RESERVE
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ANNUAL REPORT 2005

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Reserve Bank

Governor's Foreword

The period covered by this report – the financial year 2004/05 – was a period of relative calm as Australia's economic expansion continued into its 14th year. Growth in the world economy remained strong and the accompanying rises in commodity prices provided an expansionary backdrop to the Australian economy. At the same time, the most overheated part of the economy – the housing sector – cooled, and with it household consumption. Both business investment and employment continued to grow strongly, while inflation remained stable.

There was only one change to monetary policy during the year – a 25 basis point tightening in March. This was the fifth small rise in the past three years, making this the most gradual tightening phase in recent memory. More detailed accounts of monetary policy and economic developments can be found in the quarterly *Statement on Monetary Policy,* testimony to the House of Representatives Standing Committee on Economics, Finance and Public Administration, and various speeches by senior members of staff.

As well as monetary policy, the other main policy area for which the Reserve Bank is responsible is the stability of the financial system. This is divided into two main areas – the payments system and financial system stability itself. The work on the payments system is detailed in the Annual Report of the Payments System Board and in various media releases. The main publication of System Stability Department is the twice-yearly *Financial Stability Review,* which is presented to the Council of Financial Regulators before being released to the public. Both these publications contain extensive accounts of developments in their respective areas.

This Annual Report presents the Reserve Bank's Financial Statements and focuses on those activities of the Bank that have not been covered in other regular publications. Among the various activities that occurred during the year, the following are worthy of mention.

As was the case last year, the Reserve Bank again had to widen the range of securities in which its Domestic Markets Department deals to make up for the lower supply of Commonwealth Government securities. As at September 2004, the Reserve Bank's outright holdings of longer-dated domestic securities have been broadened to include semi-government paper. In the foreign exchange market it was a quiet year, with the Reserve Bank accumulating another A$2.4 billion of foreign exchange to restore international reserves, after the period of intervention in 2000 and 2001.

Australia continues to participate actively in international economic relations and will host the 2006 G-20 meeting of finance ministers and central bank governors, to be held in Melbourne. The International Department of the Reserve Bank put in a big effort last year as part of the EMEAP working group that established the Asian Bond Fund 2. This is an important initiative that enables central banks and other fund managers to invest in local-currency denominated sovereign and quasi-sovereign bonds issued by Asian governments.

Major attention is being given by Note Issue Department to improve the quality of lower-denomination currency notes in circulation. This involves increasing the number of $5 and $10 notes that are returned by banks and armoured car companies for inspection and replacement if required.

Note Printing Australia had a busy year, producing 160 million notes for the Reserve Bank and 234 million notes for export. Securency, the joint-venture company that produces the polymer substrate, is operating at full capacity servicing its overseas customers, with Chile becoming the 23rd country to issue bank notes printed on Securency's polymer substrate.

The Museum of Australian Currency Notes was opened at the Macquarie Street end of the ground floor of Head Office in Sydney in late February. As well as exhibiting all the series of Australian notes issued since the national currency was established in 1910, it shows specimens of every note issued worldwide on polymer.

In late 2004, the Reserve Bank purchased 1.48 hectares of land in outer metropolitan Sydney on which to construct a business resumption site. In early 2005 a design was prepared for the facility and presented to the Parliamentary Joint Standing Committee on Public Works. The Committee approved the proposal, which is estimated to cost $38 million. Work will commence on construction in early 2006, with final commissioning by mid 2007.

There was a small rise in staff numbers during the year but the level has been in the eight hundreds now for five years or so. A recent innovation was the establishment (with a joint-venture partner) of a childcare facility in the CBD for pre-school-age children of Reserve Bank staff.

The Australian financial system is undergoing continual change and Reserve Bank staff, along with private-sector participants, are constantly having to adapt to these changes. I am confident that our staff will continue to demonstrate a high degree of flexibility as well as a strong commitment to maintaining high standards in this changing environment. In addition to keeping up with technological changes that affect the financial infrastructure we provide, there are numerous other changes affecting the way we work. For example, since becoming the regulator of the retail payments system, we find that we are spending a lot more time in Court, and have had to adapt our work to constant legal scrutiny. Similarly, as financial markets become more sophisticated, specialised statistical surveys have had to be undertaken to fill the gaps in our knowledge. When possible, we contract the Australian Bureau of Statistics to do this for us; if not, we employ the services of commercial market research firms. As we go forward there will no doubt be many other challenges, but I am sure that the staff of the Reserve Bank have the resourcefulness to meet these challenges.

IJ Macfarlane

Chairman, Reserve Bank Board
17 August 2005

Operations in Financial Markets

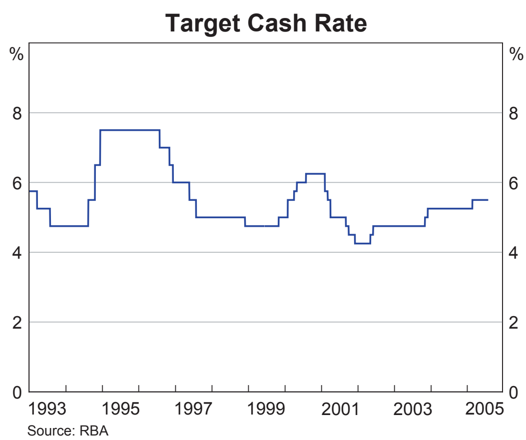
The Reserve Bank has an active presence in financial markets resulting from its operations to implement monetary policy, its provision of banking and other services to clients (mainly the Australian Government) and the management of its balance sheet.

Domestic Markets Operations

While market operations have been used to implement monetary policy since the mid 1980s, the nature of these operations has had to evolve over that time to take account of changing market circumstances. In the case of operations in domestic markets, the main challenge over recent years has been to implement monetary policy without placing undue stress on the market for Commonwealth Government securities (CGS), which has contracted significantly since the late 1990s. Mostly this challenge has been met by broadening the range of securities in which the Reserve Bank has been prepared to deal. The past year saw a further move in this direction, with outright holdings of longer-dated domestic securities broadened in September 2004 to include semi-government paper; previously, outright holdings of longer-dated paper had been limited to CGS. Around that time, the Australian Office of Financial Management (AOFM) also sought further to alleviate stress on the CGS market by introducing a new securities lending facility, which is operated by the Reserve Bank.

Monetary Policy Implementation

Decisions by the Reserve Bank Board on the appropriate setting of monetary policy are made and communicated in terms of a target for the cash rate – the interest rate payable on overnight, unsecured loans between banks. The cash rate is an important determinant of other wholesale and retail interest rates, which, in turn, influence the level of economic activity and inflation.



The target for the cash rate was changed only once in 2004/05 – an increase from 5.25 per cent to 5.50 per cent following the March 2005 Reserve Bank Board meeting. Prior to that, the target had been unchanged since December 2003. The rationale for changes in policy is provided at the time by media releases, and subsequently in the Reserve Bank's quarterly *Statement on Monetary Policy* and in appearances by the Governor before the House of Representatives Standing Committee on Economics, Finance and Public Administration.

Monetary policy decisions are implemented through operations that affect the supply of funds available to banks in the domestic market. The specific funds in question are those held by banks in their Exchange Settlement accounts at the Reserve Bank. These funds, known as Exchange Settlement (ES) funds, are the means by which banks settle their obligations with one another and with the Reserve Bank.

As these deposits earn interest at slightly below market rates, banks seek to hold only enough to meet their day-to-day settlement needs – in aggregate typically around $700-800 million. If the supply were to fall below this for any sustained period, individual banks would tend to increase the interest rate at which they are prepared to borrow in the money market to try to restore their holdings. Conversely, if supply rose excessively, banks would seek to dispose of the excess by reducing the rates at which they are willing to borrow and lend.

The domestic markets transactions used by the Reserve Bank to manage the supply of ES funds may be either outright purchases or sales of securities, or more usually repurchase agreements or 'repos', involving the purchase or sale of a security with an undertaking to reverse the transaction at a future agreed date and at an agreed price. Domestic operations may also be augmented with foreign exchange swaps.[1]

These arrangements for implementing monetary policy have proved to be effective, with volatility in the cash rate low by international standards. As in the previous year, measured volatility was close to zero in 2004/05, with the vast majority of overnight transactions in the cash market taking place at the target rate.

Open market operations are conducted mid morning, with the size of each operation being based on the expected availability of ES funds for the day. A second round of operations may be held later in the day to offset unexpected flows or shifts in demand for ES balances, but such events are rare; in 2004/05, there was only one second-round operation. 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 a 25 basis point penalty. Banks typically use this facility when there are technical factors that prevent them from sourcing funds in the market. This facility was accessed on 11 occasions during 2004/05.

Overnight Repurchase Agreement Facility

	Number of Times Used	Value[(a)] ($ 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

(a) First leg of transaction

Each morning, the Reserve Bank publishes its expectation of changes in the supply of ES funds and the types of operations that it is proposing to offset these flows, and invites approaches from the market at preferred maturities. Once bids or offers have been received from market participants, they are ranked in order of attractiveness in terms of yield and transactions are accepted up to the value needed to maintain ES balances in the desired range. Bids or offers

1 *The Reserve Bank adds to ES balances through a foreign exchange swap by providing Australian dollars to banks in exchange for foreign currency, with an agreement to reverse the transaction on an agreed forward date and at an agreed exchange rate. Such transactions have no effect on the exchange rate.*

are ranked relative to market yields for the relevant maturity. As such, for maturities other than overnight, the yields at which the Reserve Bank buys or sells securities may differ significantly from the target cash rate. The Reserve Bank does not try to influence the shape of the short-term yield curve directly by setting yields at which it is prepared to buy or sell. To do so would deprive it of an important source of market information. One consequence of this approach is that details of the yields at which the Reserve Bank buys or sells do not contain any information about its assessment of the likely future course of monetary policy.

The Reserve Bank provides banking services to various governments, official institutions and overseas central banks. Flows of funds between these customers and the community directly affect the level of ES balances held by the commercial banking sector. A run-up in customer deposits with the Reserve Bank, for instance, withdraws funds from the banking sector. During 2004/05, customer deposits at the Reserve Bank rose substantially and to offset these and other flows during the year, the Reserve Bank was required to be a net purchaser of assets from the market. These included about $3 billion of domestic assets, mostly State government and commercial bank paper bought under short-term repurchase agreements, and $8 billion of foreign assets. Apart from around $2.4 billion of foreign currency that was bought outright over the year to replenish foreign currency reserves, the rest was bought under swap agreements. As noted earlier, the Reserve Bank uses foreign currency swaps to supplement domestic markets operations so as to avoid the undue pressure on domestic markets that might arise if all its buying were concentrated in domestic assets.

The Reserve Bank's total turnover in domestic securities and in foreign exchange swaps for open market operations was about $510 billion in 2004/05, an increase of 20 per cent from the previous year. As well as an increase in day-to-day ES flows, the rise in turnover was due to a shortening of the average maturity of repos.

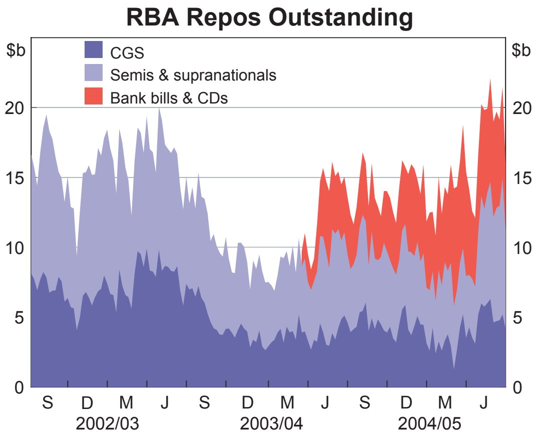
The shortening of the maturity profile was primarily in response to a preference in the market for short-dated repos. Longer-term repos – with terms of around 90 and 180 days – had been offered in recent years at the behest of market participants to facilitate market development, but demand for such repos proved to be limited.

Open Market Operations
($ billion)

	2000/01	2001/02	2002/03	2003/04	2004/05
Repurchase agreements[a]					
– Purchases	376	423	304	272	391
– Sales	17	16	17	11	10
Outright purchases[b]	5	1	3	5	5
Total operations in domestic securities	398	440	324	287	405
FX swaps[a]	90	90	90	139	106
Total	488	530	414	426	511

(a) First leg of transaction.
(b) CGS only until 2002/03. Thereafter includes State and Territory government securities.

While a shorter maturity profile for repos increases the roll-over task of the Reserve Bank, this has not raised any specific difficulty, partly owing to the widening in the range of securities eligible for repo in recent years. The repo book rose from an average of $11 billion in 2003/04 to around $15 billion in 2004/05. Of this, about $5 billion were repos in bank bills and certificates of deposit (CDs), following the decision in March 2004 to include such securities in repo operations. The weighted average rate at which repos involving bank instruments were accepted was around 7 basis points above the weighted average rate offered on the 'next best' repo collateralised by CGS.



Source: RBA

Had the Reserve Bank continued to confine its market operations to CGS, rather than expanding the pool of eligible instruments to encompass other domestic securities and foreign exchange swaps, its holdings of CGS by end 2004/05 would have accounted for over 80 per cent of all CGS outstanding.

Long-dated Liquidity Operations

As noted in the introduction, the Reserve Bank has made a number of changes to its domestic dealing arrangements in recent years to keep pace with market developments and changes in the structure of its balance sheet. One of these measures has been to broaden the range of long-term domestic securities held on an outright basis to include domestic issues by Australian State and Territory government central borrowing authorities. This change took effect in September 2004.

The decision to broaden outright holdings was aimed at rebuilding the Reserve Bank's domestic securities portfolio. Traditionally, the only domestic securities the Reserve Bank had held on an outright basis had been CGS. Over the past 10 years or so, however, as the amount of CGS on issue has declined, the Reserve Bank has reduced its purchases of these securities. As a result, its holdings on an outright basis had fallen to around 4 per cent of its total assets, compared with 40 per cent a decade ago.

Before deciding to undertake outright purchases of longer-dated semi-government securities, the Reserve Bank consulted widely with State borrowing authorities and bond market participants. A number of measures have been taken to ensure that the Reserve Bank's purchases are transparent and have minimal impact on secondary market activity: purchases are through mini-tenders; they take place on a regular basis, around once a month; they are carried out with a view to maintaining the maturity structure of the Reserve Bank's holdings at about the same as the market's; and purchases generally do not exceed $150 million in total at each operation. Eight operations involving long-dated securities were undertaken between September 2004 and June 2005, with total purchases of $700 million (see table).

Long-dated Liquidity Operations in 2004/05

Date of Operation	Range of Maturities Accepted	Amount Purchased (face value, $ million)	Weighted Average Yield Accepted (per cent)	Bid-to-Cover Ratio
22 September 2004	March 2008 to August 2008	102	5.392	16
26 October 2004	December 2010 to May 2012	100	5.495	10
25 November 2004	July 2009	50	5.330	13
24 February 2005	March 2008 to May 2010	151	5.717	7
29 March 2005	May 2010	101	5.950	8
28 April 2005	June 2013 to October 2015	102	5.636	6
30 May 2005	September 2007	50	5.385	18
27 June 2005	October 2007	50	5.310	15

As discussed in the chapter on 'Risk Management' (see section on 'Balance Sheet Risks'), the ongoing acquisition of longer-dated (domestic) securities will see some reversal of the trend towards lower interest rate risk in the Reserve Bank's portfolio of domestic assets. But this rise is quite modest, with the sensitivity of the portfolio to changes in interest rates still considerably lower than a decade ago.

Securities Lending

The Reserve Bank maintains a securities lending facility through which it is prepared to lend to market participants any issue of domestic securities that it holds on an outright basis. This activity assists market participants to meet their settlement obligations in government bonds. Until recently, the Reserve Bank priced its stock lending so as to be the most expensive lender in the market and thereby avoid displacing private activity. This made it the securities lender of last resort.

In October 2004, securities lending operations were changed to improve the availability of securities to the market. The role of lender-of-last-resort for Treasury bonds was assumed by the AOFM, with the introduction of a facility to lend CGS from the Government's holdings. The AOFM's facility, which is operated by the Reserve Bank, allows participants to obtain access to specific lines of Treasury bonds when they are not readily available in the market, but at a significant penalty relative to market prices for stock lending.

With the introduction of the AOFM's facility, the Reserve Bank discontinued lending stock at penalty rates and began lending from its portfolio at market prices. As a result, the value of stock lent by the Reserve Bank more than doubled in 2004/05, to $12 billion, though earnings on individual transactions fell as the securities were no longer priced on a last-resort basis. The average maturity of each loan was around 10 days. Most of the transactions were loans of CGS, although around $450 million of the Reserve Bank's newly acquired holdings of semi-government securities were also lent to the market. In addition to this, the Reserve Bank lent over $900 million of stock on behalf of the AOFM.

Stock Lending by the RBA			
	Number of Transactions	Amount Lent (face value, $ billion)	Net Income ($ million)
2000/01	75	1.2	0.1
2001/02	119	3.1	0.3
2002/03	32	0.9	0.1
2003/04	185	5.0	0.5
2004/05	264	11.9	0.6

Foreign Exchange Operations

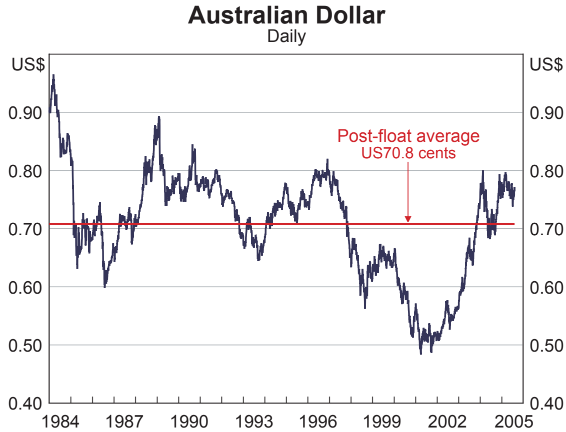
The Reserve Bank operates in the foreign exchange market both on behalf of clients and on its own account. Client transactions are mainly for the Australian Government, which has a large ongoing need for foreign exchange for defence expenditure, foreign aid payments and the cost of embassies. In the past year, this amounted to around $4.2 billion. In the previous couple of years the Government's foreign exchange needs had been substantially higher owing to the repayment of foreign currency swaps. The Reserve Bank covered sales to the Government during the past year by buying foreign exchange in the market, so these sales had no net impact on its holdings of foreign exchange. This is the normal practice unless the exchange rate is unusually low, in which case the Government's needs are met directly from foreign exchange reserves in the first instance.

Transactions on the Reserve Bank's own account fall into three main types. The most prominent are those intended to influence the exchange rate of the Australian dollar. These transactions, referred to as intervention, are typically undertaken only when the exchange rate has moved a long way from its long-term average and in a manner inconsistent with economic developments. Over the past year the behaviour of the Australian dollar did not warrant any such operations.

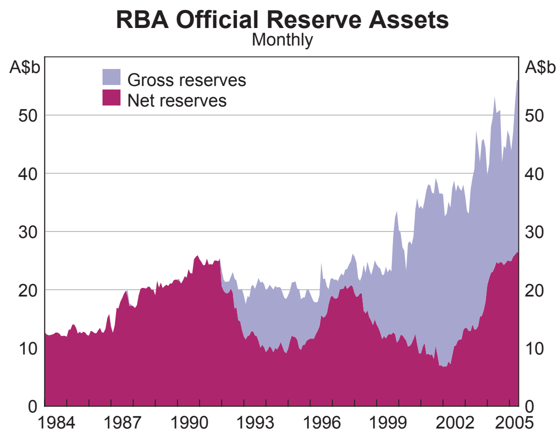
Other transactions on own-account are those undertaken to restore foreign reserve holdings after a period of intervention. This has been the main type of transaction the Reserve Bank has been undertaking since early 2002. These operations involve purchases of foreign exchange in a low-key way, usually in small amounts spread out over a period of time. While they are intended primarily to rebuild reserves, they may at the margin nonetheless have some effect on the exchange rate.

Having rebuilt foreign exchange reserves during 2003/04 to levels that took them into the range which is seen as broadly adequate, the Reserve Bank was content to be opportunistic in adding further to its reserve holdings during 2004/05, doing so during periods of strength in the exchange rate. Most of the purchases were in late 2004 and in February–March 2005, when the exchange rate was around its highs for the year. Net market purchases over the year were A$2.4 billion, at an average exchange rate of around US78 cents. At the end of June net foreign reserves (i.e. official reserve assets excluding those held under foreign currency swaps) were A$26.4 billion.

Foreign currency swaps are the third type of transaction on the Reserve Bank's own account. These do not involve the outright purchase or sale of foreign currencies, but the exchange of two currencies for an agreed period, with the exchange rate for the reversal of the transaction also agreed.[2] As discussed earlier in this chapter, the Reserve Bank makes use of foreign currency swaps to help in domestic liquidity management. For example, if the banking system is short of funds, the Reserve Bank will undertake a swap in which it provides Australian dollars in exchange for foreign currency. This has the same effect on domestic liquidity as using domestic markets operations to buy government securities under a repo agreement.



Source: Reuters



Source: RBA

Although the Reserve Bank continued to make substantial use of foreign currency swaps for domestic liquidity management in 2004/05, total turnover in swaps, at $106 billion, was lower than in the previous year. This was because the average term of swaps was a little longer and fewer roll-overs of maturing swaps were required. Swaps outstanding at the end of June 2005 were A$29.8 billion, a little higher than a year earlier. Reflecting these holdings of foreign exchange, together with the $26.4 billion held as net reserves, total official reserve assets stood at $56.2 billion, up from $50.3 billion a year earlier.

Reserves Management

The Reserve Bank holds foreign currency reserve assets to facilitate its intervention in the foreign exchange market. These assets may be required at short notice and consequently priority is given to liquidity and security when managing them. Within these constraints, the reserves are managed with the aim of maximising returns. To reflect this, a benchmark has been designed that optimises the risk/return trade-off given the overall liquidity and security constraints. This benchmark is reviewed on a regular basis.

2 *The exchange rate for the reversal is determined by adjusting the current exchange rate for the interest rate differential between the two relevant countries for maturities similar to the swap. Because the exchange rate for the reversal is fixed, foreign exchange held under swaps does not expose the Reserve Bank to risk of capital loss from adverse exchange rate movements.*

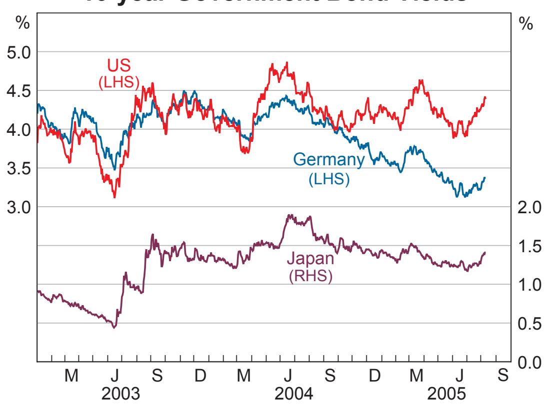
The benchmark specifies the allocation of the reserves portfolio across currencies and assets. Since February 2002 the allocation has been 45 per cent to the United States, 45 per cent to Europe and 10 per cent to Japan. The assets that can be held are securities issued by the US, Japanese, French and German governments and their agencies, repurchase agreements, commercial bank deposits with highly rated banks, and investments at the Bank for International Settlements. The duration of the portfolio in each currency is set at 30 months.

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

The return on foreign currency assets rose over the past year from the low level of 2003/04. In the US portfolio, the return was 4.1 per cent, with higher short-term interest rates and capital gains on longer-dated securities both contributing to the result. In the European portfolio the return was 5.8 per cent, with the result again boosted by capital gains on long-term bonds; interest rates at shorter maturities in Europe remained little changed at historically low levels. In Japan, the return rose to 1.1 per cent, again primarily owing to capital gains on bond holdings, with short-term interest rates remaining close to zero.

10-year Government Bond Yields



Source: Bloomberg

The constantly changing size and composition of reserves, owing to both valuation effects from movements in exchange rates and yields and the Reserve Bank's daily operations, means that for practical reasons the actual portfolio is maintained in a narrow range around the benchmark rather than precisely in line with the benchmark at all times. This gives portfolio managers a small amount of discretion to manage investments associated with the day-to-day flows of funds. Decisions taken by portfolio managers under the trading discretion available to them added $38 million, or 14 basis points, to returns for the year. This incremental return was achieved through transactions that took advantage of short-term market anomalies ($24 million) and returns from lending securities ($14 million). The extent to which the return exceeded the benchmark was lower than in the previous few years as income from both anomaly trading and securities lending was down. The latter was mainly because the increased supply of US government securities, reflecting on-going budget deficits, has reduced the instances where specific lines of stock end up in short supply in the market. The result for the year was also adversely affected by

Rates of Return in Local Currency by Portfolio (per cent)			
	US	Europe	Japan
2000/01	8.60	5.65	2.27
2001/02	6.09	4.68	0.40
2002/03	6.65	7.19	1.34
2003/04	0.01	1.89	0.04
2004/05	4.06	5.77	1.10

exchange rate changes, as the higher value of the Australian dollar reduced the value of income earned in foreign currency.

As noted in last year's Annual Report, a small amount of foreign exchange reserves has been invested in the Asian Bond Fund (ABF). An initial investment of US$50 million was made in July 2003 in ABF1, a fund that invests in US dollar debt issued by a number of Asian sovereign and quasi-sovereign borrowers. This fund has performed well since its inception. In the latest financial year it returned 8.6 per cent, well in excess of the 4.1 per cent earned on the core US dollar reserves portfolio, which is invested in assets in the United States.

Towards the end of 2004/05 the Reserve Bank invested US$222 million in a second fund (ABF2), which invests in local currency bonds issued by Asian governments and their authorities. It is too early to assess the returns on the ABF2 investment.

Actual and Benchmark Returns

	Rates of Return in SDR (per cent)		Value of Difference
	Actual	Benchmark	(A$ million)
1991/92	9.8	8.9	165
1992/93	16.3	11.6	420
1993/94	4.0	3.8	31
1994/95	5.2	7.4	-331
1995/96	4.0	3.7	40
1996/97	4.5	4.2	34
1997/98	4.5	4.6	-19
1998/99	4.9	5.1	-26
1999/00	2.8	3.8	-202
2000/01	11.0	10.8	74
2001/02	3.9	3.7	63
2002/03	6.7	6.4	77
2003/04	0.5	0.3	67
2004/05	4.7	4.5	38

Gold

The Reserve Bank holds around 80 tonnes of gold, which is currently valued at around A$1.5 billion. As the US dollar depreciated during the first half of 2004/05, the gold price rallied from around US$400 per ounce to above US$450 per ounce before settling back to around

US$435 at year end. The Australian dollar price of gold closed the year virtually unchanged around A$570 per ounce.

The Reserve Bank makes collateralised gold loans to major banks in the gold market. Demand for gold loans is highly dependent on the hedging policies of major gold producers and end users. With the gold price remaining buoyant in US dollar terms, there has been little hedging activity from miners and interest rates on gold loans have continued to fall. Interest rates for one-year loans averaged only 0.05 per cent, compared with 0.50 per cent and 0.20 per cent in 2002/03 and 2003/04 respectively. With interest rates so low there has been little incentive on a risk/reward basis for the Reserve Bank to roll-over maturing loans, and some 15 tonnes have been repaid over the year. Returns from gold lending in 2004/05 were A$15.5 million, compared with A$16.1 million in 2003/04.

International Financial Co-operation

The Reserve Bank participates in a number of international forums, along with other areas of the Australian Government, to further the country's international economic interests. In some cases, such as the Financial Stability Forum (FSF), Bank for International Settlements (BIS) meetings and the Executives' Meeting of East Asian and Pacific central banks (EMEAP), the Reserve Bank is Australia's primary representative. In other forums, such as the International Monetary Fund (IMF) and APEC, Australia's participation is mainly led by the Australian Treasury and the Reserve Bank plays a supporting role along with a number of other government agencies.

Co-ordination of work by various Australian Government agencies in international economic issues is undertaken through the International Economic Policy Group. This group 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 developments in the Reserve Bank's international dealings over the past year have been the announcement of Australia's chairing of the Group of Twenty (G-20) in 2006 and the launch by the EMEAP group of the second stage of the Asian Bond Fund. More detail on these and other initiatives is provided below.

Group of Twenty (G-20)

Representing two-thirds of the world's population and 90 per cent of world gross domestic product, the G-20 is a key forum for Australia's participation on the international economic stage. The G-20 comprises central banks and finance ministries from the G-7 and other 'systemically significant' industrialised and emerging market economies. As such, it has the advantage of having a broad representation of developed and emerging market economies, while still being small enough to provide for focused discussions.

There are several different levels of G-20 representation. At the highest level, finance ministers and central bank governors meet annually, while finance ministry and central bank deputies meet twice a year. The G-20 hosts workshops that draw on academic and private-sector expertise, as well as on public-sector knowledge, to provide more in-depth consideration of items on its agenda.

At the meeting of finance ministers and central bank governors in 2004, members discussed strategies

Membership of the G-20[a]

Argentina	Italy
Australia	Japan
Brazil	Korea
Canada	Mexico
China	Russia
European Union	Saudi Arabia
France	South Africa
Germany	Turkey
India	United Kingdom
Indonesia	United States

(a) The European Union is represented by the Council Presidency and the President of the ECB. The Managing Director of the IMF and President of the World Bank, plus the chairpersons of the International Monetary and Financial Committee and Development Committee of the IMF and World Bank, also participate as ex-officio members.

for sustainable growth and experiences with institution-building in the financial sector, regional cooperation, abuse of the financial system (harmful tax practices) and demographic challenges. From this discussion, members reached an 'accord' on a number of common principles for domestic policies to help foster sustainable growth. The G-20 Accord, which was released publicly, was supported by a reform agenda for each G-20 country member, the implementation of which will be reviewed regularly.

In 2005, the major theme of the G-20 is 'Global Co-operation: Promoting Balanced and Orderly World Economic Development'. Key issues for discussion include reform of the Bretton Woods institutions against the background of the changing global economy; consideration of development assistance issues and innovative financing mechanisms; the challenges brought about by demographic transition; and differing approaches to development.

In November 2004, it was announced that Australia will chair the G-20 for 2006. To support this increased responsibility, the Reserve Bank has established a G-20 unit within its International Department. In 2005, Australia became a member of the G-20 management troika, which is comprised of the previous, current and next year's Chairs.

Financial Stability Forum (FSF)

Since its inception in 1999, the FSF has become the prime vehicle for co-ordinating the work of national authorities and international agencies aimed at strengthening the global financial system. It consists of senior representatives from the central banks, finance ministries and supervisory agencies of the G-7 countries, as well as the governors of the central banks of four other economies with globally significant markets (Australia, Hong Kong, the Netherlands and Singapore). It also includes international regulatory bodies, such as the IMF, the Basel Committee on Banking Supervision and the International Association of Insurance Supervisors.

Membership of the FSF

Australia	Japan
Canada	Netherlands
France	Singapore
Germany	United Kingdom
Hong Kong	United States
Italy	

Much of the Forum's work is focused on improving the structure of the international financial system. Its recent initiatives in this area include research into the likely extent of abuses of financial reinsurance and the implications of new international financial reporting standards for financial stability. The FSF has also been co-ordinating efforts to improve business continuity planning in the event of disruptions to physical infrastructure.

In addition to working on structural issues, the FSF monitors current financial conditions for emerging signs of instability. Over the past year, for example, it has discussed the potential for problems to arise from current account and exchange rate imbalances between major economies and from the higher levels of household indebtedness in a number of countries.

Bank for International Settlements (BIS) and Associated Committees

The BIS is an international institution owned by central banks. The Reserve Bank is a shareholder, and participates actively in work of the BIS. The Governor or Deputy Governor takes part in the bi-monthly meetings of central bank governors of BIS member countries. These meetings discuss issues affecting the global economy, with a particular focus on those most relevant to central banks, such as financial market developments, exchange rates and financial sector stability, as well as discussion of the global macroeconomic conjuncture. The Reserve Bank also participates in two smaller groupings of BIS Governors: one focuses on governance arrangements for central banks, and the other, the BIS Asian Consultative Council (ACC), considers issues most pertinent to the Asian region and guides the work of the BIS representative office in Hong Kong. Over the past year, discussions at the ACC have mainly concerned the implementation of Basel II – the new capital framework to enhance the prudential oversight of the international banking system.

As has been the case for a number of years, a senior official of the Reserve Bank has participated in two committees associated with the BIS – the Committee on the Global Financial System (CGFS) and the Markets Committee. The CGFS discusses vulnerabilities and risks apparent in the global financial system, as well as structural developments in financial markets. The Markets Committee focuses on a narrower range of matters related to foreign exchange and capital market developments.

The CGFS regularly commissions working groups to undertake more in-depth analysis of particular issues, most of which the Reserve Bank was involved in during 2004/05. One such group undertook a survey of stress-testing at major financial institutions in 16 countries. The results of this survey were published by the CGFS in January 2005.

The Reserve Bank was also represented on the CGFS Working Group on Ratings in Structured Finance, which examined the role of rating agencies in the markets for structured finance instruments. The Group examined the methodological differences that exist between the rating of structured finance instruments and more traditional credit products, as well as the various challenges involved in rating structured finance products. The report of this group was released in January 2005.

The Reserve Bank is currently participating in a CGFS Working Group that is examining the factors driving recent changes in the market for housing finance in member countries. Its report is due in the second half of 2005. Similarly, the Reserve Bank is represented on the Foreign Exchange Settlement Risk sub-group of the BIS Committee on Payment and Settlement Systems (CPSS). This Group is responsible for coordinating central banks' efforts to contain the systemic risk inherent in the settlement of foreign exchange trades, and also forms the basis for co-operative oversight of the Continuous Linked Settlement (CLS) Bank. Commencing operations in 2002, CLS is a private-sector initiative to address foreign exchange settlement risk.

During the year the Reserve Bank took up the offer by the BIS to all its members to increase their holdings of shares in the organisation. The share offer reflected the final step in a process that had been underway at the BIS since 2001 to withdraw BIS shares that had up to that time been held privately and, in doing so, concentrate all its shareholding in the hands of member central banks. As a result of these purchases, the value of the Reserve Bank's shareholding of the BIS increased by $40 million to $240 million.

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

Since its establishment in 1991, EMEAP has been instrumental in fostering closer co-operation and understanding among its 11 member central banks drawn from east Asia and the Pacific region. It has been successful in providing a forum where members can share ideas and provide each other with insights into their economies for the benefit of all in the region. EMEAP meets at the governor and deputy governor level, with support from four working groups covering financial markets, information technology, banking supervision, and payments and settlement system issues. The Reserve Bank is represented at all levels of EMEAP, with a senior Bank official in the position of chair of the Working Group on Payments and Settlement Systems. While much of EMEAP’s activities typically involve discussing countries’ experiences with different challenges, in recent years EMEAP has taken the level of regional co-operation one step further with the establishment of the Asian Bond Fund (see box).

EMEAP Governors met in July 2004 and June 2005. Discussions focused on recent economic and financial developments, with particular emphasis on exchange rate arrangements and investment flows in Asia. The Reserve Bank hosted one of the bi-annual meetings of EMEAP Deputies in Sydney in April 2005. At this meeting, as well as considering progress reports from each of the working groups, deputies discussed issues regarding risks to economic and financial stability in the region.

Membership of EMEAP

Australia	Malaysia
China	New Zealand
Hong Kong	Philippines
Indonesia	Singapore
Japan	Thailand
Korea	

The Reserve Bank hosted the bi-annual EMEAP Deputies Meeting in Sydney on 1 April 2004. Glenn Stevens, Deputy Governor, and Guy Debelle, Head of International Department, represented the Reserve Bank.

Asian Bond Fund (ABF)

The overall aim of the ABF project has been to accelerate the deepening of local currency bond markets in Asia, following the dislocation that resulted from the Asian crisis in 1997 and 1998. The Working Group on Financial Markets, under guidance from the EMEAP Deputies, has for the past two years developed the second phase of the ABF initiative (ABF2). The RBA has played an active role in this exercise, including through the investment of US$222 million of foreign exchange reserves in the Fund in 2005, which is in addition to the US$50 million investment in the first stage (ABF1) in 2003. The table summarises the main features of each Fund.

Compared with ABF1, which involved investment in US dollar-denominated bonds, the second stage is more significant for bond market development as the investment is in local currency-denominated bonds issued by sovereign and quasi-sovereign issuers in eight EMEAP economies (i.e. excluding Australia, Japan and New Zealand, which already have developed bond markets). While the initial investment was limited to EMEAP central banks, ABF2 has now also been opened to investment by external investors.

ABF2 has two components: the Pan Asian Bond Index Fund (PAIF), which contains a mix of securities from all eight markets; and eight individual country funds. The PAIF was listed in Hong Kong in early July while the individual country funds are also in the process of being listed.

Within the overall objective of financial deepening, ABF2 is expected to yield three main benefits for the region. Firstly, it involves the introduction of a new class of products in the form of passively managed bond funds. Secondly, the initiative has helped to promote market and regulatory reforms across the region to the benefit of all potential issuers and investors. Finally, the introduction into Asia of a new set of independent and replicable bond indices should constitute a substantial improvement to financial market infrastructure across the region.

Main Features of Asian Bond Fund

ABF1	ABF2
• Investment in US dollar-denominated sovereign and quasi-sovereign bonds.	• Investment in local currency-denominated sovereign and quasi-sovereign bonds.
• Investment in bonds of eight markets: China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand.	• Investment in bonds of eight markets: China, Hong Kong, Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand. Nine separate funds – one for each market and one, the PAIF, invests in bonds across each of the markets.
• Investment limited to EMEAP central banks. US$1 billion invested in July 2003.	• EMEAP invested US$2 billion in first half of 2005. Funds open to investment by external investors.
• Passively managed by BIS to benchmark.	• EMEAP investment held by BIS. Funds passively managed by private-sector fund managers to benchmark.

The Reserve Bank also hosted a meeting of the Working Group on Banking Supervision in April. Over time this Group has acted as a conduit for information between countries in the region on issues relating to Basel II. Matters discussed by the Working Group in 2004/05 included the degree of readiness of EMEAP members to implement the intensified supervisory review process associated with Basel II, as well as sharing experiences of home-host supervision. The Group held a seminar in Sydney in conjunction with the BIS Financial Stability Institute on the supervisory review process of the Basel II framework.

The Working Group on Payments and Settlement Systems undertook work in two main areas during the year. It examined members' experiences with business continuity planning for payment and settlement systems, with the emphasis on the system as a whole. A report on this work, which drew out common themes and lessons, was prepared and also circulated to members of the BIS CPSS. The second major area of work dealt with liquidity management in real-time gross settlement (RTGS) systems. The aim was to compare the means by which liquidity is provided in members' RTGS systems and to discuss indicators of system liquidity. It canvassed the means of dealing with a liquidity shortage in the system that might be triggered by a bank in difficulty.

International Monetary Fund (IMF)

One of the important functions carried out by the IMF is to benchmark the strengths and vulnerabilities of member countries' financial systems. This is undertaken through the IMF and World Bank's Financial Sector Assessment Program (FSAP). The Australian Government has volunteered to take part in an FSAP in the coming year. The assessment process will include analysis of economy-wide financial soundness indicators, stress testing of the financial system and Australia's compliance with international standards relating to banking supervision, securities regulation, insurance supervision, anti-money laundering and payment and settlement systems. The Reserve Bank will be involved in the assessment of payment and settlement systems, including a formal assessment against the *Core Principles for Systemically Important Payment Systems* as well as informal assessments of the *Recommendations for Securities Settlement Systems* and *Recommendations for Central Counterparties*. It is also chairing the working group responsible for co-ordinating the stress test of the financial system.

Preliminary work commenced early in 2005 with the establishment of an FSAP Steering Group, comprising the Reserve Bank, Australian Treasury, Australian Securities and Investments Commission and Australian Prudential Regulation Authority. This group will continue to meet on a monthly basis. In April 2005, the IMF undertook a 'pre-FSAP' mission to Australia, holding discussions with the various regulatory authorities and the private sector.

South Pacific Central Bank Governors

Each year, the Governors of the six island nations of the Pacific region which have their own currency (Fiji, Papua New Guinea, Samoa, Solomon Islands, Tonga and Vanuatu) meet with their counterparts from Australia and New Zealand. In December 2004, this meeting was hosted by the Reserve Bank in Sydney. Representatives from the Pacific Financial Technical Assistance Centre and the IMF also attended. At the December meeting there was a discussion of economic developments, focusing on key issues for the Pacific region, as well as internal audit and risk management in central banks, which has particular relevance as the island states strive to improve overall standards of governance.

Bilateral Relations and Assistance

Central bankers in developing countries often look to their colleagues in more developed countries to provide assistance in improving their performance across the range of central bank functions. The Reserve Bank has been a regular source of such assistance, especially to countries in the Asia-Pacific region. Mostly this involves occasional country visits with intermittent work and correspondence from Sydney. During 2004/05, two Reserve Bank staff members were involved in this kind of technical assistance, one working on the monetary policy framework of Papua New Guinea and the other on the payments and settlements system in Fiji. Both these projects are being undertaken in conjunction with the IMF. In addition, a Reserve Bank staff member has taken extended leave to work as an economist at the National Reserve Bank of Tonga.

Assistance is also provided to staff from overseas central banks visiting the Reserve Bank on both long- and short-term attachments. During the year, staff were received from the central banks of Indonesia, Korea, the Solomon Islands and Zambia. The Reserve Bank also assists by providing presenters at international conferences and seminars conducted by multilateral institutions, other central banks and academic institutions, and occasionally makes its training centre (the HC Coombs Centre for Financial Studies) available for such purposes. In June 2005, one such seminar was the annual APEC Future Economic Leaders' Think Tank. Sponsored by Axiss Australia, the Think Tank brings together policy practitioners in APEC economies to discuss regional economic and financial challenges. The seminar focused on the challenges posed by population ageing for APEC economies, and in particular the implications for fiscal policy, public finances and financial markets.

During 2004/05 the Reserve Bank commenced an exchange program of senior officials with the European Central Bank (ECB), involving short-term placements of two to three months. One official from the ECB spent time in Economic Analysis Department at the end of 2004, while a Reserve Bank staff member made a reciprocal visit for two months from May 2005, working on external developments in the Economics Directorate of the ECB.

Although the Reserve Bank does not have direct responsibilities for Australia's work in anti-money laundering and combating the financing of terrorism, its staff have a broad knowledge of the operations and activities of banking systems and financial markets. This means that it is well placed to provide experts to help with the review of institutional arrangements in other countries' efforts to meet international standards in these areas. Such reviews are carried out by the IMF and the World Bank and, on a mutual basis, by the Financial Action Task Force (FATF) as well as regional bodies, such as the Asia-Pacific Group on Money Laundering. Australia is a member of both these latter groups, and during the year a staff member participated in a review of Pakistan's efforts to combat money laundering and financing of terrorism. A member of staff is also assisting in a joint IMF/World Bank review of the reports that have been undertaken by the FATF and other such bodies to ensure the standards are being adequately and consistently applied. During March, the FATF also carried out a review of Australia's efforts to prevent money laundering and financing of terrorism. The Reserve Bank provided working facilities for the review team during its two weeks in Sydney.

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 transactional banking services to various government agencies;
- the operation of Australia's high-value payments and interbank settlement systems; and
- the supply of currency notes for distribution in Australia.

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. The Reserve Bank's transactional banking and registry services are provided 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.

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.

Banking

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

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. These banking arrangements include 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 Department of Finance and Administration manages this facility on behalf of the Australian Government.

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 payment arrangements. 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 and bulk direct entry 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. Account and transaction enquiries are also available over an internet-based delivery system known as *RBANet*. 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 communication network and warehousing capabilities, and is the main vehicle used for transactional banking activities by government customers. GDES transactions include welfare, Medicare, salaries and vendor payments; 255.7 million transactions were processed in 2004/05, an increase of 38.7 million or 18 per cent from the previous year. This volume increase was mainly the result of government policy initiatives and the splitting of Part A and Part B fortnightly family tax benefit payments.

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 the payments on behalf of Centrelink of Australian pensions to recipients living abroad, which are made directly to recipients' bank accounts in local currencies through Automated Clearing House arrangements, which the Reserve Bank has established in 22 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. The volumes of transactions processed via this service increased by 11 per cent in 2004/05.

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 over the telephone or internet or over the counter using cash, cheques and EFTPOS payments. The volume of over-the-counter collections increased significantly during 2004/05. The Reserve Bank also joined the BPAY system in June 2005 as a biller financial institution, preparing the way to offer payment collection services using the BPAY network from later in 2005.

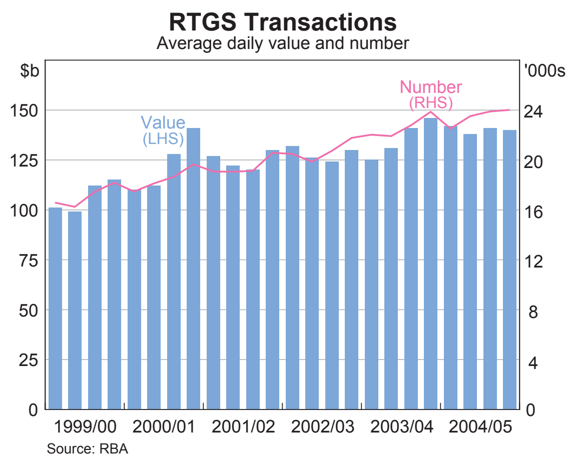
Earnings after tax in 2004/05 for the Reserve Bank's transactional banking services were $3.4 million, compared with $3.0 million in the previous year.

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 now 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 2004/05 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).

Interbank settlements take place across Exchange Settlement Accounts (ESAs) conducted by banks and other approved institutions with the Reserve Bank, and largely occur on a real-time gross settlement (RTGS) basis. About 90 per cent of the value of interbank payments is settled by RTGS; this includes all wholesale debt and money market settlements, a range of time-critical customer payments and Australian dollar foreign exchange settlements (including those settled by CLS Bank for which net settlement is made each day across RITS).

Following strong growth in 2003/04, RTGS turnover through RITS increased more modestly in 2004/05. On an average daily basis, around 23 500 payments totalling $140 billion were settled across RITS during the year. This represented growth of around 3.7 per cent and 3.2 per cent, respectively, on the corresponding figures for the previous financial year.

In addition to RTGS payments, RITS settles two batches of netted interbank payments each day: the 9:00 am batch consists mainly of positions collated by the Reserve Bank on behalf of the Australian Payments Clearing Association arising from the previous day's 'low-value' clearings (paper, and bulk and retail electronic). The second batch settles net positions for equity transactions in CHESS, the electronic settlement system operated by the Australian Stock Exchange.

RITS also provides a facility for members to participate in electronic tenders for CGS. Since February 2002, settlement of successful tender bids has occurred in the Austraclear System, owned by SFE Corporation Limited.

In 2005/06, the Reserve Bank expects to implement two significant enhancements to RITS:

- The first is a major upgrade to the user interface for on-line access to RITS, used by holders of ESAs to manage interbank payments across their accounts. The new interface is of a modern browser-based style, which will provide significant benefits to users of the system in terms of ease of operation and more efficient management of RTGS payments. It will also provide the Reserve Bank with a good technical platform for system support and future redevelopment. Members will be able to choose an implementation date for usage of the new interface that is convenient to them in the light of other priorities. It is expected that most members will be using the new interface by around the middle of 2006.
- The Reserve Bank has also been working for some time on the development of improved facilities for the net settlement of batches of related payments. Development of this facility has been completed and it is expected that processing of the CHESS batch for equities will be shifted to this new facility during the first half of 2006. Another potential use for this new facility is an initiative in various States to move towards electronic conveyancing and settlement of property transactions, to replace the current use of bank cheques.

Settlement services are also provided for financial market transactions undertaken by the Reserve Bank in the domestic securities and foreign exchange markets, and other transactions such as those relating to currency note lodgements and withdrawals. Settlement services are also provided to the Australian Government for its high-value transactions, including, for example, the settlement of tenders in CGS and the stock lending activities of the AOFM.

At end June 2005, 36 central banks and official institutions abroad were using the settlement and safe custody services provided by the Reserve Bank to settle their Australian dollar investment transactions.

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 banks for the distribution of notes;
- maintaining the quality of notes in circulation, including quality control for new notes, making arrangements with 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 2004/05 the value of Australian notes issued by the Reserve Bank rose by $1.6 billion or 4.7 per cent, to $35.6 billion. Among the different denominations, the $50 continues to account for the largest number of notes on issue as well as the largest value. Together, the $50 and $100 account for about 89 per cent of the value of notes on issue.

Volatility in the growth rate of the value of notes on issue in recent years has arisen from changes in the ownership arrangements for the cash-distribution working stocks. In 2001/02, working stock ownership was transferred from the Reserve Bank to the commercial banks, resulting in a large increase in notes on issue in 2002. As banks became more comfortable with the new arrangements, they economised on working stocks and there was only a small rise in 2003. Growth over 2004 and 2005 was more representative of underlying demand, at a rate broadly in line with growth in economic activity.

Value of Notes on Issue
($ million)

At end June	$5	$10	$20	$50	$100	Total[(a)]	Increase (per cent)
1999	379	639	1,850	10,356	10,282	23,552	8.8
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

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

Note Quality

The Reserve Bank pursues a goal of maintaining a high quality of notes in circulation, to ensure that notes remain fit for use (including in the growing number of note accepting and dispensing machines in the community) and that counterfeits 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 for replacement. In order to monitor note-sorting performance and its impact on note quality, the Reserve Bank conducts a program of sampling notes from those in approved cash centres; notes collected in the sampling program are transported to the Bank's NNPDC for evaluation.

In the past year, the Reserve Bank strengthened its work with commercial banks and armoured car companies to correct a decline in the quality of the lower denomination notes received in its sampling program and to improve further the general quality of notes in circulation. As a result of this work, some changes were made to the note-sorting standards and the arrangements between the commercial banks and the Reserve Bank to reduce the costs to banks of holding unfit notes awaiting return to the Reserve Bank. There was a consequent sharp increase – to 98 million, from 67 million in 2003/04 – in the number of notes returned by banks and armoured car companies designated as unfit. A working group, comprising representatives of the commercial banks and the Reserve Bank, has been formed to examine further existing arrangements between the commercial banks and the Reserve Bank for the identification and removal of unfit notes from circulation. The work of this group is likely to lead to a renegotiation of existing agreements between the commercial banks and the Reserve Bank, with the scope of the agreements widened to place the objectives for note quality into sharper focus.

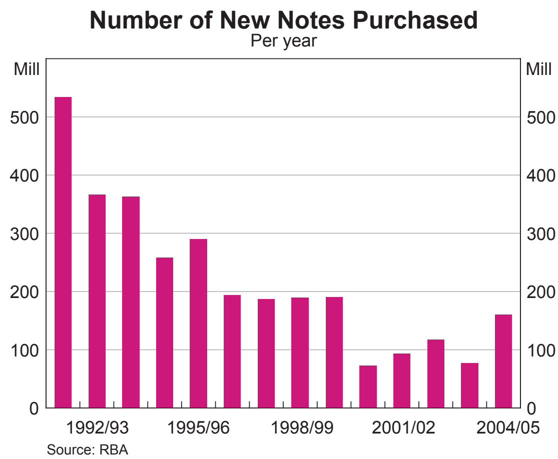
Work has also been completed during the past year for the upgrading of high-speed note-processing equipment at the NNPDC, incorporating improved detectors for identifying unfit notes. The new machines will enhance the Reserve Bank's monitoring of compliance with sorting standards by commercial banks and armoured car companies.

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 always had a policy of paying value for these severely damaged notes, depending on the amount of the note which remains recognisable and can be authenticated. 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 partial value is paid on each piece. These incomplete notes can be assessed manually by banks, although many are passed directly to the Reserve Bank for assessment, in which case the assessment is done at the NNPDC. During the year, the NNPDC assessed over 24 000 note claims, with a total value of $3.0 million. The volume of claims assessed was more than double the previous year's volume, but the total value was only 20 per cent higher.

As the emphasis on note quality was increased during the year, some confusion occasionally arose in the community about the differences between notes with normal wear and tear (for which full value would be paid) and those which are incomplete or have other severe damage (for which full value might not be paid, if large pieces were missing). This confusion appeared to result from a misunderstanding of the guide issued to commercial banks for their use in determining note fitness. The Reserve Bank moved to correct this situation through media interviews to clarify the policy on damaged notes as well as by providing clearer explanatory material on damaged notes to staff of commercial banks and to the public, including on the Reserve Bank's website.

New Note Orders

The Reserve Bank took delivery of a total of 160 million new notes in 2004/05 from Note Printing Australia; this amounts to 10 new notes for every person in Australia aged 15 years and over. This was made up of 42 million $5 notes, 34 million $20 notes and 84 million $50 notes. In 2004/05 the number of notes printed was about double that of the previous financial year, reflecting the desire to improve the quality of notes in circulation and to rebuild the Reserve Bank's new note stocks.



In recent years, the level of new note purchases has been considerably lower than was the case over most of the 1990s. In the first half of the 1990s, the replacement of paper notes with polymer required large new note orders, as did contingency plans for Y2K towards the end of the decade. The size of new note orders subsequently declined as the change to polymer was completed. The high durability of polymer notes also contributed to the decline in the magnitude of new note orders – as polymer notes last considerably longer in circulation than paper notes, fewer unfit notes are required to be replaced each year.

Distribution

Under the arrangements introduced in November 2001, whereby commercial banks own the working stocks of notes and coin required to operate the cash distribution system, the banks deal directly and actively with each other in order to manage short-term surpluses or deficits in their individual holdings of currency. Notes required to meet increased demand, typically at peak periods, and to replace unfit notes withdrawn from circulation, are purchased from the Reserve Bank and added to working stocks. Commercial bank holdings of working stocks over the past year have, on average, seen little change compared with the previous year.

The Reserve Bank operates a central distribution point for notes at the NNPDC. Armoured car companies transport notes to and from the NNPDC on behalf of the commercial banks. Under agreements with the commercial banks, unfit notes, surplus fit notes (following Christmas and Easter seasonal peaks in demand) and notes sought by the Reserve Bank for quality-assessment purposes are returned to the NNPDC. As surplus fit notes have already been sorted by banks, generally they are not re-sorted by the NNPDC. Commercial banks also draw notes from the NNPDC to meet demand when they cannot meet their requirements from their own holdings or from other banks. Notes that have been previously returned to the NNPDC by banks as surplus fit notes are used first in meeting banks' orders.

During 2004/05, 287 million notes ($9 billion) were issued (despatched from the NNPDC) and 256 million ($7 billion) were redeemed (returned to the NNPDC). This level

At times, the Reserve Bank needs to move currency notes between its storage points. Movements are tightly controlled and protection is provided by State police forces.

of activity was some 4 per cent higher than the previous year. Of the notes issued in 2004/05, 160 million were new notes and 127 million were previously circulated notes that were reissued after they had been returned to the NNPDC, processed as necessary and judged fit for reissue. Greater quantities of new notes were used by the NNPDC to meet orders in line with the Reserve Bank's aim for high-quality notes in circulation. Of the notes returned to the NNPDC, 216 million notes were returned for processing through high-speed note-processing equipment for verification, authentication and quality control. The remaining 40 million notes were surplus fit notes returned to the NNPDC by commercial banks after Christmas or Easter. During 2004/05, 205 million notes were processed, compared with 196 million notes during 2003/04. Notes deemed fit for reissue represented 45 per cent of notes processed, compared with 47 per cent in the previous year.

The Reserve Bank pays commercial banks interest forgone on their working stocks of notes and coin up to a specified amount, provided the stocks are held in approved cash centres and notes are sorted for quality. The sorting standard is set and monitored by the Reserve Bank. The Reserve Bank also bears the cost of producing new notes and costs associated with the return of unfit and sampling notes. All other costs associated with the distribution of cash are met by others, including commercial banks, retailers and the public.

Counterfeiting Activity

Counterfeiting activity remained low in 2004/05. The number of counterfeits passed was about 4 300, with a face value of about $220 700. Although an increase on 2003/04, when 3 600 counterfeits were passed, the number of counterfeits passed per million notes in circulation remained at around 5. By international standards, this is a very low rate of counterfeiting.

In 2004/05, around two-thirds of polymer series counterfeits were of the $50; the remainder were mostly $100 and $20 counterfeits. Almost all were reproduced on paper. Although many now include a simulation of the clear window in a genuine note, they are typically crude and the counterfeits are easily detected by visual inspection, as well as by feel. Notwithstanding the low level of counterfeiting activity, the Reserve Bank continues to conduct research to improve the security of polymer notes. The aim is to make counterfeits more difficult, time-consuming and costly to produce, and easier for the public to detect.

Note Printing Australia and Securency

Note Printing Australia

Note Printing Australia Limited (NPA), based at Craigieburn in Victoria, is a wholly owned subsidiary of the Reserve Bank producing currency notes, passports and other security documents for Australia and for export. It is the world pioneer in using polymer substrate and associated security features in manufacturing banknotes and it prints predominantly on Guardian® substrate manufactured by Securency Pty Ltd (see below).

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 (Managing Director and Chief Executive of Australian Business Ltd) and Frank Campbell (an Assistant Governor of the Reserve Bank). The Chief Executive of NPA is Chris Ogilvy.

During 2004/05, NPA produced 160 million notes for the Reserve Bank and 234 million export banknotes. Among the export deliveries were orders for Bank Negara Malaysia and Banco Central de Chile, which issued their first circulating polymer banknotes. NPA produced a further two new banknotes on polymer for the Brunei Currency and Monetary Board, and now all the commonly used banknotes in that country are on polymer. NPA also fulfilled repeat polymer banknote orders for the Reserve Bank of New Zealand.

For 2005/06, in addition to the Reserve Bank's requirements, NPA has confirmed orders for the production and delivery of 84 million export banknotes for countries in Asia and the Pacific. NPA was recently awarded a gold medal at the 22nd National Print Awards in the category of security printing for its Brunei $50 and $100 banknotes.

NPA transferred its in-house ink manufacturing facility to a commercial ink manufacturer as part of a new partnership agreement, which will ensure quality improvements and technological advancements in the ink manufacturing process. This new arrangement will further enhance the development of polymer banknotes worldwide.

NPA printed and assembled 1.4 million Australian passports during 2004/05 for the Department of Foreign Affairs and Trade. This complementary line of business has created a number of challenges for NPA, in particular the development and production of Australian 'e' passports, which will incorporate data stored on a chip. During the year NPA embarked on producing other secure documents, namely academic transcripts for a number of universities throughout Australia. Initial reaction to the academic transcripts has been very positive, with a number of enquiries received for further work in this area.

The National Note Processing and Distribution Centre (NNPDC), operated by NPA under contract from the Reserve Bank to process circulating Australian notes, has undertaken a major upgrade of its note-processing equipment. The installation of new equipment and training

NPA Polymer Notes Export Orders

Year of first issue	Customer	Denomination	Issue
1990	Singapore	50 Dollar	Commemorative
1991	Western Samoa	2 Tala	Circulating
1991	Papua New Guinea	2 Kina	Special Issue Circulating
1993	Kuwait	1 Dinar	Commemorative
1994	Indonesia	50 000 Rupiah	Special Issue Circulating
1995	Papua New Guinea	2 Kina	Special Issue Circulating
1996	Papua New Guinea	2 Kina	Circulating
1996	Brunei Darussalam	1, 5, 10 Dollar	Circulating
1996	Thailand	50 Baht	Commemorative
		500 Baht	Special Issue Circulating
1997	Thailand	50 Baht	Circulating
1997	Western Samoa	2 Tala	Circulating
1998	Sri Lanka	200 Rupee	Circulating
1998	Malaysia	50 Ringgit	Commemorative
1999	New Zealand	5, 10, 20, 50, 100 Dollar	Circulating
		10 Dollar Millennium Note	Commemorative
1999	Papua New Guinea	50 Kina	Circulating
1999	Romania	2 000 Lei	Commemorative/ Circulating
1999	Indonesia	100 000 Rupiah	Circulating
2000	Romania	10 000 Lei	Circulating
2000	Romania	500 000 Lei	Circulating
2000	Papua New Guinea	2, 10, 50 Kina	Special Issue Circulating
2000	Papua New Guinea	10 Kina	Circulating
2000	Bangladesh	10 Taka	Circulating
2001	Kuwait	1 Dinar	Commemorative
2001	Solomon Islands	2 Dollar	Special Issue Circulating
2002	Mexico	20 Peso	Circulating
2002	Nepal	10 Rupee	Circulating
2003	Papua New Guinea	20 Kina	Commemorative
2003	Vietnam	50 000 Dong	Circulating
2004	Singapore	10 Dollar	Circulating/ Commemorative
2004	Brunei Darussalam	50, 100 Dollar	Circulating
2004	Chile	2 000 Peso	Circulating
2004	Malaysia	5 Ringgit	Circulating

of staff has adversely affected throughput rates for the year; however, these are expected to improve in 2005/06.

A new occupancy agreement with the Reserve Bank was negotiated for the Craigieburn facility. This is consistent with NPA's focus on core business activities under its 'Back to Basics' strategy, where attention is focused on quality and product delivery, and where non-core activities are outsourced. NPA has also worked closely with the Reserve Bank in the area of information technology as NPA embarks upon replacing its existing system with a new fully integrated Enterprise Resource Planning system, which is expected to be operational in the latter half of 2005.

NPA has continued to work closely with Securency on research and development, marketing and customer support. PolyTeQ Services, a joint initiative of NPA and Securency, conducts the formal technology transfer program and training for printworks converting from paper to polymer banknotes.

Securency

Securency Pty Ltd was formed in 1996 as a joint venture between the Reserve Bank and Belgium-based UCB group. On 30 September 2004 Innovia Films, owned by a consortium led by Candover PLC, a leading UK private equity company, acquired UCB's films division, including the interest in Securency.

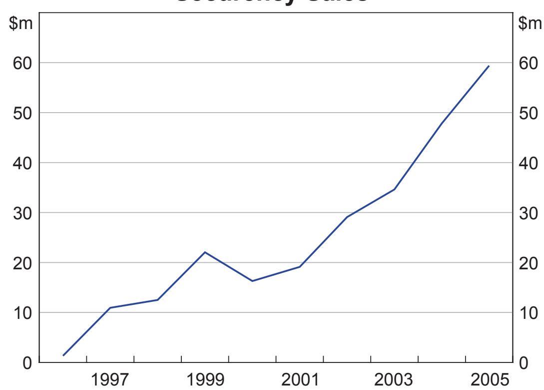
Securency supplies its press-ready Guardian® polymer substrate to NPA and to printers for banknotes abroad, Sentinel® for other high-security documents such as land titles, and Sentrii® for secure cards. These products are produced by applying unique coatings and security features to specialised films produced by Innovia.

Securency'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. Securency's offices and plant are located at Craigieburn, on the same site as NPA and adjacent to the films plant that supplies it.

The outlook for Securency looks increasingly promising after a long period of market-building. Recent repeat orders from several countries indicate a high degree of customer satisfaction.

In 2004/05, Securency produced Guardian® substrate for a range of banknote denominations in Australia, Brunei Darussalam, Chile, Malaysia, Nepal, New Zealand, Romania, Vietnam and Zambia. These included both repeat orders and new customers. The State Bank of Vietnam has announced that it will convert all its denominations to polymer.

Securency Sales*



* Estimate for 2005
Source: Securency

Five new denominations were launched on Guardian® polymer substrate in the 2004/05 financial year. This includes the Brunei $50 and $100 for Brunei Darussalam, the 100 000 dong for Vietnam, the 2 000 peso for Chile and the 5 ringgit for Malaysia. Additionally, Banco de Mexico has announced that it will issue its 50 peso banknote on polymer in 2006.

Chris Ogilvy, Chief Executive of Note Printing Australia, and Myles Curtis, Managing Director of Securency Pty Ltd, at the launch of the 2 000 peso polymer note in Santiago, Chile in September 2004.

The National Bank of Romania will issue a new series of the Leu printed on Guardian® polymer substrate during 2005. In all, 23 countries have now issued polymer banknotes, with representatives on all continents. Australia, New Zealand and Romania have converted all their denominations to polymer.

To broaden its market, Securency has successfully marketed polymer substrate for secure documents. Sentinel® substrate was produced for a land title for Taiwan and for education certificates for both Australian and Vietnamese universities.

During 2004/05, Securency received the Austrade Business Entrepreneurial Award for its work with the State Bank of Vietnam. This award recognises Australian businesses that have made a significant business breakthrough in developing business opportunities during the year. Additionally, Securency was awarded a gold medal for innovation, for the 100 000 dong, at the 22nd National Print Awards. This note comprises high-security features including the DOE™, which has been an integral security feature on all three Vietnam notes issued to date.

The Reserve Bank in the Community

Accountability

An important aspect of the Reserve Bank's accountability is its twice-yearly appearances before the House of Representatives Standing Committee on Economics, Finance and Public Administration. In 2005 the Governor and senior officers testified at hearings of the Committee in Sydney in February and in Melbourne in August. The hearings covered a wide range of issues, including the domestic and international economic outlook, inflation, the household sector, microeconomic reform, payments system reform, central bank governance and, of course, interest rates.

These hearings are given substantial media coverage and over the years have been held in various locations throughout the country. They are in addition to the long-standing requirement to provide Parliament with an annual report and financial statements.

The *Statement on Monetary Policy* is published quarterly, providing 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 provide information to the financial markets, media and the wider community on the Reserve Bank's thinking on monetary policy matters as well as being a basis for the Parliamentary Committee's questioning. A media lock-up is provided, which allows journalists to review the statements under embargo prior to publication.

Communication

In addition to the formal requirements, senior members of staff make speeches and presentations during the course of the year. During 2004/05, the Governor and senior officers spoke in Australia and abroad on topics such as the economic conjuncture and outlook, and on specific topics such as reform of the payments system and problems of statistical analysis and forecasting.

Published monthly, the Reserve Bank *Bulletin* is a record of media releases and comprehensive statistics, plus articles on numerous topics; in the past year, these included oil market developments, Australia's international trade, international capital markets and banking fees. In addition, it contains the more important speeches made by senior staff during the year.

The *Financial Stability Review* is published twice a year, in March and September. It gives a detailed assessment of the overall condition of Australia's financial system, focusing on potential risks to its strength and stability.

Research work conducted by staff is made available to the broader community through the *Research Discussion Paper* (RDP) series. Eleven RDPs were published in the past year, covering topics such as the profitability of the Reserve Bank's foreign exchange operations, the links between monetary policy and financial markets, housing investment cycles, trade and property ownership decisions. While this work is primarily of interest to professional economists, non-technical summaries of some of these papers are published in the *Bulletin*, making their findings accessible to a wider audience. Many of the RDPs focus on questions of relevance to monetary policy, though the views expressed are those of the authors rather than the Reserve Bank, with the aim of encouraging discussion and comment among researchers in these fields.

In addition to producing discussion papers and related *Bulletin* articles, staff publish work in journals in Australia and abroad. Examples of publications over the past year include journal articles on central bank foreign exchange intervention, household debt and financial constraints, and the co-ordination of monetary policy across countries.

As has been the case since 1989, the Reserve Bank held an annual two-day economic research conference in Sydney. These conferences bring staff together with leading academics, financial market experts and senior staff from central banks around the world to discuss a topic of general interest. The theme of the most recent conference was *The Changing Nature of the Business Cycle*.

The Reserve Bank publishes all this information in both electronic and hardcopy formats. While hardcopy publications remain important in meeting the needs of users, use of the website continues to grow strongly. Over 2004/05, the number of subscribers to the free email service for information posted on the website grew by over 20 per cent to nearly 10 500; this compares with around 1 000 subscribers for the hard copy *Bulletin*, about 10 per cent lower than a year earlier.

The Reserve Bank chairs the 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. 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 Office program. The Regional Offices, which are located across the country,[3] 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. A second role is representation, where the presence of Reserve Bank staff in regional locations is intended to improve communication with the wider community.

The liaison function of the Regional Offices ensures that staff interact with a broad cross-section of the community. The Reserve Bank has developed a pool of over 1 500 contacts with whom liaison is conducted. The bulk of these contacts represent individual businesses, though another valuable part of the program is in liaison with industry associations and government agencies. With the program now well established, many contacts participate in regular meetings with Regional Office staff. Liaison has grown steadily over the past few years, and has now levelled out at interviews with around 100 contacts per month.

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

In addition to their interaction with businesses and other agencies, Regional Office staff are often the first point of contact with the Reserve Bank for the 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. Most of these have been to teachers' associations and students (from both high schools and universities), though many have been to industry bodies. The presentations have generally been about the framework for monetary policy or current economic conditions. Other staff from Head Office have travelled interstate and given presentations on published research work.

The Reserve Bank's presence in the community has also been elevated by the hosting of functions in the Regional Offices. The Queensland, Victorian and Western Australian Offices have hosted Reserve Bank Board meetings, and a Board meeting is planned for the South Australian Office later in the year. Presentations on the *Statement on Monetary Policy*, which have become a regular event in all State capitals, are given by senior managers, who communicate the main themes of the *Statement* to liaison contacts as well as engage in discussion with participants.

Museum of Australian Currency Notes

During the year, a Museum of Australian Currency Notes was completed. Officially opened in late February, the museum tells the story of our currency notes against the backdrop of Australia's broader history. Visitors can inspect all the main series of notes from the first series in 1913-15 through to the advent of polymer notes, which has placed Australia at the forefront of

The Museum of Australian Currency Notes is located at the Macquarie Street end of the Sydney headquarters building in Martin Place. Great care was taken to integrate museum design and construction with the marble and granite structures of the original, heritage-listed building (below and overleaf).

Some of the displays inside the museum (above). Photograph courtesy of John Gollings.

currency note development. The museum also displays some of the intricate artwork used in the notes and provides information on the men and women represented on our notes over the years. Displays of archival film and photographs help visitors experience some of the key episodes in the history of the notes.

So far, over 3 000 people have visited the museum, entry to which is free of charge. Tours and talks on the museum are available on request and these are becoming increasingly popular with school groups. The content of the museum is also available on the Reserve Bank's website (www.rba.gov.au/museum), which has received about 35 000 visitors since early March 2005.

Financial Assistance for Economic and Financial Research and Education

The Reserve Bank provides assistance for a variety of research 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 Australian Centre for Industrial Relations Research and Training at the University of Sydney. The Reserve Bank also contributed funds to support the research activities of the Centre for Applied Macroeconomic Analysis at the Australian National University.

Scholarships under the Elite Executive Honours Scholarship Program, organised by Axiss Australia, the government agency charged with positioning Australia as a global financial services centre, were again supported during 2004/05. This year, the two scholarships funded by the Reserve Bank under this program were for study at the Australian National University and the University of Queensland. In conjunction with the Australian Prudential Regulation Authority

(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; four scholarships were awarded under this program for 2005, to two Honours students in actuarial studies at the University of Melbourne, an Honours student in commerce at the University of Western Australia and a PhD student in economics at the University of Queensland.

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 2004/05, these conferences included the annual Conference for PhD Students in Economics and Business, held this year at the Australian National University, the Economic Society of Australia's 33rd Conference of Economists, held at the University of Sydney, and the University of New South Wales' 17th Australasian Finance and Banking Conference.

Along with a number of other central banks, the Reserve Bank made a contribution to the International Accounting Standards Committee Foundation; this was the fifth instalment of a five-year pledge to the Foundation by the Reserve Bank.

Charitable Donations

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 a broad range of medical problems and disabilities. In addition, the Reserve Bank made its third 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 seven years.

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 & Diversity Annual Report 2004 was tabled on 17 November 2004, and included a review of the Reserve Bank's Disability Action Plan.

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 Licensed Authority under the *Safety, Rehabilitation and Compensation Act 1988*, to report each year on matters of health and safety, workers' compensation and rehabilitation as they affect the Reserve Bank.

The Reserve Bank's licence to self insure and manage workers' compensation claims is current until 30 June 2007, as is the Bank's agreement with Australia Post for it to undertake reconsiderations of workers' compensation determinations made by Reserve Bank delegates. Both the number of OH&S incidents reported (78) and claims determined (18) declined slightly from 2003/04, with the majority again occurring away from the workplace, namely during travel or lunchtime sport. Three requests for reconsideration of the Reserve Bank's workers' compensation determinations were received in the period; two affirmed the primary determination and one is pending. In terms of Section 68 of the *OH&S Act*, four incidents were notified to Comcare in the period; two related to absences of 30 days or more and two to dangerous occurrences. All were investigated and preventative actions taken to the satisfaction of the Reserve Bank and Comcare.

The Safety Rehabilitation and Compensation (SRC) Commission approved self-audit status in OH&S for the Reserve Bank on 16 September 2004, confirming the maturity of the Reserve Bank's OH&S management systems. Three audits were undertaken by independent auditors at the end of 2004 – two in OH&S and another in the claims management and rehabilitation functions. These audits showed no areas of non-compliance, with either the relevant legislation or the Reserve Bank's conditions of licence. The Reserve Bank's performance measured by the audit program and against SRC Commission indicators was reported to Comcare in March 2005 in the Reserve Bank's annual report on its Management Systems Review and Improvement Program. This report demonstrated a healthy workplace environment and evidence of continuing improvement.

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 organisational chart appears at the end of this Report.

Categories of documents: Lists of publications, including speeches, articles, occasional papers, information booklets, conference volumes, regular media releases and other publications are published from time to time in the Reserve Bank *Bulletin*. These publications, as well as other information about the Reserve Bank, are also available on our 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 Reserve Bank is an exempt agency under the *Freedom of Information Act 1982 (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 (in Head Office), the Senior Representatives in the Regional Offices (in Adelaide, Brisbane, Melbourne and Perth) or the Manager of the Branch (in Canberra). Applications should be accompanied by the application fee (currently $30). Facilities to inspect documents to which access has been granted are available.

Section 93 statement

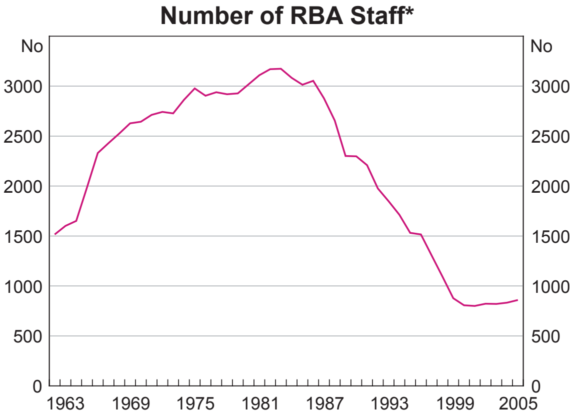
One request, from a media organisation, for access to documents under the *FOI Act* was received in 2004/05, and was still in progress at the end of the year. By comparison, seven requests were received in 2003/04. While the number of requests received by the Reserve Bank in recent years may seem relatively small in comparison with those received by some other Australian Government agencies, the scope of the individual requests is sometimes very extensive and requires a large commitment of staff resources, including those of senior management, to meet. For instance, during 2004/05 substantial resources were engaged in work relating to a number of aspects of a request that arose in the previous financial year. The estimated number of staff hours spent dealing with all aspects of FOI requests in 2004/05 was around 240 hours, almost entirely related to the request that continued from 2003/04; staff hours in 2003/04 amounted to almost 500 hours.

An application for internal review that was received during 2003/04 (relating to a request that had been denied in part) resulted in a denial of the request.

The total cost to the Reserve Bank of administering the *FOI Act* in 2004/05 was estimated to have been $420 945, compared with approximately $125 830 in 2003/04. An application fee of $30 was collected in the year; there were no other charges.

Management of the Reserve Bank

Staff numbers rose in 2004/05 with an increase in graduate recruitment, mainly in the policy areas. In addition, more resources were devoted in Note Issue to monitoring the quality of currency notes, and in IT to short-term, project-related work. As the Reserve Bank resumed operational responsibility for facilities at NPA, there was a small increase in related staff, although this was more than offset by a reduction in maintenance staff at NPA. Overall, staff numbers rose from 833 at 30 June 2004 to 860 at 30 June 2005.



* As at 30 June, excluding NPA
Source: RBA

Staffing policies continue to be reviewed to ensure that staff with appropriate qualifications and of the required standard are attracted and retained. Reflecting the focus on financial policy, the Reserve Bank's recruitment efforts are concentrated on university graduates of the highest quality in disciplines that are directly relevant to monetary policy and financial system stability. With the growing operational importance of IT systems and financial reporting, the Reserve Bank has more recently also sought graduates of high quality in these disciplines. In recognition of the competition for well-qualified recruits, considerable effort is directed to maintaining strong relationships with universities, professional associations and graduate communication networks.

Forty graduates, representing a third of all new employees in 2004/05, began the Reserve Bank's two-year Graduate Development Program. These graduates were employed mainly in policy areas. Twenty-nine staff completed the Graduate Development Program in 2004/05, all of whom were offered and accepted ongoing employment.

The Cadetship scheme has been particularly effective as a recruitment vehicle. This program provides two months of work experience, before the university honours year begins, for high-potential students who have completed three years of undergraduate study. The program provides financial support during the honours year for those who accept a place on the next Graduate Development Program. In 2004/05, 16 of the new graduates had previously been cadets.

While the intake for other positions at junior levels has been relatively low for a number of years, such positions are often filled by trainees who have completed the Australian Governments' New Apprenticeship and Traineeship System, in which the Reserve Bank participates. In 2004/05, five of the seven graduates from this program, which combines on-the-job training with classroom learning, were offered and accepted permanent employment. Fourteen new trainees, including in IT and print design, have recently commenced the 2005 scheme.

Formal and informal training and development programs are aimed at improving the skills of staff; more than half already have degree qualifications and almost a fifth have post-graduate qualifications. Employees who seek to improve their qualifications are supported in a number of ways, including through the Post-Graduate Study Award (PGSA) Program, which provides financial assistance to a few of the most capable staff to allow them to undertake full-time post-graduate study in relevant disciplines at universities in Australia and abroad. At 30 June 2005, six staff were studying overseas under the PGSA Program. Employees who receive these awards are required to reimburse costs if they resign during the term of the award or if they leave the Reserve Bank before completing an agreed period of work after they return from their studies. Financial assistance to obtain relevant qualifications via part-time study is also available. Eighty-one members of staff were supported in this way during the year, the majority seeking post-graduate qualifications. Tuition fees are met on the successful completion of course subjects.

The performance management process encourages managers and supervisors to identify training and development needs of individual employees. A high level of investment in internal and external vocational training is maintained. Transfers to overseas and regional offices, and to other organisations, provide broader experience and develop skills. During 2004/05, there were secondments to the BIS, ECB, Bank of England, Australian Treasury, Australian Taxation Office, APRA and its counterpart in the UK, the Financial Services Authority.

Staff turnover and retention rates continue to be monitored closely, particularly for graduates, to help ensure a sound return on the investment in training and development. Turnover of graduates in the Reserve Bank is similar to that for graduates in comparable organisations.

A key factor in attracting and retaining staff of suitable calibre is the ongoing process of reviewing the terms and conditions of employment. Almost 80 per cent of staff in the professional and managerial stream are now employed on individual contracts, which provide greater flexibility to match remuneration with responsibility and performance. Short-term contracts are also used to recruit staff when the need is specialised and not expected to be ongoing. Nineteen IT staff, for example, are employed on short-term contracts. The move to individual contracts for staff is voluntary. No staff member on contract has a housing loan from the Reserve Bank. Comparison of remuneration with positions of similar responsibility in the private sector is based on advice from remuneration consultants, with market benchmarking undertaken through participation in industry-based salary surveys.

For other staff, the enterprise bargaining agreement (EBA) provides the basis for changes to remuneration and other employment conditions. The most recent agreement provides greater scope than in the past to reward staff according to performance within existing budget constraints. Staff covered by this agreement received an annual salary increase of 4 per cent in November 2004, and were eligible for a performance payment. Staff on contract received, on average, the same annual increase as staff covered by the EBA. Discussions are currently under way for the next enterprise bargaining agreement.

The Reserve Bank participates in a joint-venture early childcare facility in the Sydney CBD. Children of Reserve Bank staff are shown with one of the parents (Stephanie Weston, Senior Manager, Payments Policy Department).

A key initiative this year was the participation by the Reserve Bank in a joint-venture childcare facility in the Sydney CBD. This facility provides 20 places for pre-school-age children of staff. Management of the centre is contracted to a specialist, non-profit company, which has been involved in early childhood education for many years. The conditions of the joint-venture agreement satisfy relevant taxation tests for staff to pay for the childcare from pre-tax salary. A Parent Room has also been established in Head Office to assist staff, especially with very young children. Another initiative to assist with caring responsibilities has been the replacement of existing sick and carer's leave arrangements with a combined entitlement, allowing staff to take up to 10 days leave per year for caring purposes. This is in addition to existing arrangements for paid maternity leave and part-time work.

Operating Costs

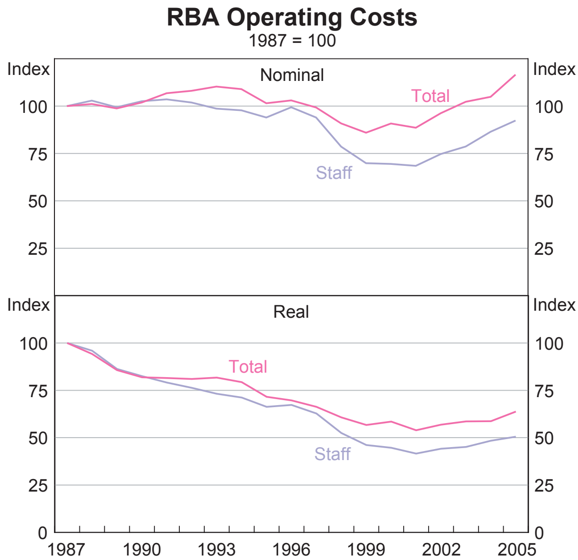
Several factors worked to increase operating costs in 2004/05, including a number of upgrades to important operating systems. The major improvements include replacement of the trading system for both international and domestic transactions with an integrated trading, settlements and accounting system; and further development of RITS, the core of the high-value interbank payments system, to enhance its access, security and backup functions. These projects will continue into 2005/06. The leasing of space for a temporary business resumption site, and preparatory work for construction of a permanent site, due to be commissioned in mid 2007, also added to costs. In addition, the Reserve Bank incurred expenses of about $3½ million on litigation in relation to payments system reform proposals. If the Reserve Bank successfully defends these proposals, it could recover some of these costs.

Operating Costs[(a)]
($ million)

	1997/98	1998/99	1999/00	2000/01	2001/02	2002/03	2003/04	2004/05
Staff costs	77.7	69.1	68.7	67.7	73.9	77.8	85.5	91.4
Other costs	47.2	49.1	56.1	54.1	58.4	62.7	58.6	68.8
Underlying operating costs	124.9	118.2	124.8	121.8	132.3	140.5	144.1	160.2
Cost of redundancies	20.7	18.4	9.3	2.6	3.4	2.6	0.2	0.2

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

The rise in staff costs reflected an annual increase in base salaries of 4 per cent in November 2004, plus some performance payments. Average staff levels in 2004/05 were slightly higher than those of the previous year. While nominal staff costs remain about 10 per cent less than their level at the peak in 1990/91, in real terms they are still around half their peak.



Source: RBA

The core policy areas of monetary policy and financial system surveillance account for more than half of the Reserve Bank's costs, a higher share than was typical until recent years. The apparent shift in resources towards policy areas mainly reflects the fact that note issue and banking operations are now much smaller in absolute terms than they were, although there has also been some increase in resources in the monetary policy and financial stability areas. Policy groups aside, the remaining costs are now spread fairly equally between note distribution, banking and registry operations, and the provision of settlement services, including the in-house operation of RTGS. (Details on these activities are provided in the chapter on 'Business Services'.)

Facilities Management

The Reserve Bank owns a number of properties in Sydney, Melbourne and Canberra for business reasons, and also leases premises for regional representation in Adelaide, Brisbane and Perth. Within Head Office, all of the vacant space made available by the recent consolidation of functions has now been leased on commercial terms to tenants, earning gross rental income of about $1.9 million in a full year.

As noted in the chapter on 'The Reserve Bank in the Community', the construction phase of the Museum of Australian Currency Notes was successfully completed and the museum was officially opened in late February 2005. The museum is located on the ground floor of Head

Office and provides a high-quality display, with strict environmental controls to protect and conserve the exhibits, and a multi-purpose meeting room. There is improved access for people with disabilities, both to the banking chamber and the museum.

In late 2004, contracts were exchanged for the purchase of 1.48 hectares of vacant land in outer metropolitan Sydney on which to construct a business resumption site. Following the exchange of contracts, a design team was appointed to prepare a concept design for the facility. In accordance with the provisions of the *Public Works Committee Act 1969*, the project was referred to the Parliamentary Standing Committee on Public Works for consideration and report. The Committee's report, which followed a public inquiry, recommended that the works proceed at an estimated cost of $38 million. The recommendation was endorsed by Parliament in late June 2005. This endorsement has enabled contract documentation to commence for an anticipated start to construction early in 2006.

The Reserve Bank has established a number of environmental policies and programs that assist in reducing waste and the use of energy and other resources. Over the past decade, the Energy Management Program has led to a reduction in energy consumption in line with targets of the Australian Government. Other environmental initiatives, including enhanced waste-paper recycling practices, have also been adopted and included in procurement policies.

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 is a person or organisation that investigates particular issues and then provides independent advice.

Consultancies[(a)]
2004/05

Name	Project	Cost ($, excl GST)	Purpose
Mallesons Stephen Jaques	OH&S Liabilities	10 774	Legal advice on the OH&S Act 1991
Hay Group Pty Limited	RBA Personnel	48 909	Market testing of remuneration of RBA staff
Clayton Utz	Reform of EFTPOS System	120 433	Legal advice on reform of the EFTPOS system
The Asset Partnership	NPA Passport Production	53 600	Risk review of passport production
Mercer Human Resources Consulting	NPA Personnel Practices	38 200	Market benchmarking of NPA remuneration

(a) Costing $10 000 or more

Risk Management

Objectives and Governance Structure

The Reserve Bank encounters a range of risks in fulfilling its responsibilities. The largest of these, in financial terms, flow from its market operations and the holding of assets needed to underpin those operations. There are also various operational risks that affect all parts of the organisation to differing degrees; these vary from personnel and information-management issues, which may be specific to individual areas, to events such as the loss of access to Head Office, which would affect the whole organisation.

The Reserve Bank cannot eliminate all the risks it faces. Rather, it manages these risks with a view to containing them to levels that are consistent with the satisfactory fulfilment of its public policy responsibilities. Underlying this approach is the principle that risk management is an integral part of the management function in the organisation. As such, the prime responsibility for controlling and mitigating risk on a day-to-day basis rests with line management of the respective functional areas.

These arrangements for risk management are overseen by a Risk Management Committee, which comprises the Deputy Governor, who is Chairman; the Assistant Governors of Financial Markets, Business Services and Corporate Services; the Heads of Audit and Risk Management; and the Bank's General Counsel and Deputy Secretary. The Committee is mainly responsible for ensuring that the full spectrum of non-policy risks – particularly those that extend over more than one functional area – are managed properly across the organisation. The Committee meets at least quarterly and keeps the Audit Committee apprised of its activities; it makes a formal report to the Reserve Bank Board annually.

Assisting the Risk Management Committee in its work is a small Risk Management Unit. Besides this role, the main tasks of the Unit are to facilitate, co-ordinate and advise on the risk-management process, to help Groups and Departments manage their risk environment in a manner that is broadly consistent across the organisation. Although the Unit remains separate from Audit Department, risk-management work in the two areas is closely co-ordinated. More generally, the internal-audit process supports the overall risk management strategy by providing independent assurance on the Reserve Bank's risk management and control systems. Audit Department reports directly to the Audit Committee, which meets quarterly (see the chapter on 'The Reserve Bank Board and Governance').

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

Balance Sheet Risks

The Reserve Bank is exposed to three main risks related to its balance sheet, namely credit risk, interest rate risk and exchange rate risk. The primary responsibility for managing these risks lies with Financial Markets Group. A comprehensive framework of controls is in place to ensure that these risks are managed in accordance with the objectives and guidelines approved by the Governor and the Board. This framework includes a clearly defined and documented delegation structure, detailed procedures manuals, a well-defined benchmark for the foreign reserves portfolio, and limits on open positions and counterparty exposures. 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.

Credit Risk

Credit risk is the potential for financial loss arising from the default of a debtor or issuer. For the Reserve Bank, credit risk arises from exposure to the issuers of securities held as assets, the banks with which funds have been deposited and the counterparties with which transactions have been undertaken. By confining its dealings to highly creditworthy counterparties and by holding only highly rated securities, the Reserve Bank's overall credit exposure is low in comparison with that of a typical private financial institution. Details of credit exposures are given in Note 18 to the Financial Statements.

In the case of the Reserve Bank's foreign currency portfolio, credit risk is limited by investing primarily in securities issued by the US, German, French and Japanese governments. These securities have Aaa credit ratings, apart from those issued by the Japanese government, which are rated Aa2. The credit risk on foreign currency deposits is managed by placing deposits only with banks with a high credit rating (a short-term rating of P-1 and a long-term rating of Aa3 or above) and by imposing limits on the amount that can be deposited with each bank.

As noted in the chapter on 'International Financial Co-operation', during 2004/05 the Reserve Bank invested in the second phase of the Asian Bond Fund initiative (ABF2), following its earlier investment in ABF1. While the ABF2 portfolio includes securities of lower credit rating than those otherwise held as foreign reserves, the average credit rating of the investment is still relatively high, at A2. Also, the ABF investments represent only a small portion of foreign currency reserves.

Within the domestic portfolio, as noted in the chapter on 'Operations in Financial Markets', the ongoing consolidation of the market for CGS has seen the Reserve Bank broaden its holdings of other securities. The range of securities eligible for domestic repurchase agreement transactions was widened to include bank bills and CDs in March 2004; holdings of these securities grew to $4.7 billion as at June 2005, from $4.1 billion a year earlier. Holdings under repo of State government paper have also increased, while holdings of CGS under repo are little changed.

In addition to the broadening of repo collateral, the range of securities held outright now includes securities of State and Territory central borrowing authorities. The Reserve Bank currently holds about $1.3 billion of semi-government securities on an outright basis, all of which are rated Aa1 or higher. Outright holdings of CGS have continued to decline.

The Reserve Bank may deal with a counterparty across a variety of financial products and the exposure to a given counterparty is measured so as to capture all transactions with that party. For the foreign currency portfolio, a single limit on the absolute exposure to each

Domestic Portfolio Holdings
($ billion)

	June 2003	June 2004	June 2005
Outright holdings[(a)]			
– CGS	4.7	3.7	3.1
– State and Territory central borrowing authorities	–	1.0	1.3
Repurchase Agreements			
– CGS	7.2	4.6	4.5
– State and Territory central borrowing authorities	6.7	4.2	6.9
– Supranational organisations	0.4	0.1	0.1
– Bank bills and CDs	–	4.1	4.7
– Foreign sovereigns and government agencies	–	0.6	0.4

(a) Includes securities sold under Sell repos

counterparty is imposed, in accordance with the institution's financial strength, credit rating and the size of its capital base. Counterparty limits are reviewed on a regular basis and adjusted immediately following changes to credit ratings.

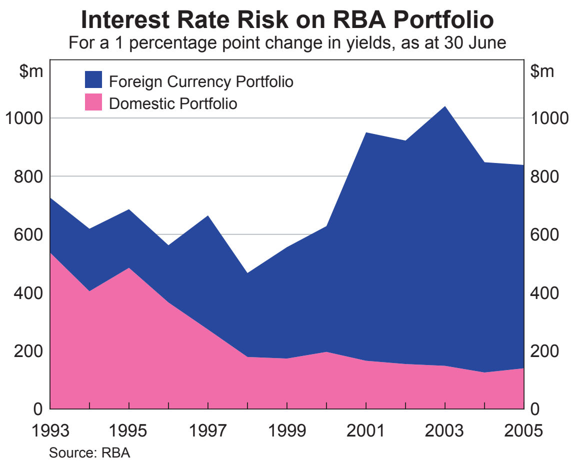
The Reserve Bank also has some credit exposure arising from its repurchase operations in both the domestic and foreign portfolios. A loss would arise if a counterparty failed to repurchase securities it had sold to the Reserve Bank and the market value of these securities had fallen to less than the value of the cash consideration. This risk is managed by requiring that the initial position be over-collateralised, the collateral be revalued daily and that counterparties supply additional securities once the market value of the collateral falls below the required amount. Credit exposure on foreign repurchase agreements is further controlled by imposing limits on individual counterparty exposures.

Delivery-versus-payment for domestic and foreign securities transactions eliminates intraday settlement risk for outright transactions and repurchase agreements. However, settlement risk on foreign exchange transactions still arises because the two legs of the foreign exchange transaction are settled in different time zones, requiring the Reserve Bank to pay out funds well before it receives any funds in return. This risk is controlled by restricting foreign exchange transactions to certain counterparties and by imposing a limit on the total value of foreign currency transactions allowed to settle on a given day with those counterparties.

Interest Rate Risk

The Reserve Bank's assets are mainly financial assets, such as domestic and foreign fixed-income securities. The value of these assets is subject to movements in domestic and foreign market yields. Since the income stream from these securities is fixed, a rise in market yields results in a fall in the value of these securities. Securities that have a longer maturity (or duration) contain a greater degree of interest rate risk, as cashflows further in the future are more sensitive to discounting than are near-term cashflows.

Around one-quarter of the Reserve Bank's assets are invested in domestic securities. Of these, a large portion is invested in relatively short-term repurchase agreements, with the result that interest rate risk on domestic assets is quite small. Furthermore, the overall exposure to a change in domestic interest rates is reduced by the presence of liabilities that also pay a domestic short-term interest rate, as these provide an offset. During the past year, the purchase of longer-term holdings of semi-government securities saw some rise in the interest rate risk on the domestic portfolio, but this risk nonetheless remains low by historical standards.



The overall level of interest-rate risk on foreign assets, measured by the duration of the foreign currency portfolio, has been set at 30 months, a level that meets the Reserve Bank's long-term risk and return preferences.

Across the balance sheet, including domestic and foreign assets, the Reserve Bank would suffer a capital loss of about $800 million if interest rates in Australia and abroad were to rise uniformly by 1 percentage point.

Exchange Rate Risk

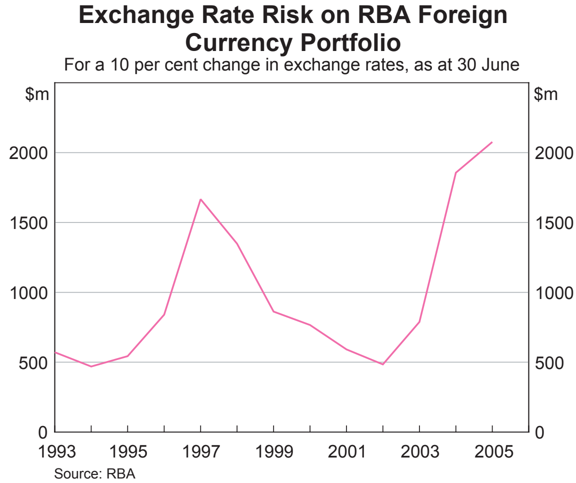
As the holder of Australia's reserve assets, the Reserve Bank is required to maintain a portfolio of foreign currency assets. These are exposed to exchange rate risk as their value, when measured in Australian dollars, varies with movements in the exchange rate between the currency in which the assets are denominated and the Australian dollar.

Holdings of foreign currency are largely determined by intervention operations and cannot be separately managed. If carried out effectively, however, intervention operations themselves serve to mitigate the level of exchange rate risk (even though that is not their main purpose). This is because they involve selling foreign exchange when the Australian dollar is undervalued, so foreign exchange risk on the balance sheet tends to be lowest when the exchange rate is relatively low and therefore most likely to appreciate.

The risks in holding foreign currency are also reduced by diversifying holdings across three currencies. Forty-five per cent of foreign exchange is held in the US dollar, 45 per cent is held in the euro and 10 per cent is held in the Japanese yen. The benefit, in terms of risk reduction, from this diversification is illustrated by the fact that over the past four years the US dollar has depreciated by 34 per cent against the Australian dollar, whereas the basket of currencies held in the portfolio depreciated by only 20 per cent against the Australian dollar.

A portion of foreign assets is held under foreign exchange swap agreements. These do not expose the Reserve Bank to exchange rate risk because, at the time the foreign exchange is acquired, an exchange rate for the reversal on a future date is agreed.

As noted, the level of foreign currency risk varies over time. Currently, the level of risk is above average as reserve holdings are in the upper end of their historical range. A 10 per cent rise in the Australian dollar (on a weighted average basis against the three currencies in the portfolio) would at present result in valuation losses of a little over $2 billion.



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 clients and to the market as a whole. Significant operational risks can also arise from the mishandling of sensitive information, as this can cause financial loss or damage to the organisation's reputation.

Operational risk in Financial Markets Group arises from the large volume of transactions undertaken in markets each day. Around 51 000 transactions were undertaken in 2004/05, with average daily settlement flows of around $22 billion. These risks are managed by having systems and processes that are efficient and robust. A new financial markets trading and settlement system is currently being installed to replace a number of existing systems and put all dealing functionality and risk controls onto an integrated platform. Foreign exchange operations were shifted onto the new platform during the past year and domestic operations will migrate in the coming year.

A significant risk facing any financial institution is that staff may undertake unauthorised transactions and expose it to financial loss or reputational damage. This risk tends to be smaller for the Reserve Bank than other financial institutions because of the specialised and relatively narrow nature of its operations, and because staff incentive structures do not encourage the undertaking of these risks. Nonetheless, the Reserve Bank has put in place a number of measures to control these risks, including a clear decision-making hierarchy, with all staff involved in financial dealing having limits to their authority to take on risk; controls in the computer systems to prevent unauthorised dealing; separation between those who initiate transactions and those who settle them; an independent middle office to monitor compliance; and a strong internal-audit function.

Operational risks involved in providing services to clients or market participants are especially significant for the Reserve Bank because a failure could have widespread consequences. The Reserve Bank is the main banker for a number of government agencies, and processes on average about 270 million transactions a year, including all Australian Taxation Office, Health Insurance Commission and Centrelink payments. It also provides real-time interbank payment and settlement services through RITS, which typically involve processing about 23 500 payment instructions per day, for an average daily value of $140 billion. It is important that these functions be carried out not only efficiently but also with complete reliability. Back-up capacity and plans for business resumption in the event of a loss of access to premises or IT systems are therefore vital, and a major program is under way to strengthen these capacities. As part of this, the Reserve Bank plans to build a new self-contained back-up site in Sydney, housing computer systems and able to accommodate all staff necessary for maintaining core services. This will require substantial investment over the next couple of years.

Earnings and Distribution

The Reserve Bank holds a large portfolio of financial assets that it manages in support of its operations to implement monetary policy and which are invested primarily in domestic and overseas securities. 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'.

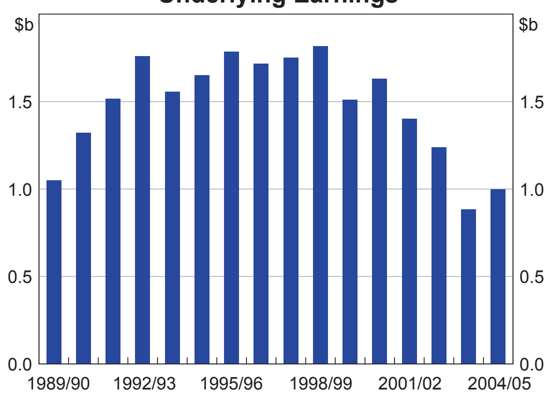
Distributable Earnings

Section 30 of the *Reserve Bank Act 1959* provides for certain components of the Reserve Bank's total profits to be paid as a dividend to the Australian Government. Specifically, earnings available for distribution comprise underlying earnings – net interest earnings less operating costs – plus any realised gains or losses. Unrealised valuation gains or losses do not affect distributed earnings, but are reflected in the Unrealised Profits Reserve. Valuation gains arise when interest rates decline or – in the case of foreign assets – the Australian dollar depreciates. Valuation losses arise when interest rates rise or the exchange rate appreciates. These gains and losses are realised when assets are sold.

Underlying earnings arise because, while the Reserve Bank earns interest on almost all of its assets, it does not pay interest on a large proportion of its liabilities, such as currency notes in circulation or capital and reserves. In 2004/05, underlying earnings totalled $997 million, compared with $882 million the previous year. This increase in underlying earnings primarily reflected the rise in short-term interest rates in Australia and the United States. As shown in the graph, the small increase in underlying earnings comes after a run of years in which they fell; this reflects the fact that interest rates around the world tended to rise in 2004/05, following a period in which they had generally moved down.

The Reserve Bank realised gains of $366 million in 2004/05, compared with realised losses of $188 million in 2003/04. The main factor in these gains was the sum of $266 million from the sale of foreign exchange, mainly to customers, notwithstanding the appreciation in the Australian dollar during the year. In addition, gains of $157 million were realised on holdings of foreign securities. These gains were partially offset by realised losses of $57 million on domestic investments.

Underlying Earnings



Source: RBA

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

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

Earnings available for distribution – the sum of underlying earnings and realised gains – amounted to $1 363 million in 2004/05, compared with $694 million 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 that most financial institutions face. The RBRF has been funded over time from transfers from earnings available for distribution and is akin to capital.

Consistent with the *Reserve Bank Act 1959*, the Treasurer determines, after consultation with the Reserve Bank Board, the amount, if any, to be credited to the RBRF from earnings available for distribution. The balance of distributable earnings is payable to the Australian Government after any such transfers. At 30 June 2005, the balance of the RBRF stood at $6 285 million. As the Board regarded this balance as satisfactory, it did not approach the Treasurer for a transfer from profits in 2004/05. Accordingly, all of the earnings available for distribution in 2004/05 will be paid as a dividend to the Australian Government.

Dividends are usually paid 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. The Treasurer deferred the sum of $320 million of the dividend due to be paid in 2004/05 until 2005/06. He has decided this year to defer receipt of

$300 million from earnings in 2004/05 until 2006/07; this means that $1 063 million will be paid in August 2005 from earnings in 2004/05. Accordingly, the total amount to be paid to the Australian Government in August 2005 is $1 383 million – the sum of earnings available for distribution from profits in 2004/05 plus the amount deferred from the previous year minus the sum deferred until 2006/07, as summarised below.

Dividend Payment: August 2005
($ million)

Sum deferred from Earnings in 2003/04 (to be paid in 2005/06)	320
Plus	
Total Distributable Earnings from 2004/05 (payable in 2005/06)	1 363
Minus	
Earnings from 2004/05 deferred until 2006/07	300
Total Payment in 2005/06	1 383

In addition to the RBRF, the Reserve Bank maintains a number of other financial reserves. Balances in asset revaluation reserves 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 2005, balances in these reserves were $1 685 million, $9 million lower than a year earlier.

Reserve Bank Payments to Government
($ million)

			Payments to the Australian Government				
	Earnings available for distribution	Transfers to reserves	Balance available from current year's profit	Interim payment from current year's profit	Payment from previous year's profit	Payment delayed from previous year	Total payment
1990/91	1 713	210	1 503	400	275	–	675
1991/92	2 554	200	2 354	400	1 103	–	1 503
1992/93	4 563	750	3 813	600	1 954	–	2 554
1993/94	1 508	–	1 508	–	3 213	–	3 213
1994/95	1 772	–	1 772	200	1 508	–	1 708
1995/96	2 486	150	2 336	200	1 572	–	1 772
1996/97	3 705	2 005	1 700	–	2 136	–	2 136
1997/98	3 274	548	2 726	–	1 700	–	1 700
1998/99	3 676	–	3 676	–	2 726	–	2 726
1999/00	803	–	803	–	3 000	–	3 000
2000/01	2 834	–	2 834	–	803	676	1 479
2001/02	1 889	–	1 889	–	2 834	–	2 834
2002/03	2 397	133	2 264	–	1 889	–	1 889
2003/04	694	–	694	–	1 300	–	1 300
2004/05	1 363	–	1 363	–	374	964	1 338
2005/06	–	–	–	–	1 063	320	1 383
2006/07	–	–	–	–	–	300	–

As noted, under the *Reserve Bank Act 1959*, and consistent with international practice for central banks, unrealised gains are not available to be distributed but are transferred to the Unrealised Profits Reserve. Balances in this reserve are available to absorb future valuation losses or are realised when relevant assets are sold.

The Reserve Bank recorded an unrealised loss of $1 289 million in 2004/05 as the exchange rate appreciated over the year against both the US dollar and euro. A measure of the exchange rate weighted by the currency composition of holdings of international reserves appreciated by about 11 per cent in 2004/05. This resulted in an unrealised foreign exchange loss of $1 663 million, partly offset by unrealised gains of $374 million on domestic and foreign securities. The unrealised valuation loss in 2004/05 saw the balance in the Unrealised Profits Reserve fall to a level of $1 548 million at 30 June, compared with $2 837 million on the previous balance date.

A number of other central banks that hold a significant proportion of their international reserves in US dollars and with currencies that float against the US dollar have also recently recorded valuation losses, and in some cases overall losses, as the US dollar has depreciated.

Accounting profits

The Reserve Bank follows generally accepted accounting principles so that, in line with the Finance Minister's Orders, issued under the *Commonwealth Authorities and Companies Act 1997*, it discloses its accounting profits as profits from all sources, including unrealised gains and losses. The unrealised loss in 2004/05 worked to offset distributable earnings, so that accounting profits amounted to $74 million.

The unrealised valuation loss has no implications for earnings available for distribution, or the dividend, since it was fully absorbed within the Unrealised Profits Reserve, leaving a significant credit balance, which remains available to absorb future unrealised losses or to be realised when relevant assets are sold.

Financial Disclosure

Commencing in 2005/06, the Reserve Bank's financial statements will be prepared in accordance with the Australian equivalents to International Financial Reporting Standards (AIFRS). The financial statements for 2004/05, which are presented in the following pages, provide in the notes to the accounts indicative effects of AIFRS if these standards had been adopted for disclosure in the latest financial year.

Financial Statements

As at 30 June 2005

Directors' Statement

In the opinion of the directors, the financial statements for the year ended 30 June 2005 give a true and fair view of the matters required by the Finance Minister's Orders 2004-2005 made under the *Commonwealth Authorities and Companies Act 1997*. These statements have been prepared from properly maintained financial records.

IJ Macfarlane

Chairman, Reserve Bank Board
10 August 2005

STATEMENT OF FINANCIAL POSITION As at 30 June 2005
Reserve Bank of Australia and Controlled Entities

	Note	2005 $M	2004 $M
ASSETS			
Cash and liquid assets	6, 19	1 008	623
Australian dollar securities	1(d), 18	20 900	18 317
Foreign exchange	1(c), 18	60 928	52 051
Gold	1(b), 18	1 494	1 492
Property, plant and equipment	1(f), 8	313	293
Loans, advances and other	7	316	297
Total Assets		84 959	73 073
LIABILITIES			
Deposits	1(g), 9	29 228	18 126
Distribution payable to Australian Government	1(i), 3	1 683	1 658
Other	10	8 866	8 411
Australian notes on issue	1(k), 18	35 624	34 022
Total Liabilities		75 401	62 217
Net Assets		9 558	10 856
Capital and Reserves			
Reserves:			
Unrealised Profits Reserve	1(h), 5	1 548	2 837
Asset revaluation reserves	1(h), 5	1 685	1 694
Reserve Bank Reserve Fund	1(h), 5	6 285	6 285
Capital	5	40	40
Total Capital and Reserves		9 558	10 856

STATEMENT OF FINANCIAL PERFORMANCE For the year ended 30 June 2005
Reserve Bank of Australia and Controlled Entities

	Note	2005 $M	2004 $M
REVENUES			
Interest revenue	2	2 392	1 889
Net gains/(losses) on securities and foreign exchange	2	(923)	1 073
Dividend revenue	2	4	4
Fees and commissions	2	19	18
Other revenue	2	57	92
Total Revenue		1 549	3 076
EXPENSES			
Interest expense	2	1 243	929
General administrative expenses	2	206	165
Other expenses	2	26	27
Total Expenses		1 475	1 121
Net Profit		74	1 955
Net revaluation adjustments in asset revaluation reserves	1(h), 5	(9)	181
Net profit plus net revaluation adjustments in asset revaluation reserves		65	2 136

STATEMENT OF DISTRIBUTION For the year ended 30 June 2005
Reserve Bank of Australia and Controlled Entities

	Note	2005 $M	2004 $M
Net Profit		74	1 955
Transfer (to)/from Unrealised Profits Reserve	5	1 289	(1 261)
Earnings available for distribution		1 363	694
Distributed as follows:			
Reserve Bank Reserve Fund	5	–	–
Payable to the Australian Government	3	1 363	694
		1 363	694

NOTES TO AND FORMING PART OF THE FINANCIAL STATEMENTS 30 June 2005

Reserve Bank of Australia and Controlled Entities

Note 1 SUMMARY OF ACCOUNTING POLICIES

The financial statements have been prepared in accordance with the *Reserve Bank Act 1959* and the *Commonwealth Authorities and Companies Act 1997*.

The form and content of the financial statements incorporate the requirements of the Finance Minister's Orders (FMOs) 2004-2005. These orders provide that the financial statements of agencies and authorities must comply with accounting standards and accounting interpretations issued by the Australian Accounting Standards Board. As the Reserve Bank of Australia (RBA) is a financial institution, the financial statements have been prepared using AASB1032 – *Specific Disclosures by Financial Institutions*.

The RBA has been granted an exemption from the requirements of the FMOs as detailed in Note 1(m). 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.

The statements are a general purpose financial report prepared in accordance with Australian Accounting Standards. All amounts are expressed in Australian dollars unless another currency is indicated. Current market values are used for the RBA's major assets, including domestic and foreign marketable securities, gold and foreign currency, as well as for premises, 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. Unless otherwise stated, the accounting policies and practices followed in these statements are consistent with those followed in the previous year.

(a) Consolidation and associated company

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

The assets, liabilities and results of Note Printing Australia Limited have been consolidated with the parent entity accounts in accordance with AASB1024 – *Consolidated Accounts*. All internal transactions and balances have been eliminated on consolidation. Note Printing Australia Limited is subject to income tax; its income tax expense is included in the Statement of Financial Performance as part of Other Expenses.

The RBA accounts for its investment in Securency Pty Ltd in accordance with AASB1016 – *Accounting for Investments in Associates*. The carrying amount of the RBA's investment in Securency Pty Ltd is reviewed annually to ensure that it is not in excess of its recoverable amount. The RBA's investment in Securency Pty Ltd is included in Note 7.

(b) Gold

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

(c) Foreign exchange

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

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

Foreign government securities

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

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

Foreign currency swaps

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

Foreign exchange holdings contracted for sale beyond 30 June 2005 (including those under swap contracts) have been valued at market exchange rates (refer Note 18).

Interest rate futures

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

Interest rate futures are off-balance sheet items. Interest rate futures positions are marked to market on the last business day of June and valuation gains and losses are taken to profit (refer Note 18). The RBA did not trade in any other derivative instruments during 2004/05.

(d) 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. Realised and unrealised gains or losses on Australian dollar securities are immediately taken to profit, but only realised gains are available for distribution.

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

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

(e) Repurchase agreements

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

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

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

(f) Property, plant and equipment

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. These valuations have been incorporated in the accounts. Annual depreciation is based on market values and assessments of useful remaining life.

Plant and Equipment has been recognised on a fair value basis in accordance with the FMOs. The fair value of plant and equipment at the beginning and end of the reporting period was determined by an independent valuer, with valuation losses taken to accounting profits. Annual depreciation is based on fair values and the RBA's assessments of useful remaining life. In accordance with the FMOs, the RBA continues to recognise computer software at cost less depreciation.

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

(g) Deposits

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

(h) Reserves

Reserves are maintained to cover the broad range of risks to which the RBA is exposed. The Reserve Bank Reserve Fund (RBRF) is a general reserve which provides for events which are contingent and non-foreseeable, mainly those which arise from movements in market values of the RBA's holdings of Australian dollar and foreign securities; the RBRF also provides for potential losses from fraud and other non-insured losses. Amounts set aside for this reserve are determined by the Treasurer after consultation with the Board (refer Note 1(i)).

Asset revaluation reserves reflect the impact of changes in the market values of a number of the RBA's assets, mainly non-traded assets (gold; property, plant and equipment; and shares in international financial institutions).

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 Unrealised Profits Reserve.

(i) 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.

(j) Provisions

The RBA maintains provisions for accrued annual leave, 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 in accordance with AASB1028 – *Employee Benefits*. In addition, the RBA makes provision for future workers' compensation claims in respect of incidents which have occurred before balance date, based on an independent actuarial assessment.

(k) Australian notes on issue

After a note series ceases to be issued, the RBA periodically adjusts its liability for that series, to reflect the likelihood that the remaining notes on issue will not be presented for redemption because they are judged to have been destroyed or are otherwise unavailable for presentation. No amount was written off Australian notes on issue in 2004/05 ($45 million was written off in 2003/04). 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.

(l) Rounding

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

(m) Exemptions

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

Requirement	Description	Detail of exemption
Appendix A	Form of Statement of Financial Position and Statement of Financial Performance.	The Statement of Financial Position is presented according to AASB1032 and details of revenues and expenses are disclosed in Note 2.

(n) Australian equivalents to International Financial Reporting Standards (AIFRS)

Commonwealth authorities reporting under the *Commonwealth Authorities and Companies Act 1997* are required to adopt AIFRS for reporting periods beginning on or after 1 January 2005. The RBA will publish its financial statements under AIFRS for the first time for the year ending 30 June 2006. The RBA has reviewed AIFRS and identified the standards which will affect its accounting policies and measurement of items in its financial statements and has put in place arrangements which will enable it to comply with these standards. Staff have been trained in AIFRS and systems and internal controls have been changed so that the required information can be collected. AIFRS will affect the RBA's financial statements in a number of areas. Adjustments for changes in accounting policies have been incorporated in the opening AIFRS balance sheet as at 1 July 2004. While the new standards have little impact on the balance sheet footings, they involve a number of changes to disclosure. The main effects on the financial statements for 2004/05 if prepared in accordance with AIFRS are discussed below.

Superannuation

Under AIFRS, the RBA will recognise in its balance sheet as at 30 June 2005 an asset, estimated at $53 million, representing the surpluses in the RBA's Officers Superannuation Fund and UK Pension Scheme; the counterpart to this asset is a new accounting reserve. The RBA proposes to adopt the 'corridor' approach (under AASB119 – *Employee Benefits*) for the recognition of the surpluses on these defined benefit superannuation funds. The RBA will recognise all previous cumulative actuarial gains and losses in the opening fair value of the surpluses. The corridor approach is used, subject to this approach being consistent with the FMOs or receiving an exemption from them if necessary. Under this approach, superannuation expense charged to the Income Statement includes the RBA's contributions, the service cost and the interest cost less the expected return on fund assets. At present, surpluses from the defined benefit schemes are not recorded on the balance sheet, but are disclosed in the notes to the RBA's financial statements (Note 16), and superannuation expense comprises only the RBA's contributions to these superannuation schemes. Accordingly, the RBA estimates that its superannuation expense in 2004/05 under AIFRS would be $4 million higher than in the financial statements published for 2004/05.

Financial instruments

The RBA expects to bring its foreign and domestic securities transactions and foreign exchange transactions to account under AIFRS on a trade date basis – that is, it will recognise 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. Bank deposits and repurchase agreements will continue to be brought to account on settlement date. All securities will be valued at bid prices, while all foreign currency assets and liabilities will be valued at bid and offer rates respectively. This approach is used subject to it being consistent with the FMOs or receiving an exemption from them if necessary. As a result of these changes: foreign currency assets and liabilities as at 30 June 2005 are estimated to be $259 and $267 million higher under AIFRS compared with current standards; accounting profits are estimated to be $13 million higher than under current standards; and the Reserve for Unrealised Profits on Investments is estimated to be $8 million lower.

Interest receivable of $137 million on repurchase agreements and foreign bank deposits as at 30 June 2005 will be reported as a separate asset under AIFRS, rather than included in the asset value, the treatment under existing standards. This will have a small compositional effect on the RBA's balance sheet.

Asset revaluation reserves

Under current Australian Accounting Standards, for revaluation purposes the RBA values individual properties as a single class of asset and all plant and equipment assets as a separate aggregate class of asset. In accordance with the reporting requirements for for-profit entities under AIFRS, individual asset revaluation reserves for each property and item of plant and equipment will be maintained. As a result, the balance of asset revaluation reserves is estimated to be $3 million lower than under current standards, although there is no material impact on profits. These adjustments have their counterparts in the RBA's equity. Accordingly, the Reserve Bank Reserve Fund is expected to increase by $1 million, compared with the 2004/05 published accounts.

The estimated effects of the adjustments outlined above on the RBA's balance sheet as at 30 June 2005 are summarised overleaf.

Accounting profits for 2004/05 determined in accordance with AIFRS are estimated to be $8 million higher than in the financial statements published for 2004/05. The adoption of AIFRS would have no impact on measured earnings available for distribution to the Australian Government in 2004/05. No material impacts are expected on the Statement of Cash Flows.

	Current Accounting Standards $M	AIFRS Estimate $M	Difference $M
RBA Balance Sheet			
as at 30 June 2005			
Assets			
Cash and liquid assets	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	313	–
Loans, advances and other	316	369	53
Total Assets	84 959	85 269	310
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	9 601	43
Capital and Reserves			
Reserves:			
Unrealised Profits on Investments	1 548	1 540	(8)
Unrealised Profits on Superannuation	–	53	53
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	9 601	43

These estimates have been prepared on the basis of the accounting standards (and interpretations) expected to prevail as at 30 June 2006. If the FMOs, accounting standards or interpretations of these evolve, or the RBA does not receive the exemptions from the FMOs that may be required, the estimates might be revised when the first full set of financial statements under AIFRS is published for 2005/06.

	Note	2005 $M	2004 $M

Note 2 NET PROFITS

	Note	2005 $M	2004 $M
Interest revenue			
Overseas investments	1(c)	1 265	1 024
Australian dollar securities	1(d)	1 069	811
Overnight settlements		42	37
Gold loans	1(b)	15	16
Loans, advances and other		1	1
		2 392	1 889
Net gains/(losses) on securities and foreign exchange			
Overseas investments	1(c)	443	(587)
Australian dollar securities	1(d)	31	(169)
Foreign currency	1(c)	(1 397)	1 829
		(923)	1 073
Dividend revenue			
Earnings on shares in Bank for International Settlements		4	4
Fees and commissions			
Banking services fees received		19	18
Other revenue			
Reimbursement by Australian Government for loan management and registry expenses		1	1
Rental of Bank premises		6	5
Sales of note products		35	22
Australian notes on issue written down	1(k)	–	45
Other		15	19
		57	92
Total		1 549	3 076
Less:			
Interest expense			
Deposit liabilities	1(g)	919	670
Currency note holdings of banks	1(k)	148	136
Repurchase agreements	1(e)	176	123
		1 243	929
General administrative expenses			
Staff costs		126	102
Special redundancy/retirement payments	12	1	3
Depreciation of property	1(f), 8	7	7
Depreciation of plant and equipment	1(f), 8	11	9
Premises and equipment	1(f)	26	24

	Note	2005 $M	2004 $M
Note 2 (CONTINUED)			
Materials used in note production		21	9
Travel		2	3
Consultants' fees, legal fees and payments to contractors		6	4
Other		6	4
		206	165
Other expenses			
Agency business reimbursement		3	2
Subsidiary income tax		–	–
Cash distribution expenses		6	6
Write down of plant and equipment	1(f), 8	–	2
Other		17	17
		26	27
Total		1 475	1 121
Net Profit		74	1 955

Staff costs in 2004/05 include an expense of $10 million associated with the increase in the balance of the Provision for post-employment benefits (gain of $2 million in 2003/04) (refer Note 10).

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(i)).

	2005 $M	2004 $M
Opening balance	1 658	2 264
Distribution to Australian Government	(1 338)	(1 300)
Transfer from Statement of Distribution	1 363	694
As at 30 June	1 683	1 658

Of the $694 million payable to the Australian Government out of profits for 2003/04, $374 million was paid in August 2004, and $320 million will be paid in August 2005. Earnings available for distribution of $1 363 million from 2004/05 will also be distributed in two tranches – $1 063 million in August 2005 and $300 million in the 2006/07 financial year. Accordingly, $1 383 million of the balance of the distribution payable account as at 30 June 2005 will be distributed to the Australian Government in August 2005, and $300 million will be deferred until 2006/07.

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

Note 4 INTEREST REVENUE AND INTEREST EXPENSE

Analysis for the year ended 30 June 2005

	Average balance $M	Interest $M	Average annual interest rate %
Interest revenue			
Overseas investments	49 331	1 265	2.6
Australian dollar securities	18 999	1 069	5.6
Overnight settlements	827	42	5.1
Gold loans	1 440	15	1.0
Loans, advances and other	29	1	3.9
	70 626	2 392	3.4
Interest expense			
Banks' Exchange Settlement balances	769	39	5.1
Deposits from governments	16 206	873	5.4
Deposits from overseas institutions	690	7	0.9
Currency note holdings of banks	2 766	148	5.3
Overseas repurchase agreements	5 602	107	1.9
Domestic repurchase agreements	1 313	68	5.2
Other deposits	39	1	3.6
	27 385	1 243	4.5
Analysis for the year ended 30 June 2004			
Interest revenue total	65 807	1 889	2.9
Interest expense total	25 031	929	3.7

	2005 $M	2004 $M

Note 5 RESERVES

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

	2005 $M	2004 $M
Asset revaluation reserves (Note 1(h))		
Gold		
Opening balance	1 368	1 222
Net revaluation adjustments	(6)	146
As at 30 June	1 362	1 368
Shares in international financial institutions (Note 7)		
Opening balance	214	179
Net revaluation adjustments	(16)	35
As at 30 June	198	214
Bank properties (Notes 1(f), 8)		
Opening balance	112	112
Net revaluation adjustments	13	–
As at 30 June	125	112
Total asset revaluation reserves		
Opening balance	1 694	1 513
Net revaluation adjustments	(9)	181
As at 30 June	1 685	1 694
Unrealised profits reserve (Note 1(h))		
Opening balance	2 837	1 576
Net transfers (to)/from Statement of Distribution	(1 289)	1 261
As at 30 June	1 548	2 837
Reserve Bank Reserve Fund (Note 1(h))		
Opening balance	6 285	6 285
Transfer from Net Profit	–	–
As at 30 June	6 285	6 285
Capital		
Opening and closing balance	40	40
Total capital and reserves		
Opening balance	10 856	9 414
Net Profit plus net revaluation adjustments in asset revaluation reserves	65	2 136
Transfer to the distribution payable to Australian Government (Note 3)	(1 363)	(694)
As at 30 June	9 558	10 856

Note 6 CASH AND LIQUID ASSETS

This includes net amounts of $992 million owed to the RBA for overnight clearances of financial transactions through the clearing houses; an amount of $617 million was owed to the RBA at 30 June 2004.

	2005 $M	2004 $M
Note 7 LOANS, ADVANCES AND OTHER ASSETS		
Shareholding in Bank for International Settlements	241	216
Officers' Home Advances	21	23
Gold coin	19	19
Investment in Securency	14	11
Other	21	28
As at 30 June	316	297

The Reserve Bank of Australia has a 50 per cent share in Securency Pty Ltd, which is incorporated in Victoria, Australia, and whose principal activity is the marketing and manufacture of polymer substrate. The capital of Securency as at 30 June 2005 was $36 530 001. The carrying value of the RBA's investment in Securency as at 30 June 2005 was $13 703 684 ($11 484 170 at 30 June 2004). Securency has a 31 December balance date.

As at 30 June 2005, other assets included receivables of $15.8 million, of which $12.2 million is current (at 30 June 2004 other assets included receivables of $15.1 million, of which $11 million was current).

	Land $M	Buildings $M	Plant and Equipment $M	Computer Software $M	Total $M
Note 8 PROPERTY, PLANT AND EQUIPMENT					
Gross Book Value as at 30 June 2004	91	136	132	8	367
Accumulated depreciation	–	–	(71)	(3)	(74)
Net Book Value	91	136	61	5	293
Additions	7	1	16	2	26
Depreciation/amortisation expense	–	(7)	(10)	(1)	(18)
Net revaluation increment/decrement	3	10	–	–	13
Disposals	–	–	(1)	–	(1)
Gross Book Value as at 30 June 2005	101	140	105	9	355
Accumulated depreciation	–	–	(39)	(3)	(42)
Net Book Value	101	140	66	6	313

	2005 $M	2004 $M

Note 9 DEPOSITS

	2005 $M	2004 $M
Banks' Exchange Settlement balances	1 257	1 377
Australian Government	26 890	16 104
State Governments	4	8
Foreign governments, foreign institutions and international organisations	1 062	573
Other depositors	15	64
As at 30 June	29 228	18 126

Note 10 OTHER LIABILITIES

	2005 $M	2004 $M
Provisions (Note 1(j))		
Provision for accrued annual leave	10	10
Provision for long service leave	23	21
Provision for post-employment benefits	63	53
Provision for workers' compensation	1	1
Total employment liabilities as at 30 June	97	85
Other		
Amounts outstanding under repurchase agreements (contract price) (Note 1(e))	8 261	7 315
Interest accrued on deposits	189	143
Other	319	868
As at 30 June	8 769	8 326
Total other liabilities	8 866	8 411

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

Contingencies

The RBA has a contingent liability, amounting to $68.8 million at 30 June 2005 ($63.9 million at 30 June 2004), in respect of the uncalled portion of its shares held in the Bank for International Settlements.

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

Other items

The RBA has commitments of $0.5 million at 30 June 2005 ($3.2 million at 30 June 2004) payable within one year; and no commitments payable beyond one year ($0.5 million at 30 June 2004).

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

Note 12 SPECIAL REDUNDANCY/RETIREMENT PAYMENTS

The RBA's expenses in 2004/05 include $681 961 paid or payable to, or on behalf of, staff who accepted special redundancy/retirement offers. Corresponding payments in 2003/04 totalled $3 081 672. Staff leaving the RBA in 2004/05 under these arrangements numbered 13 (31 in 2003/04).

Note 13 REMUNERATION OF EXECUTIVES

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

Remuneration band	Number 2005	Number 2004
$100 000 – $109 999	1	1
$110 000 – $119 999	1	2
$120 000 – $129 999	3	6
$130 000 – $139 999	5	7
$140 000 – $149 999	12	7
$150 000 – $159 999	6	8
$160 000 – $169 999	11	6
$170 000 – $179 999	5	9
$180 000 – $189 999	6	6
$190 000 – $199 999	6	2
$200 000 – $209 999	2	3
$210 000 – $219 999	2	2
$220 000 – $229 999	2	4
$230 000 – $239 999	3	1
$240 000 – $249 999	3	2
$250 000 – $259 999	2	
$260 000 – $269 999	1	1
$280 000 – $289 999	1	1
$290 000 – $299 999		3
$300 000 – $309 999	5	
$310 000 – $319 999		2
$320 000 – $329 999		1
$350 000 – $359 999		1
$360 000 – $369 999	2	2
$370 000 – $379 999	1	
$380 000 – $389 999	2	
$420 000 – $429 999		1
$430 000 – $439 999	1	
$550 000 – $559 999		1
$570 000 – $579 999	1	

Total remuneration received or due and receivable by these 84 executives amounted to $17 147 300 (79 executives totalling $15 506 945 in 2003/04). Remuneration includes cash salary, the RBA's contribution to superannuation, housing assistance, motor vehicles, car parking and health insurance and the fringe benefits tax paid or payable on these benefits. Remuneration excludes amounts paid to executives posted outside Australia, or seconded to other organisations for the whole or part of the financial year. Remuneration includes amounts paid to executives who are also members of the Bank Board (refer Note 15).

Termination payments of $1 176 670 were made to executives who left the Bank during 2004/05 ($375 568 in 2003/04); these payments are not reflected in the above table.

Note 14 REMUNERATION OF AUDITOR

Fees paid or payable to the statutory auditor (Auditor-General of the Commonwealth of Australia) for audit services (excluding GST) totalled $196 000 in 2004/05 ($186 000 in 2003/04). 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 are estimated at about $71 000 (excluding GST).

Note 15 RELATED PARTY AND OTHER DISCLOSURES

The Remuneration Tribunal determines the remuneration appropriate to the RBA's non-executive Board members. In 2004/05, payments to executive and non-executive Board members totalled $1 320 330 ($1 221 946 in 2003/04). Remuneration includes amounts paid to members of the Bank Board who are also executives (refer Note 13).

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

Remuneration band	Number 2005	Number 2004
$30 000 – $39 999		5
$40 000 – $49 999	1	1
$50 000 – $59 999	5	
$420 000 – $429 999		1
$430 000 – $439 999	1	
$550 000 – $559 999		1
$570 000 – $579 999	1	

At 30 June 2005 and 30 June 2004 there were no loans by the RBA to the Governor, Deputy Governor or non-executive members of the Board.

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

In addition, $179 547 was paid for the services of non-executive members of the Board of Note Printing Australia Limited who are not employees of the RBA or members of the Bank Board ($163 222 in 2003/04). The RBA also paid $164 532 for the services of members of the Payments System Board who are not employees of the RBA ($158 923 in 2003/04).

Note 16 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 these 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 contributions to the OSF in accordance with the Reserve Bank (Officers' Superannuation) Rules, and to the UK Pension Scheme in accordance with the UK Trust Deed, are included in staff costs in Note 2. Administration and other operational costs (eg salaries, overheads, legal costs and valuation fees) incurred by the RBA for superannuation arrangements are also included in Note 2. There were no other related-party transactions between the RBA and the funds during 2004/05.

At 30 June 2005, the OSF had a surplus of assets over accrued benefits of $115 million ($60 million at 30 June 2004). The UK Pension Scheme had a surplus equivalent to $2 million ($5 million at 30 June 2004). During 2004/05, the RBA made superannuation contributions of $6.9 million ($6.2 million in 2003/04).

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

	2005 $M	2004 $M
Reserve Bank of Australia Officers' Superannuation Fund		
Accrued benefits	594	588
Net market value of assets	709	648
Surplus	115	60
Vested benefits	550	539
Reserve Bank of Australia UK Pension Scheme		
Accrued benefits	21	19
Net market value of assets	23	24
Surplus	2	5
Vested benefits	22	21
Total Superannuation Funds		
Accrued benefits	615	607
Net market value of assets	732	672
Surplus	117	65
Vested benefits	572	560

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

Note 17 SEGMENT REPORTING

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

Note 18 FINANCIAL INSTRUMENTS

Australian Accounting Standard AASB1033 – *Presentation and Disclosure of Financial Instruments* requires disclosure of information relating to: both recognised and unrecognised financial instruments; their significance and performance; accounting policy terms and conditions; net fair values and risk information.

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

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

Financial risk of financial instruments embodies price risk (currency risk and interest rate risk); credit risk; liquidity risk and cash flow risk. AASB1033 requires disclosure on interest rate risk and credit risk.

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

Interest rate risk

Interest rate risk is the risk that the value of a financial instrument will fluctuate due to changes in market interest rates. The following table shows the RBA's Statement of Financial Position restated in compliance with AASB1033.

Note 18 (CONTINUED)

Interest rate risk As at 30 June 2005

	Balance sheet total $M	Floating interest rate $M	Repricing Period $M 0 to 3 months	3 to 12 months	1 to 5 years	Over 5 years	Not bearing interest $M	Weighted average rate %
Assets								
Gold loans	1 217	–	147	92	952	–	26	1.3
Gold holdings	277	–	–	–	–	–	277	n/a
Sub-total	**1 494**							
Foreign exchange								
Securities sold under repurchase agreements	7 629	–	–	363	3 971	3 295	–	3.4
Securities purchased under repurchase agreements	29 301	–	29 301	–	–	–	–	3.0
Deposits and other securities	23 810	613	11 935	2 670	5 366	2 337	889	2.7
Accrued interest – foreign exchange	188	–	–	–	–	–	188	n/a
Sub-total	**60 928**							
Australian dollar securities								
Securities sold under repurchase agreements	573	–	–	30	170	373	–	5.1
Securities purchased under repurchase agreements	16 569	–	16 569	–	–	–	–	5.5
Other securities	3 688	–	1 060	53	1 561	1 014	–	5.2
Accrued interest – Australian dollar securities	70	–	–	–	–	–	70	n/a
Sub-total	**20 900**							
Property, plant & equipment	313	–	–	–	–	–	313	n/a
Cash and liquid assets	1 008	992	–	–	–	–	16	5.5
Loans and advances	21	21	–	–	–	–	–	3.7
Other	295	–	–	–	–	–	295	n/a
Total assets	**84 959**	**1 626**	**59 012**	**3 208**	**12 020**	**7 019**	**2 074**	**3.6**
Liabilities								
Australian notes on issue	35 624	2 376	–	–	–	–	33 248	0.3
Deposits	29 228	2 808	24 100	1 350	–	–	970	5.3
Distribution payable to Australian Government	1 683	–	–	–	–	–	1 683	n/a
Other	8 866	–	8 545	4	–	–	317	2.5
Total liabilities	**75 401**	**5 184**	**32 645**	**1 354**	–	–	**36 218**	**2.5**
Capital and reserves	9 558							
Total balance sheet	**84 959**							
Off balance sheet items								
Interest rate futures	65	–	–	–	–	65	–	n/a

Note 18 (CONTINUED)

Interest rate risk As at 30 June 2004

	Balance sheet total $M	Floating interest rate $M	Repricing Period $M 0 to 3 months	3 to 12 months	1 to 5 years	Over 5 years	Not bearing interest $M	Weighted average rate %
Total assets	73 073	1 295	45 989	4 670	11 984	7 216	1 919	2.9
Total liabilities	62 217	5 211	22 996	11	–	–	33 999	2.0
Capital and reserves	10 856							
Total balance sheet	73 073							
Off balance sheet items	1 386	–	–	–	–	1 386	–	n/a

Other liabilities include amounts outstanding under sell repurchase agreements.

All recognised financial instruments are shown at net fair value.

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

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

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

Credit risk

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

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

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

1. ***Foreign exchange swaps*** – As at 30 June 2005 the RBA was under contract to purchase $6.3 billion of foreign currency and sell $36.0 billion of foreign currency. As of that date there was an unrealised net loss of $1.0 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 2005 the amount of credit risk on interest rate futures contracts was approximately $0.3 million ($1.4 million at 30 June 2004). As at 30 June 2005 there was an unrealised gain brought to account on those contracts of $0.1 million ($0.3 million unrealised gain at 30 June 2004).

Note 18 (CONTINUED)

Concentration of credit risk

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

Credit risk

	Risk rating of security issuer*	Risk rating of counterparties*	% of total assets as at 2005	% of total assets as at 2004
Domestic Government Securities				
Holdings – Commonwealth Government securities	AAA	n/a	2.9	2.8
Holdings – Semi Government	AAA	n/a	1.1	0.9
securities	AA	n/a	0.3	0.4
Securities sold under	AAA	AAA	0.0	1.6
repurchase agreements	AAA	AA	0.5	0.7
	AAA	other	0.2	0.0
Securities held under	AAA	AA	17.4	11.7
repurchase agreements	AAA	other	1.7	0.6
	AA	AA	0.2	4.6
	AA	other	0.2	1.0
	other	other	0.0	0.7
Foreign investments				
Holdings of securities	AAA	n/a	12.0	20.4
	AA	n/a	3.0	3.7
	A	n/a	0.4	0.1
Securities sold under	AAA	AA	8.5	6.2
repurchase agreements	AAA	other	0.6	1.6
Securities held under	AAA	AA	32.0	20.2
repurchase agreements	AAA	other	2.5	6.2
Deposits	n/a	AAA	1.1	0.3
	n/a	AA	10.1	12.6
	n/a	other	1.2	0.0
Other	n/a	AAA/other	0.3	0.1
Gold loans	n/a	AAA	0.1	0.1
	n/a	AA	0.7	1.1
	n/a	other	0.6	0.8
Other			2.4	1.6
			100	100

* Standard & Poor's equivalent ratings

Note 19 CASH FLOW STATEMENT

The following cash flow statement appears as a matter of record to meet the requirements of AASB1026 – *Statement of Cash Flows*; in the RBA's view, it does not shed any additional light on the RBA's financial results. For the purpose of this statement, cash includes the notes and coin held at the Reserve Bank and overnight settlements system account balances with other banks.

STATEMENT OF CASH FLOWS For the year ended 30 June

	2005 Inflow/ (outflow) $M	2004 Inflow/ (outflow) $M
Cash flows from operating activities		
Interest received on investments	2 159	1 767
Interest received on loans, advances, and on net overnight settlements systems	43	38
Loan management reimbursement	1	1
Banking service fees received	18	17
Rents received	6	5
Net payments for and proceeds from sale of investments	(12 007)	(5 135)
Interest paid on deposit liabilities	(874)	(581)
Interest paid on currency note holdings of banks	(148)	(136)
Staff costs (including redundancy)	(113)	(105)
Premises and equipment	(26)	(24)
Other	(24)	25
Net cash provided by operating activities	(10 965)	(4 128)
Cash flows from investment activities		
Net expenditure on property, plant and equipment	(25)	(16)
Net cash used in investing activities	(25)	(16)
Cash flows from financing activities		
Profit payment to Australian Government	(1 338)	(1 300)
Net movement in deposit liabilities	11 102	3 390
Net movement in loans and advances	2	2
Net movement in notes on issue	1 602	1 850
Other	7	(14)
Net cash provided by financing activities	11 375	3 928
Net increase/(decrease) in cash	385	(216)
Cash at beginning of financial year	623	839
Cash at end of financial year	1 008	623

Note 19 (CONTINUED)

Reconciliation of cash	2005 $M	2004 $M
Cash	16	6
Overnight settlements systems	992	617
	1 008	623

Reconciliation of net cash provided by operating activities to Net Profits in terms of the *Reserve Bank Act 1959*	2005 $M	2004 $M
Net Profit	74	1 955
Increase/(decrease) in interest payable	46	88
Net loss/(gain) on overseas investments	(443)	587
Net loss/(gain) on Australian dollar securities	(31)	169
Net loss/(gain) on foreign currency	1 397	(1 829)
Decrease/(increase) in income accrued on investments	1	54
Depreciation of property	7	7
Depreciation of plant and equipment	11	9
Net payments for and proceeds from sale of investments	(12 007)	(5 135)
Other	(20)	(33)
Net cash provided by operating activities	(10 965)	(4 128)

Auditor-General for Australia

Australian National Audit Office

INDEPENDENT AUDIT REPORT

To the Treasurer

Scope

The financial statements and directors' responsibility

The financial statements comprise:

- Directors' Statement
- Statements of Financial Position, Financial Performance and Distribution; 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 2005. The consolidated entity comprises both the Bank and the entity it controlled during the 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*, accounting standards and other mandatory financial reporting requirements in Australia. 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 Australian National Audit Office Auditing Standards, which incorporate 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.

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Email ian.mcphee@anao.gov.au

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*, accounting standards and other mandatory financial reporting requirements in Australia, 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 statements of financial performance 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 Bank's and the consolidated entity's financial position as at 30 June 2005 and of their performance and cash flows for the year then ended, in accordance with:

(i) the matters required by the Finance Minister's Orders; and

(ii) applicable accounting standards and other mandatory financial reporting requirements in Australia.

Ian McPhee
Auditor-General

Sydney
10 August 2005

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**	
	2003/04 $ million	**2004/05 $ million**	**2003/04 $ million**	**2004/05 $ million**
Revenue				
– Service fees	15.6	16.4	0.6	0.7
– Other revenue	3.6	3.1	0.1	0.1
Total	19.2	19.5	0.7	0.8
Expenditure				
– Direct costs	11.6	11.5	0.4	0.4
– Indirect costs	3.2	3.2	0.2	0.2
Total	14.8	14.7	0.6	0.6
Net profit/(loss)	4.4	4.8	0.1	0.2
Net profit/(loss) after taxes (a)	3.0	3.4	0.1	0.1
Assets (b)				
– Domestic markets investments	459.3	340.4	1.3	1.4
– Other assets	8.2	9.5	0.1	0.1
Total	467.5	349.9	1.4	1.5
Liabilities (b)				
– Capital & reserves	25.0	25.0	1.0	1.0
– Deposits	437.9	319.2		
– Other liabilities	4.6	5.7	0.4	0.5
Total	467.5	349.9	1.4	1.5

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

(b) As at 30 June

The Reserve Bank Board and Governance

The Role of the 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 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.

When APRA was established in 1998, it took on the prudential supervision of banks but the Reserve Bank retained responsibility for overall financial system stability. 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 Board comprises the Governor, who is Chairman, the 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 94 and 95. Five members form a quorum for a meeting of the Board.

During the year, the Australian Government released its response to the report of the review of corporate governance arrangements of statutory authorities conducted by John Uhrig AC. Among the matters considered was the appropriate governance template for statutory authorities. The review concluded that the current structure of the Board and the nature of its responsibilities meet the expectations of the international financial community with respect to effective governance arrangements for central banks.

Meetings of the Reserve Bank Board

The *Reserve Bank Act 1959* does not stipulate the frequency of Board meetings. For many years the Board's practice has been to meet 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 and from time to time the Board also meets in other State capitals.

Number of meetings attended by each member in 2004/05[a]

IJ Macfarlane	11	(11)
GR Stevens	11	(11)
KR Henry	11	(11)
JR Broadbent	10	(11)
RG Gerard	7	(11)
FP Lowy	8	(11)
DG McGauchie	11	(11)
WJ McKibbin	11	(11)
HM Morgan	11	(11)

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

Conduct of Reserve Bank Board Members

On appointment to the 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 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 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 2004/05, the Committee met on four occasions; all members attended each of these meetings. At its July 2005 meeting, the Committee considered the draft financial statements for the year ended 30 June 2005 and agreed that the statements be presented to the 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 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 2 August 2005, they resolved that the Chairman sign the Report and the Financial Statements as at 30 June 2005, 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 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*.

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

Chairman: Ian Macfarlane AC

Governor since
18 September 1996
Present term ends
17 September 2006

Chairman – Payments System Board

Chairman – Council of Financial Regulators

Glenn Stevens

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

Ken Henry

Secretary to the Treasury
Member since
27 April 2001

Jillian Broadbent AO

Member since 7 May 1998
Present term ends
6 May 2008

Director – Coca-Cola Amatil Limited

Director – Special Broadcasting Service

Director – Woodside Petroleum Limited

Robert Gerard AO

Member since 20 March 2003
Present term ends
19 March 2008

Chairman & Managing Director – Gerard Corporation Pty Ltd

Frank Lowy AC

Member since 27 June 1995
Present term ends
9 December 2005

Chairman – Westfield Holdings Limited

Chairman – Lowy Institute for International Policy

Chairman – Football Federation Australia

Director – Daily Mail and General Trust PLC (UK)

Donald McGauchie AO

Member since 30 March 2001
Present term ends
29 March 2006

Chairman – Telstra Corporation Limited

Director – Nufarm Limited

Director – James Hardie Industries NV

Warwick McKibbin

Member since 31 July 2001
Present term ends
30 July 2006

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 ends
28 July 2007

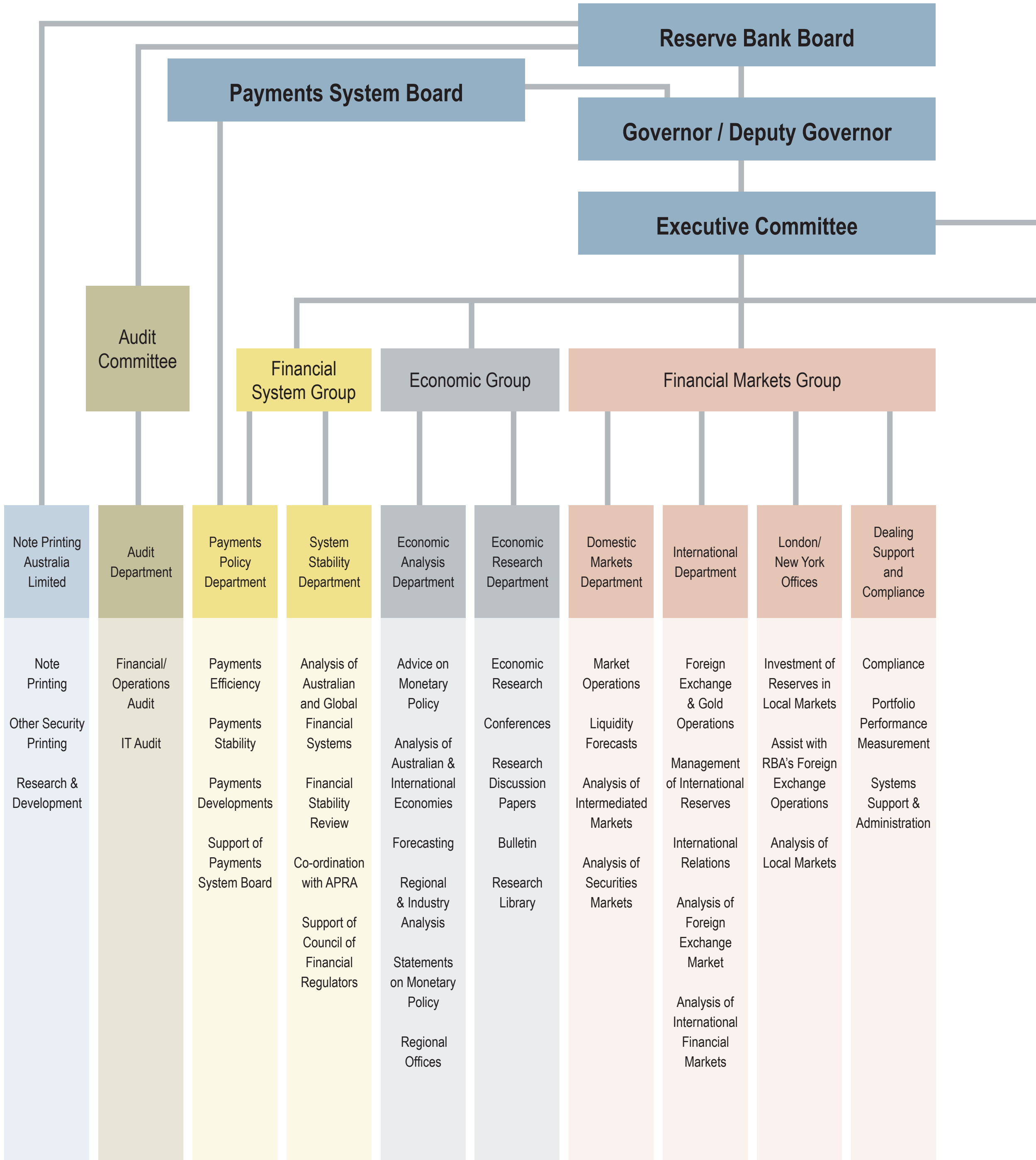
Principal – First Charnock Pty Ltd

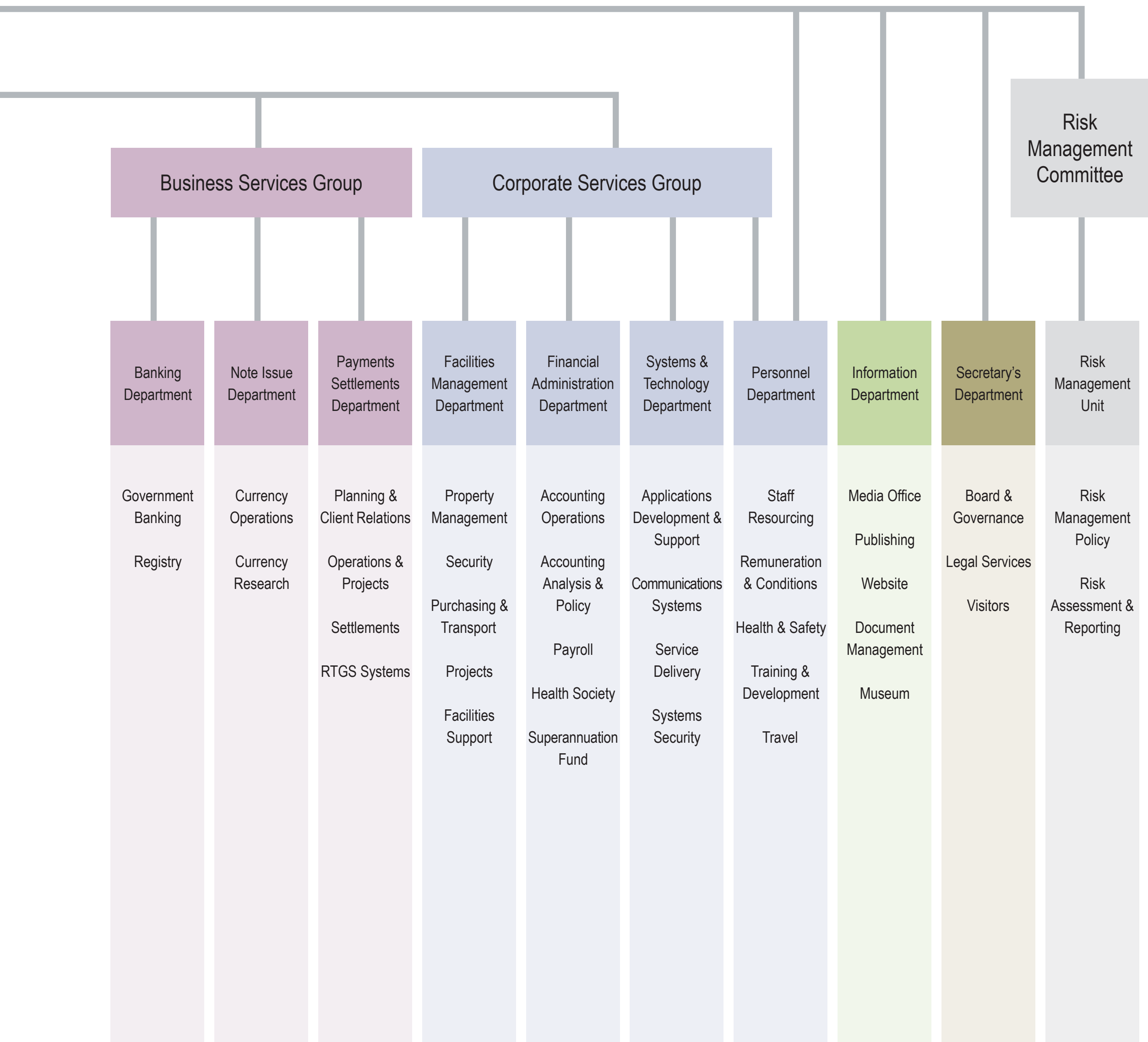
President – Business Council of Australia

Joint Chairman – Commonwealth Business Council

Member – Lafarge International Advisory Board

Organisational Chart | July 2005




Risk Management Committee
Business Services Group
Corporate Services Group
Banking Department
Government Banking
Registry
Note Issue Department
Currency Operations
Currency Research
Payments Settlements Department
Planning & Client Relations
Operations & Projects
Settlements
RTGS Systems
Facilities Management Department
Property Management
Security
Purchasing & Transport
Projects
Facilities Support
Financial Administration Department
Accounting Operations
Accounting Analysis & Policy
Payroll
Health Society
Superannuation Fund
Systems & Technology Department
Applications Development & Support
Communications Systems
Service Delivery
Systems Security
Personnel Department
Staff Resourcing
Remuneration & Conditions
Health & Safety
Training & Development
Travel
Information Department
Media Office
Publishing
Website
Document Management
Museum
Secretary's Department
Board & Governance
Legal Services
Visitors
Risk Management Unit
Risk Management Policy
Risk Assessment & Reporting

Head Office Management | End July 2005

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

System Stability Department

Head: Keith Hall
Chief Manager: 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

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Note Printing Australia Limited

Chief Executive: Chris Ogilvy
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Craigieburn 3064
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Glossary

ABF	Asian Bond Fund
ACC	Asian Consultative Council (of the BIS)
AOFM	Australian Office of Financial Management
APEC	Asia-Pacific Economic Co-operation
APRA	Australian Prudential Regulation Authority
BIS	Bank for International Settlements
CAC Act	*Commonwealth Authorities and Companies Act 1997*
CD	Certificate of deposit
CGS	Commonwealth Government securities
CGFS	Committee on the Global Financial System (of the BIS)
CHESS	Clearing House Electronic Subregister System of the Australian Stock Exchange
CLS	Continuous linked settlement
CPSS	Committee on Payment and Settlement Systems (of the BIS)
ECB	European Central Bank
EEO	Equal employment opportunity
EMEAP	Executives' Meeting of East Asian and Pacific central banks
ESAs	Exchange Settlement Accounts
ES	Exchange Settlement (funds)
FATF	Financial Action Task Force
FOI	Freedom of Information
FSAP	Financial Sector Assessment Program
FX	Foreign exchange
GDES	Government Direct Entry Service
G-7	Group of Seven
G-20	Group of Twenty
IMF	International Monetary Fund
NNPDC	National Note Processing and Distribution Centre
NPA	Note Printing Australia Limited
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