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MEMORANDUM FOR THE BOARD

APRIL 2007 MEETING

Note Printing Australia Limited: Charter

This memorandum seeks the Board's endorsement of a revised charter for Note Printing Australia Limited (NPA). NPA is a wholly-owned subsidiary of the Bank; its role is to print at acceptable cost Australian currency notes of high quality and high security. It has also played a leading role in the development of polymer currency notes and in expanding the market for these notes.

As NPA's current charter was endorsed in 1990 by the Reserve Bank Board, it is now well out of date and has been overtaken by events. In 1990, NPA was a separate Division of the Bank, whereas it is now separately incorporated and operates under its own Board of Directors, appointed by the Bank.¹ The proposed charter makes explicit the Reserve Bank Board's current expectations regarding NPA's role and governance. It also addresses the complementary role of Securrency Pty Ltd, which was not established until 1996 and which is not mentioned in the original charter.² The proposed charter has been discussed with NPA's directors who are agreeable to it.

The proposed charter (see Attachment) is in two parts: the first part deals with the Bank's objectives for NPA; the second deals with the responsibilities of NPA's Board.

NPA's Functions

The proposed charter identifies NPA's prime functions as being to print notes for the Reserve Bank and to work, in conjunction with Securrency, to promote the polymer technology. An important reason for reviewing the charter is to anchor the company's strategy around these activities.

The proposed charter places the printing of export banknotes and other security documents as secondary functions. When the original charter was drafted in 1990, the expectation was that NPA would be the vehicle for exporting the polymer technology in the form of printed notes. For a variety of reasons, however, Securrency has become the main avenue for exploiting the technology, with NPA playing a complementary or supporting role.³ That said, there remains a role for NPA to supply currency notes to some overseas central banks with which it has a longstanding relationship, especially in the Asia-Pacific region, or where it has entered long-term supply agreements. Export activity has consistently made a moderate contribution to covering NPA's overheads in recent years. Its passport business has been profitable.

¹ NPA's Board currently comprises: GJ Thompson (Chairman), FM Bethwaite, RFE Warburton AO, LJ Austin and F Campbell.

² Securrency is the Bank's joint venture with Innovia Films, a global supplier of polypropylene films. Securrency sells to NPA, and other currency note printers overseas, high-security, press-ready polymer substrates that it produces by applying unique coatings and security features from a plant on the site it shares with NPA at Craigieburn in Victoria. Working together, these companies have led the way in establishing the polymer technology as a viable alternative to paper banknotes.

³ NPA's production capacity on a global scale is very small and falls far short of the level needed to make a serious dent in the global banknote market. NPA is also regarded as a competitor for state print works in countries that might otherwise be prepared to use polymer. It is no coincidence that sales of polymer substrate, and Securrency's profits, have taken off when the 'competitor' was taken out of the equation and Securrency began to supply other print works directly.

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NPA's Board

The proposed charter assigns responsibility for the overall conduct of NPA's affairs to the Board of NPA. It gives this Board authority to appoint the CEO, establish a budget and perform the duties and obligations of company boards required at law, including any responsibilities arising from the *Reserve Bank Act 1959* and Australian Government policies. The responsibilities of NPA's CEO are more tightly defined than in the original charter so that it is now explicit that the CEO will manage NPA in accordance with the charter.

In addition, there are a number of matters contained in the charter flowing from the RBA's ownership of NPA. In particular, the proposed charter requires the NPA Board to have regard to the RBA's reputation; to develop the market for polymer banknotes, including by supporting Securrency's activities; and to adopt policies on risk management and on NPA's security and control environment. Some of these matters reflect trends in governance since the original charter was developed. Having regard to the RBA's reputation is relevant both from the perspective of the quality of banknotes produced as well as from NPA's dealings with other entities, including in overseas markets. Reputational considerations are also relevant in relation to security and controls, as failure to have strong controls around the printing of currency notes could damage the RBA's reputation in a number of ways, including by theft or counterfeit. Accordingly, the charter requires that the Board of NPA ensure that the company adopts policies to control these risks and that these policies are implemented effectively.

It is proposed that, instead of reporting twice a year to the Reserve Bank Board, NPA report annually in future, or as required. Reporting by Securrency would be on the same timetable.

It is **recommended** that the Board endorse the proposed charter for Note Printing Australia Limited.

Corporate Services Group
29 March 2007

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ATTACHMENT

NOTE PRINTING AUSTRALIA LIMITED: CHARTER

Note Printing Australia (NPA) shall have as its prime functions:

- the efficient and cost-effective production of Australian currency notes of high quality and security, in accordance with the specifications and requirements of the Reserve Bank of Australia (RBA);
- in co-operation with Securrency Pty Ltd and separately:
 - the development of markets for polymer currency note technology;
 - research and development related to the efficient production of polymer currency notes and to the security of currency notes and other documents; and
 - the exploitation, in Australia's interests, of the results of that research and development.

NPA may undertake as its secondary functions:

- the production and sale of polymer currency notes to other issuing authorities; and
- the development, production and sale of passports, other security instruments and products (other than currency notes) which are compatible both with its primary role as a printer of currency notes and also with being a subsidiary of the RBA.

NPA is required to adopt sound commercial practices across its operations and maintain the highest standards of risk management consistent with its role as a printer of currency notes.

The Board:

- is responsible for the strategy and operations of NPA in accordance with NPA's charter;
- shall adopt and oversee the implementation of policies of NPA, including in relation to risk management and NPA's control and security environment, and shall have responsibility for the overall conduct of NPA on a sound commercial basis;
- in the conduct of NPA's affairs, shall have regard to the reputation of the RBA as Australia's central bank and the need to maintain this reputation;
- shall have regard to the provisions of the *Reserve Bank Act 1959*, where relevant to the charter of NPA, other legislation relevant to the RBA and NPA as its subsidiary and Australian Government policies as appropriate;
- in addition to its duties and obligations at law, shall have regard to any direction of the RBA;
- shall report to the Board of the RBA yearly and at other times as appropriate on the operations and results of NPA; and
- shall be responsible for the appointment, remuneration, and other terms and conditions of employment of the Chief Executive.

The Chief Executive shall manage NPA in accordance with its charter, the Chief Executive's duties and obligations at law and in accordance with the terms and conditions established by the NPA Board.

Reserve Bank of Australia
29 March 2007

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MEMORANDUM FOR THE BOARD

OCTOBER 2007 MEETING

Note Printing Australia Limited: History and Future Options

The Board at its August meeting requested that the Bank give consideration to its relationship with Note Printing Australia (NPA). This note provides some background on how the current relationship evolved, assesses the present situation and makes some recommendations for the Board's consideration.

1. Historical Background

Since the *Australian Notes Act 1910*, legislation in Australia has given the power to issue currency either to the Commonwealth Government or the central bank.¹ The first denomination issued by the Australian Government was in 1913, by the Treasury from print works in Flinders Street, Melbourne. In 1920, responsibility for note issue passed to the Commonwealth Bank (as a central banking function), which in 1924 acquired new printing works at Fitzroy, Melbourne. These days, the *Reserve Bank Act 1959* empowers the Bank to be the sole issuer of banknotes in Australia.² The Reserve Bank took over the Fitzroy plant from the Commonwealth Bank in 1959, before establishing the existing premises at Craigieburn in 1981.

Issuance of banknotes can be distinguished from the related tasks of printing and distribution of currency. The Bank has in recent years virtually outsourced the physical distribution of notes. However, it has always printed the banknotes it issues. These arrangements for printing notes are similar to those in countries with which we usually compare ourselves, i.e. most major central banks either have an affiliate print their banknotes or they use a private printer in their own country – they do not import. Each of the G20 countries, for example, prints its own notes domestically.

Planning for the current works at Craigieburn began in the 1970s when it was projected that a new facility would be required to cope with expected growth as capacity at the existing print works would be inadequate. The original cost of the building was \$68 million in 1980. (The cost of the land was an additional \$725 000 in 1971.) The new facility was designed on the basis that: the inflationary era of the 1970s would continue; notes would continue to be printed on paper; and that \$1 and \$2 notes (representing 40 per cent of the number of notes in circulation) would continue to be issued. Each of these assumptions proved to be wrong: the advent of the much more durable polymer substrate, a return to low inflation and the replacement of the \$1 and \$2 notes with coins each worked to reduce the demand for new bank notes.

Consequently, the assessment on which the construction of Craigieburn was based grossly overestimated the future demand for banknotes in Australia. While the building was designed to produce 1 200 million pieces a year and eventually accommodate almost 1 000 staff, the peak output of Australian notes was 533 million pieces in 1991/92 as the new polymer series was being introduced. Production of Australian banknotes subsequently declined, averaging about 155 million notes a year over the past decade. This has been augmented by export notes averaging about 200 million pieces a year, giving total production of 355 million pieces.

¹ Before then, banknotes in Australia were issued by the private banks and the Government of Queensland.

² Under Section 34 of this Act, the Bank may issue, re-issue or cancel Australian notes. This Section also requires that Australian notes shall be printed by, or under the authority of, the Bank.

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The impact of changes in substrate, the denominations issued and in the inflationary environment is easy to see. In 1980, the last year of the Fitzroy plant's operation, when banknotes were printed on paper and \$1 and \$2 notes were still circulating, 375 million Australian banknotes were printed, against a stock of outstanding notes of about 355 million. In the past year, the Bank purchased about 250 million banknotes against the stock of 900 million pieces in circulation. In other words, more notes were printed for the Reserve Bank in the late 1970s than has been the case in recent years, mainly because, although the stock of notes on issue was much smaller than today, this stock was fully replaced, on average, in less than a year, whereas now this takes about 3½ years.

While information about the efficiency of banknote printers in other countries is hard to come by (because such information is so sensitive), some consistent and timely information is available for a group of countries from around the Pacific. This is summarised in Table 1. The group of globally competitive European printers is absent from the countries shown in the Table.

Australia is a small producer. This partly reflects the size of Australia's population – as population is a major influence on the demand for banknotes. Generally speaking, the NPA plant operates at far below optimal capacity, resulting in a high cost structure. The efficiency of capital in countries such as India and Indonesia, with large populations, is much greater than in the smaller countries shown. While economies of scale have been a key consideration in emphasising the importance of exports for NPA, the level of exports produced by NPA has not reached that required to significantly close the efficiency gap.

2. Corporate Structure

The relationship between the note printing function and the Bank has changed over the years. From 1924 until it moved to Craigieburn, note printing was a department of the central bank. Soon after the move, it became a branch, with the aim of giving it greater operating autonomy, although it remained part of the Bank for administrative purposes. Also in the early 1980s, a new branch manager, effectively the chief executive, was appointed from the private sector. Since then four more chief executives have been appointed in this way. Almost all of NPA's current team of managers are external appointments by the NPA Board or executive management.

In 1990, Note Printing Australia (NPA) became a separate division of the RBA, following a report commissioned from McKinseys that recommended that note printing become a stand-alone business enterprise with separate accounts, and under a separate board which would be responsible for the policy and operations of NPA. McKinseys saw efforts to increase exports as critical to operating the plant efficiently and that greater organisational autonomy would be required to do so.

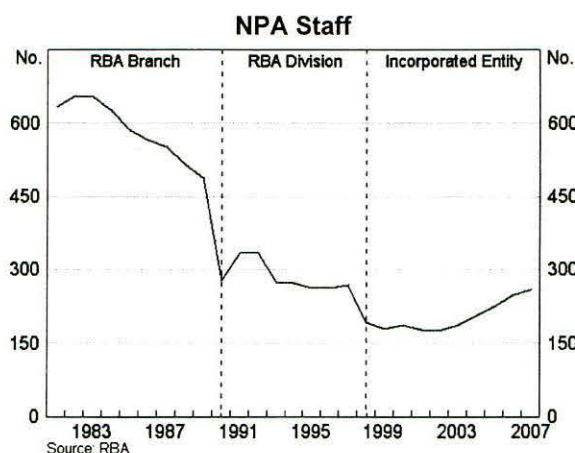
The final step of corporatising NPA occurred in July 1998, when it was established as a separately-incorporated and wholly-owned subsidiary of the Bank. Since then, Note Printing Australia Limited has reported as a public company, and has been subject to the Corporations Act. Staff of NPA are no longer employees of the Bank.

An important factor in the RBA Board's decision to incorporate NPA was the Government's competitive neutrality policies, in which Cabinet agreed that the RBA's commercial activities – including note printing – should be corporatised, provided it was feasible and cost-effective to do so. This step was also seen as being consistent with improving the efficiency and commercial orientation of NPA, including establishing a more arms-length relationship with the Bank.

While large reductions in staffing have occurred as this process unfolded, most of this reduction occurred when the function was either a branch or division of the RBA. Staff numbers had fallen from 655 in 1981 to about half that level by the time NPA changed from a branch to a division in 1990. They fell further, to 193, while it was still a division. In the period since corporatisation, staff

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has increased to 258, with about half of this increase due to NPA beginning to produce Australia's passports.



The decision to corporatise was based on a business plan that showed returns on equity were expected to exceed the Government's guidelines for corporatised entities. This was based on strong growth in exports. These projections were not realised. A related strand running through these considerations was the desire to develop the polymer technology and earn a return on the Bank's investment; at the time, this was also thought to depend critically on NPA's exports of banknotes. At that stage, Securrency was embryonic and its prospects highly uncertain.³

While these things can be seen more clearly in retrospect, this model for NPA was flawed for two reasons: firstly, NPA did not have the capacity to 'polymerise the world' – it has been unable to sustain the production of banknotes even at a rate of 500 million a year (with the largest global player printing at a rate of 6 billion pieces); secondly, many potential central bank customers viewed NPA as a competitor for their own print works. Subsequent developments show that marketing the polymer substrate itself (via Securrency) to other banknote printers (rather than exporting finished banknotes) has been a more successful strategy for exporting the technology.

Rather than developing export markets, NPA has in the past few years become more reliant on producing for the Reserve Bank, with the latter's demand for notes increasing due to its policy of raising the quality of banknotes in circulation. NPA has also tried to diversify its activities, including by printing passports for the Australian Government at a small profit.

In determining NPA's charter in 1990, the Board emphasised the importance of NPA's research and development activities as the basis for new security features that would minimise the rate of forgery of Australian notes, the key consideration for central bank issuers. The Bank is now asking NPA to lift its R&D effort as the Bank aims to upgrade the security of the current banknote series. Since the Bank has important interests in maintaining NPA's R&D program and in influencing its R&D strategy, it directly finances a considerable proportion of this program each year.

The aim of establishing a more arms-length relationship between the Bank and NPA has had mixed results. It is true that the Bank's senior management has typically been able to spend less time on matters internal to NPA, such as workplace relations, which occupied significant Head Office management time before NPA was a stand-alone operation. At the same time, there has been a long

³ Securrency is a joint venture between the Bank and Innovia Films Ltd, a British company that supplies polypropylene films. Securrency produces press-ready polymer substrate for NPA and export.

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history of concern, including that expressed by the Audit Committee and the RBA Board, that the laxity of the control environment at NPA has been at serious odds with the careful risk-management culture of the Bank and that these cultural deficiencies potentially expose the Bank to serious reputational and financial risk.

3. The Present Situation

It should also be recognised that the Bank's aims for NPA have changed importantly since the current structure was put in place in the 1990s. The Bank's key operational interest in NPA is now to ensure that the banknotes produced for Australia are of a high and consistent standard and that NPA undertakes research activities to improve the security of these banknotes. This change in

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priorities was reflected in the revised Charter for NPA approved by the Board in April.