Annual Performance Statement for 2015/16

Introduction

This performance statement is prepared for 2015/16 in accordance with section 39(1)(a) of the *Public Governance, Performance and Accountability Act 2013* (PGPA Act).

It outlines the key purposes of the Reserve Bank as set out in the 2015/16 corporate plan and provides the results of the measurement and assessment of the Bank's performance in achieving those purposes for the year ending 30 June 2016. Where necessary, additional context is provided, including an analysis of the significant factors that have contributed to the performance of the Bank in achieving its purposes in 2015/16.

As noted elsewhere in this annual report, the Reserve Bank is Australia's central bank and it conducts central banking business. The Bank has two boards, the Reserve Bank Board and the Payments System Board. The Reserve Bank Board is responsible for the Bank's monetary and banking policy and the Bank's policy on all other matters, except for payments system policy, for which the Payments System Board is responsible.

The accountable authority of the Reserve Bank is the Governor.

In the opinion of the Bank's accountable authority, this performance statement:

i. accurately presents the Bank's performance in 2015/16; and

ii. complies with section 39(2) of the PGPA Act.

Monetary Policy

Purpose

It is the duty of the Reserve Bank Board to ensure that the monetary and banking policy of the Bank is directed to the greatest advantage of the people of Australia and that the powers of the Bank are exercised in a way that, in the Board's opinion, will best contribute to:

(a) the stability of the currency of Australia;

(b) the maintenance of full employment in Australia; and

(c) the economic prosperity and welfare of the people of Australia.

In support of the above duties, the most recent *Statement on the Conduct of Monetary Policy* agreed by the Treasurer and the Governor, dated 24 October 2013, confirms the Bank's continuing commitment to keeping consumer price inflation between 2 and 3 per cent, on average, over the cycle, consistent with its duties under the *Reserve Bank Act 1959*. Ensuring low and stable inflation preserves the value of money and facilitates strong and sustainable growth in the economy over the longer term.

Results

Assessing the conduct of monetary policy by the Reserve Bank during 2015/16 involves judging whether the policy decisions taken by the Reserve Bank Board, based on the information available at the time, were consistent with the objectives of monetary policy.

During 2015/16, monetary policy remained focused on the medium-term inflation target, which allows the Bank to foster sustainable economic growth in Australia and maintain inflation of between 2 and 3 per cent, on average, over time.

The Reserve Bank's forecasts for output, the unemployment rate and inflation are published quarterly in the *Statement on Monetary Policy*. As outlined in the August 2015 *Statement*, the economy was initially expected to grow at a rate slightly below long-term trend, increasing to slightly above trend during the 2½-year forecast period, while inflation was expected to be 2–3 per cent throughout. During 2015/16, as new data were received, there were upward revisions to the Bank's near-term forecast for output growth and downward revisions to the forecast profile for the unemployment rate. At the same time, data on domestic cost pressures, including unit labour costs and final prices facing consumers, led to downward revisions to the forecasts for inflation.

The Reserve Bank Board decided to lower the cash rate by 25 basis points at each of its May and August 2016 meetings, to improve the prospects for achieving sustainable growth in the economy and inflation consistent with the target over the medium term. Given the already very low level of interest rates, prior to making these decisions, the Board also carefully considered movements in asset values and leverage over this period because, over the long term, preserving financial stability, as well as low inflation, is key for sustainable growth.

In the August 2016 *Statement*, the central forecast was for output growth to be close to trend and unemployment to be little changed over the next year or so, before a strengthening in growth started to reduce unemployment further in 2018. Inflation was forecast to be 1½ per cent in 2016 and 1½–2½ per cent thereafter, until the end of the forecast period. This is consistent with the medium-term inflation target, which requires that inflation is 2–3 per cent, on average, over the cycle, rather than in any short timeframe. Taking a longer perspective, inflation has averaged around 2½ per cent since the inflation-targeting period commenced in the early 1990s.

Analysis

There have been considerable challenges in the conduct of monetary policy globally. Interest rates are extremely low, inflation is generally subdued and growth in output appears to be lower than in previous decades. There is always uncertainty around the economic forecasts that are an important input to the Reserve Bank Board's monetary policy deliberations, and forecasting performance has not been noticeably different from earlier years. Of more importance, with interest rates already low, and a good deal of debt already on household balance sheets, the trade-offs for monetary policy have become more complex. On the one hand, policymakers are wary of fostering a further substantial build-up in debt. At the same time, high debt levels mean that monetary policy's ability to stimulate growth in the short term may be more limited than in the past.

Globally, the current persistent period of highly accommodative monetary policies is unprecedented. These global influences partly condition the environment in which policy in Australia is conducted. All these factors contributed to a difficult policy environment in 2015/16 and this seems likely to continue in 2016/17. The quarterly *Statement on Monetary Policy* provides further analysis by the Reserve Bank of the developments in the international and domestic economy and financial markets relevant to monetary policy, as do speeches by the Governor and other senior Bank officials, and the monthly statements and minutes following the monetary policy meetings of the Reserve Bank Board.

Financial Stability

Purpose

The Reserve Bank's responsibilities for fostering overall financial stability, while not explicitly established in statute, are similar to those of most other central banks and are also recognised in the *Statement on the Conduct of Monetary Policy*. The Bank works with other official organisations in Australia to foster financial stability. The Governor chairs the Council of Financial Regulators (CFR) – comprising the Bank, Australian Prudential Regulation Authority (APRA), Australian Securities and Investments Commission (ASIC) and Australian Treasury – whose role is to contribute to the efficiency and effectiveness of regulation and the stability of the financial system. The Bank's responsibility to promote financial stability does not, however, equate to a guarantee of solvency for financial institutions, nor is its balance sheet available to support insolvent institutions. Nevertheless, the Bank's central position in the financial system – and its position as the ultimate provider of liquidity to the system – gives it a key role in financial crisis management, in conjunction with the other members of the CFR.

Results

The ultimate measure of performance in financial stability policy remains the stability of the financial system itself. The Reserve Bank assesses a range of economic and financial data to help gauge the soundness of the financial system and potential vulnerabilities. As noted in the October 2015 and April 2016 issues of the Bank's half-yearly *Financial Stability Review*, domestic financial risks shifted from housing lending towards lending for residential development and some other commercial property markets during 2015/16, and there were ongoing concerns associated with the challenges in the resources-related sector. Tighter lending standards by authorised deposit-taking institutions (ADIs), in part induced by earlier regulatory actions, have assisted in enhancing resilience to potential risks, and none of the domestic risks on its own appears to be enough to be a source of domestic financial instability in the near term. Risks in the global financial system to date have not significantly affected Australia's financial system, although a large global shock could have spillover effects on Australia, which could be exacerbated by the aforementioned domestic risks.

The Reserve Bank uses its powers, influence and public communications to ensure as far as possible that the Australian financial system remains stable. This entails the assessment and, together with other CFR agencies, management of domestic sources of systemic risk, as well as enhancing the resilience of the financial system to any shocks that might come from abroad. During 2015/16, the Bank highlighted to the public the key issues and risks for the Australian financial system in its half-yearly *Financial Stability Review*, as well as in various public speeches. The Bank contributed to work with other CFR agencies during the year in the areas of: housing and mortgage markets; derivative markets and financial market infrastructures; Australia's shadow banking sector; APRA's countercyclical capital buffer framework; exploring a domestic loss-absorbing and recapitalisation capacity framework in response to a government-endorsed recommendation of the Financial System Inquiry and related new international standard for global systemically important banks; and preparatory work for a CFR crisis management exercise focused on the general insurance industry, which was held in early 2016/17.

In 2015/16, the Bank also contributed to work undertaken in relation to financial stability under the auspices of various international regulatory bodies, including the Financial Stability Board (FSB), the Basel Committee on Banking Supervision and the Trans-Tasman Council on Banking Supervision. The Governor participated as a member of the FSB Plenary (the decision-making body of the FSB) and Steering Committee, and also served as the chair of the FSB's Standing Committee on Assessment of Vulnerabilities. Other Bank staff participated as members of various committees and working groups. For further information, see the chapter on 'International Financial Cooperation' in this annual report.

Analysis

Financial stability in Australia has been assisted by the sustained strong financial performance of the domestic banking system. Australian banks have improved their resilience to future financial and economic shocks by increasing their capital ratios in 2015/16, as well as strengthening their lending standards, particularly for their mortgage business. Further relevant analysis by the Reserve Bank is provided in the half-yearly *Financial Stability Review* and speeches by the Governor and other senior Bank officials.

Financial Market Operations

Purpose

The Reserve Bank has a sizeable balance sheet, which is managed in support of the Bank's policy objectives. Part of the balance sheet is used to ensure that there is sufficient liquidity in the domestic money market on a daily basis. This promotes the stable functioning of the financial system, in particular the payments system, and the objectives of monetary policy. The Bank's regular transactions in the foreign exchange market are conducted to manage Australia's foreign currency reserves, which are held on the balance sheet of the Bank, and also to provide foreign exchange services to the Bank's clients, the largest of which is the Australian Government. On occasion, the Bank may intervene in the foreign exchange market, consistent with the objectives of monetary policy.

Results

The Reserve Bank's operations in financial markets support its monetary policy objectives through the specification of an operational target for the overnight cash rate in the domestic money market, which is a decision of the Reserve Bank Board. When supplying liquidity to the domestic money market, the Bank seeks to ensure that the overnight cash rate is maintained at the prevailing cash rate target each day. The Bank collects information on each participant's activity in the money market in order to make this assessment and it publishes the outcome daily. The cash rate was equal to the target every day during 2015/16.

The Bank manages its foreign reserves portfolio relative to a benchmark. During 2015/16, the portfolio was managed in a manner consistent with the objective of only small deviations around the asset and duration benchmarks.

Analysis

The nature of the Reserve Bank's financial markets operations continues to be influenced by the diverging monetary policy trends among the major central banks, as well as the regulatory regimes that are imposed on financial markets in which the Bank transacts and/or the counterparties with which it deals, both domestically and internationally. During 2015/16, the Bank continued to adjust to an environment where regulations are undergoing a period of substantial reform and market functioning and structure is evolving significantly. The historically extremely low level of global interest rates provided challenges for the Bank in managing its holdings of foreign reserves.

Payments

Purpose

There are several distinct aspects to the Reserve Bank's role in the payments system, involving that of policymaker and that of owner and operator of key national payments infrastructure.

In relation to the policymaking role, it is the duty of the Payments System Board to ensure that the Bank's payments system policy is directed to the greatest advantage of the people of Australia, to ensure that the powers of the Bank under the *Payment Systems (Regulation) Act 1998* and the *Payment Systems and Netting Act 1998* are exercised in a way that, in the Board's opinion, will best contribute to:

(a) controlling risk in the financial system;

(b) promoting the efficiency of the payments system; and

(c) promoting competition in the market for payment services, consistent with the overall stability of the financial system.

In addition, it is the Payments System Board's duty to ensure that the powers and functions of the Bank under Part 7.3 of the *Corporations Act 2001* are exercised in a way that, in the Board's opinion, will best contribute to the overall stability of the financial system.

The Bank's operational role in the payments system is effected through its ownership and management of the Reserve Bank Information and Transfer System (RITS), Australia's high-value payments system, which is used by banks and other approved financial institutions to settle their payment obligations on a real-time, gross settlement basis. Extinguishing settlement obligations in a safe and efficient manner ensures that there is no build-up of settlement risk and thereby promotes the stability of Australia's financial system.

Results

As the owner and operator of RITS, the Reserve Bank seeks to ensure that this system operates with extremely high levels of reliability and security, while also adapting to the needs of a 24/7 payments world. The system availability target is 99.95 per cent for RITS during core system hours. The Bank met this target during 2015/16.

A broad range of operational metrics were tracked in real time during 2015/16, including measures of system liquidity, participants' transaction values and volumes, and system throughput and performance. The 2015 assessment of RITS against the *Principles for Financial Market Infrastructures,* which was published in December 2015, concluded that RITS observed all of the relevant Principles.

The Reserve Bank's regulatory responsibilities in the retail payments area include promoting competition and efficiency. Consistent with this, in 2015/16 the Bank completed, in a timely and effective manner, the required consultation processes for the wide-ranging review of card payments regulation, which followed from some recommendations of the Financial System Inquiry. The review process included publication of an Issues Paper in March 2015, a Consultation Paper with draft standards in December 2015 and a Conclusions Paper in May 2016. The Bank consulted widely with stakeholders throughout the review process. At the conclusion of the review, the Payments System Board determined three new standards, two dealing with interchange payments in debit and credit card systems and one relating to merchant surcharging. End users of the payments system, including leading consumer and merchant organisations, expressed significant support for the reforms contained in the new standards. More detail on the Bank's policy role in the payments system is available in the Payments System Board annual report.

In addition, to support innovation in the payments system, aimed at improving the efficiency and performance of Australia's retail payments infrastructure, the Reserve Bank has been developing the Fast Settlement Service (FSS), which is the settlements hub for the new industry retail payments platform. This large, complex project with multiple stakeholders has had the usual attendant challenges, but these have been effectively managed so as to meet the mid-2016 target to commission the test system. During 2015/16, the Bank purchased and installed test infrastructure and developed systems to operate the FSS. The FSS test environment is expected to be used for industry testing from October 2016.

The Reserve Bank's regulatory responsibilities also include supervision of clearing and settlement systems. The Bank published its assessments against the domestic regulatory standards of the ASX clearing and settlement facilities in September 2015, of LCH.Clearnet Limited's SwapClear Service in December 2015 and of Chicago Mercantile Exchange Inc. in March 2016. The Bank participates actively in the Basel-based Committee on Payments and Market Infrastructures to ensure that domestic regulatory standards are fully adapted as needed in response to international developments. Accordingly, in line with international developments, an important domestic policy focus in recent years has been the development of a special resolution regime for financial market infrastructures. Advised by the Bank and other financial regulators, the Australian Government consulted on the design of such a regime in 2015. This included the proposal that the Bank be the resolution authority for central counterparties and securities settlement facilities. The conclusions from this consultation were published in November 2015 and indicated that stakeholders were generally supportive of the proposed regime. The CFR has been advising the government on the development of draft legislation to implement the regime. No other changes to the domestic regulatory standards have been identified as necessary in response to international developments.

Analysis

The Reserve Bank's work in the payments area in 2015/16 occurred in an environment that was continuing to change rapidly, with higher expectations of users and the industry concerning the speed of payments and the capacity to combine information with payments. Use of cash and cheques is declining relative to other payment instruments, while use of cards and other electronic forms of payment continues to grow strongly. New technologies, including distributed ledger technologies and other forms of 'fintech', have the potential to change the payments landscape and the operation of financial market infrastructures significantly. Bank staff liaise actively with the private sector to better understand trends in these areas and have participated in a range of domestic and international working groups with other regulators.

Banking

Purpose

Insofar as the Commonwealth requires it to do so, the Reserve Bank must act as banker for the Commonwealth. In common with most other central banks, the Bank also provides banking services to a number of overseas central banks and official institutions. These services include payments and collections as well as general account maintenance and reporting.

Results

The Reserve Bank competes with other organisations to provide banking services to Australian Government agencies. It must cost and price the services separately from other activities as well as meet an externally prescribed minimum rate of return on capital over a business cycle. At present, the return on capital is the Bank's principal measure of financial performance for its transactional banking business. In 2015/16, the Bank met the prescribed rate. Pro forma accounts for the transactional banking business are published in a separate chapter of this annual report.

During 2015/16, the Bank achieved progress in implementing several important banking projects, including the renovation of its banking applications and systems, building the capabilities to participate in the industry's New Payments Platform and refreshing its online payment service, Government EasyPay. All these projects have encountered the usual challenges associated with projects of large scale and complexity, mostly around hiring and retaining appropriate resources. These challenges have been effectively handled. The Government EasyPay project was completed as planned in early 2015/16. Key milestones were reached on schedule for the renovation of banking applications and systems, including renovation of international payments functionality in October 2015, renovation of the initial phases of payment collections functionality in May 2016 and commencement of work in mid 2015 to replace the core account maintenance system. Building capability to participate in the New Payments Platform proceeded in step with the payments industry's schedule. This project involved working with other financial institutions to meet an industry-set deadline, and so has had to manage the usual challenges associated with coordinating with multiple stakeholders, each with their own business pressures and priorities.

Analysis

Substantial changes are under way in transactional banking, particularly in the area of payment services. The broader community is embracing technology and demanding digital services from all providers, including the government, at a rapid pace. During 2015/16, the Bank continued to ensure that it remained in a position to respond appropriately with convenient, secure, reliable and cost-effective services as the largest provider of transactional banking services to the Australian Government.

Currency

Purpose

The Reserve Bank is responsible for the issue, reissue and cancellation of Australian banknotes. Its primary purpose in carrying out this role is to maintain public confidence in the supply, security and quality of Australian banknotes. The Bank works with its wholly owned subsidiary, Note Printing Australia Limited (NPA), to design the banknotes and arranges for their production through NPA. The Bank distributes the banknotes to financial institutions, monitors and maintains their quality in circulation and withdraws unfit banknotes from circulation. It also monitors and analyses trends in counterfeiting and carries out research into banknote security technology.

Results

The next Reserve Bank survey measuring public confidence in Australian banknotes is on schedule to occur in late 2016, as planned. During 2015/16, the Bank continued to monitor indicators that could affect the public's confidence in the supply, security and quality of Australian banknotes in circulation as described below.

Fulfilment of banknote orders by commercial banks provides an indication that the public's demand for banknotes is being met. As an indicator of meeting demand, the Bank aims to fulfil 99.5 per cent of banknote orders on the day requested; during 2015/16, 100 per cent of orders were fulfilled on the day requested.

The Reserve Bank's key initiative to enhance banknote security is the issuance of the new banknote series. Work on the Next Generation Banknote (NGB) program continued during 2015/16, with the new $5 banknote on track to enter circulation on 1 September 2016, as planned. Wide acceptance and distribution of these banknotes over subsequent years will be important to this strategy. The Bank has a detailed communication strategy involving both businesses and consumers to assist with public recognition of the new series of banknotes.

Construction of the new National Banknote Site at NPA's Craigieburn facility has been under way since June 2015 and is currently scheduled for completion and commissioning in 2017. This will facilitate the effective issuance of the new banknote series and is designed to meet Australia's banknote storage, processing and distribution needs for the next 25 years.

The Reserve Bank continued to monitor Australian banknote counterfeiting rates, which declined in 2015/16 compared with the previous year. A new significant counterfeit production source was identified, however, and is being investigated by the Australian Federal Police. The Bank also continued to monitor international developments in counterfeiting. This was aided by the Bank's engagement with overseas central banks and international organisations.

Bank staff attended meetings of the Central Bank Counterfeit Deterrence Group and the Four Nations Group of central banks, including hosting meetings of the latter in Sydney and Melbourne, and undertook work at the Reproduction Research Centre.[1]

In order to ensure banknotes in circulation remain of high quality – to make it easier for the public to detect counterfeits – in 2015/16 the Reserve Bank continued to accept banknotes only of sufficiently high quality for issuance to the public. NPA met the bulk of the Bank's Australian banknote orders for $5, $10 and $50 banknotes from the existing series in full, on time and to the required quality standard. NPA also met the bulk of the Bank's production orders for the new generation banknotes.

In 2015/16, the Reserve Bank also continued to operate the Note Quality Reward Scheme (NQRS), which encourages the private sector to sort banknotes to desired standards. Information collected indicated that banknote quality exceeded the desired standard and remained significantly better than prior to the introduction of the NQRS.

Analysis

While the proportion of payments made using banknotes is declining relative to electronic payments, the number and value of banknotes on issue continues to rise, highlighting their continued importance as a payment mechanism and store of value. Australia's level of counterfeiting remains low by international standards, although it has been tending to increase over time as advances in technology make it easier and cheaper to produce and distribute counterfeit banknotes.

1 The Four Nations Group of central banks collaborates on banknote security research, testing and development and comprises the Reserve Bank of Australia, Bank of Canada, Bank of England, Bank of Mexico and Federal Reserve Board. The Reproduction Research Centre provides facilities to test new security features.

Financial Position and Capital

Purpose

The Reserve Bank makes profits that are incidental to its policy outcomes. The Bank holds assets primarily to conduct operations in financial markets to achieve its central banking policy objectives – specifically, to implement monetary policy, support the Bank's role in the Australian foreign exchange market and manage the country's international reserves. Although carried out largely for policy purposes, these activities have been profitable in most years in the past. Nonetheless, the Bank's balance sheet contains substantial financial risk, and the Bank seeks to ensure that its retained profits and other capital reserves are sufficient over time to absorb losses to which the Bank may be exposed.

Results

The Reserve Bank Board has set a target for capital of 15 per cent of the Bank's assets at risk; this target was met as at the end of June 2016. A transfer of $1 390 million was made to the Reserve Bank Reserve Fund (RBRF) at the end of June 2016 as part of the distribution of the Bank's profit in accordance with section 30 of the *Reserve Bank Act 1959*, resulting in the balance of the RBRF being equal to 15 per cent of the Bank's assets at risk.

Analysis

The Bank's profits primarily come from two sources: underlying earnings, mainly net interest and fee income, less operating costs; and valuation gains and losses (realised and unrealised). The increase in underlying earnings in 2015/16 reflected higher net interest income and the first full-year receipt of fees from authorised deposit-taking institutions (ADIs) for providing the Committed Liquidity Facility, which was introduced on 1 January 2015. Net valuation gains were recognised in 2015/16, primarily from the net depreciation of the Australian dollar against the reserve currencies. More detail is provided in the chapter on 'Earnings and Distribution' in this annual report.