8501

Note Printing Australia Limited

Chief Executive: Chris Ogilvy
Hume Highway
Craigieburn 3064
Telephone: (03) 9303 0444
Fax: (03) 9303 0491

Glossary

ABF	Asian Bond Fund
AIFRS	Australian equivalents to International Financial Reporting Standards
AOFM	Australian Office of Financial Management
APEC	Asia-Pacific Economic Co-operation
APRA	Australian Prudential Regulation Authority
BIS	Bank for International Settlements
BRS	Business resumption site (of the RBA)
<i>CAC Act</i>	<i>Commonwealth Authorities and Companies Act 1997</i>
CD	Certificate of deposit
CGS	Commonwealth Government securities
CGFS	Committee on the Global Financial System (of the BIS)
CHES	Clearing House Electronic Subregister System of the Australian Stock Exchange
CLS	Continuous linked settlement
CPSS	Committee on Payment and Settlement Systems (of the BIS)
EEO	Equal employment opportunity
EFTPOS	Electronic funds transfer at point of sale
EMEAP	Executives' Meeting of East Asian and Pacific central banks
ES	Exchange Settlement (accounts, balances or funds)
FOI	Freedom of Information
FSAP	Financial Sector Assessment Program
GDES	Government Direct Entry Service
G-7	Group of Seven
G-20	Group of Twenty
GPF	Government Partnership Fund (with Indonesia)
IMF	International Monetary Fund
NNPDC	National Note Processing and Distribution Centre
NPA	Note Printing Australia Limited
OECD	Organisation for Economic Co-operation and Development
OH&S	Occupational health & safety
OPA	Official Public Account
RBA	Reserve Bank of Australia
RBRF	Reserve Bank Reserve Fund
RITS	Reserve Bank Information and Transfer System
RTGS	Real-time gross settlement
SDR	Special Drawing Rights