

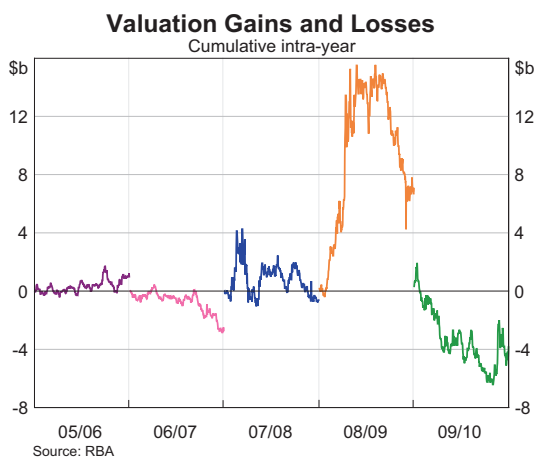
Earnings and Distribution

The Reserve Bank holds assets to carry out its policy and operational responsibilities. Over the past year, these assets amounted to about \$88 billion, on average. The portfolio of domestic securities, primarily repurchase agreements, is used to conduct market operations and manage domestic liquidity. The portfolio of foreign securities represents Australia's foreign reserves, which are invested mainly in highly rated securities. The Bank operates in the foreign exchange market on behalf of its customers and to manage these foreign reserves. The main counterparts to these assets are capital, liabilities from issuing banknotes in Australia and deposits of the Australian Government.

Reflecting the structure of its balance sheet, the Reserve Bank has two general sources of earnings: underlying earnings and valuation gains and losses. Underlying earnings are composed of the Bank's net interest earnings plus small sums of other revenue, less its operating costs. Underlying earnings are usually substantial because the Bank earns market rates of interest on most of its assets but pays no interest on banknotes or capital (which together account for about 70 per cent of the balance sheet). The second component of earnings, namely valuation gains and losses, arises because the value of the Bank's financial assets changes according to movements in the exchange rate and market interest rates. An appreciation of the exchange rate results in valuation losses, as foreign assets are worth less in Australian dollars; an exchange rate depreciation leads to valuation gains. In the case of securities, a decline in market yields increases security prices, producing valuation gains; a rise in yields results in losses. Gains and losses are realised only when the Bank sells the relevant asset; until then they remain unrealised.

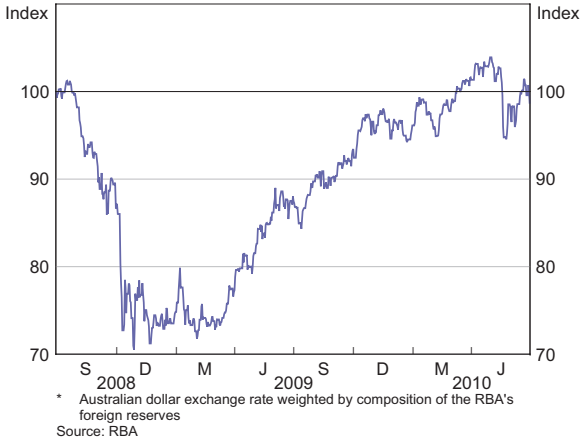
The variability in gains and losses associated with fluctuations in exchange rates and security yields is a reflection of the market risk faced by the Reserve Bank. As the Bank's assets are held essentially for policy purposes, however, it has no scope to manage foreign exchange risk and only limited discretion to manage interest rate risk. As discussed elsewhere in this Annual Report, these market risks are large and can produce marked swings in earnings through the year and from year to year.

Since the Reserve Bank is constrained in managing market risk, it inevitably records valuation losses when the exchange rate appreciates or bond yields rise. This has important consequences for the Bank's earnings, measured either by the yardstick of accounting profits, as determined by the accounting standards, or in terms of earnings that are available for distribution under section 30 of the *Reserve Bank Act 1959*. Under the relevant accounting standards – Australian equivalents to International Financial Reporting Standards (AIFRS) – disclosed profits include earnings from all sources, namely underlying earnings and all valuation gains or losses, whether realised or unrealised. On the distribution of net profit, the Reserve Bank Act determines that

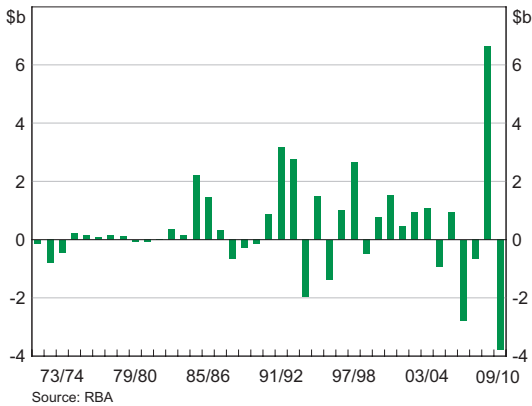


Reserves-weighted Exchange Rate*

30 June 2008 = 100



Valuation Gains and Losses



unrealised gains are not distributed, but are transferred to the Unrealised Profits Reserve where they remain available to absorb future valuation losses or are realised when relevant assets are sold. Unrealised losses are, in the first instance, also taken to the Unrealised Profits Reserve and charged against the unrealised gains retained from previous years. This distribution framework accords with sound central banking practice, as it ensures that the Bank's capacity to absorb valuation losses, when they occur, is not compromised by the previous distribution of unrealised gains.

If unrealised losses exceed the balance of the Unrealised Profits Reserve, the amount by which they do so is initially charged against other sources of income – underlying earnings and realised gains. Any such charge would reduce the earnings available to be paid as a dividend by a corresponding amount. If such a charge exhausted these resources, it would be necessary to absorb the remaining loss in the Reserve Bank Reserve Fund (RBRF), the Bank's permanent general reserve. In this case, no dividend would be payable.

Following the very large gains in the previous year, when the exchange rate fell, the Reserve Bank incurred valuation losses in 2009/10 as the exchange rate recovered. These losses were partly absorbed by underlying earnings and earlier unrealised gains, and partly by a reduction in the RBRF.

The Reserve Bank's Earnings

The Reserve Bank recorded an accounting loss of \$2 928 million, following the unusually large profit of \$8 806 million in the previous year. The components of the loss in 2009/10 were:

- Underlying earnings of \$866 million, \$1 284 million less than in 2008/09 as interest rates around the world were, on average, lower than in the previous year and the appreciation of the exchange rate meant that foreign interest earnings were worth less in Australian dollar terms. At this level, underlying earnings were lower than had been the case since 1982/83.
- Realised valuation losses of \$128 million, comprising losses on foreign exchange of \$358 million, partially offset by gains of \$190 million realised on the sale of foreign securities and of \$40 million on domestic securities.
- Unrealised valuation losses of \$3 666 million, reflecting an appreciation of 12 per cent in a measure of the exchange rate weighted by the composition of Australia's international reserves.

The net accounting loss was absorbed by:

- a transfer of \$2 248 million from the Unrealised Profits Reserve, which exhausted the balance of this reserve; and
- a transfer of \$680 million from the RBRF.

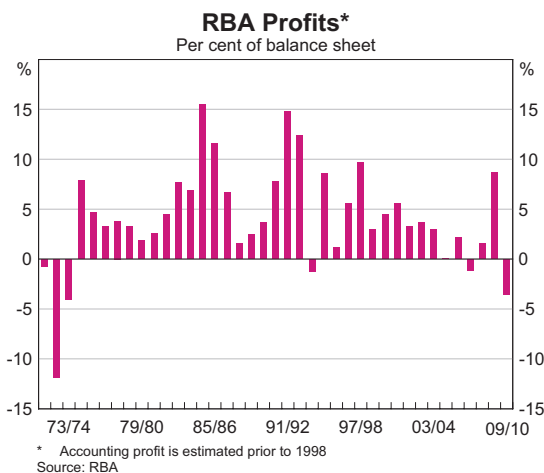
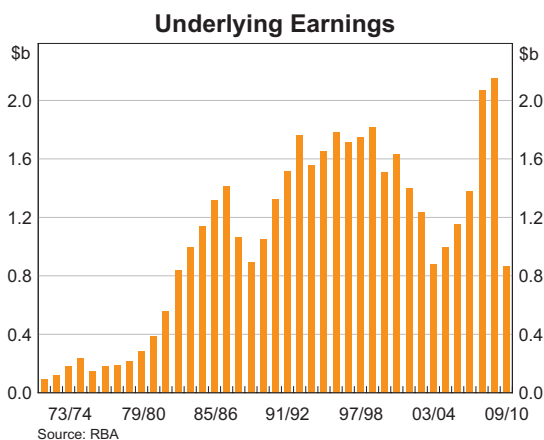
Reflecting these results, no dividend is payable to the Australian Government from the Reserve Bank's profits in 2009/10. However, the sum of \$750 million, deferred from the dividend payable in 2009/10 and as such a liability of the Bank, was paid to the Government in August 2010.

The composition and distribution of the loss in 2009/10, and of the profit or loss in earlier years, is summarised in the table on page 58.

The Reserve Bank Reserve Fund and Other Reserves

The transfer from the RBRF in 2009/10 is consistent with the purpose of this reserve and the policy of the Reserve Bank Board towards it. In making the transfer from the RBRF, the Board took account of a number of considerations. In particular, the RBRF is a permanent reserve, established by section 29 of the Reserve Bank Act as a 'reserve fund', built up by transfers from earnings over the years to provide for exceptionally large losses in the value of the Bank's assets that cannot be absorbed by the Bank's other available resources. The other available resources – namely, the balance in the Unrealised Profits Reserve and underlying earnings – were exhausted in absorbing the valuation loss in 2009/10. Further, while the Board's policy is to hold a balance in the RBRF at a benchmark ratio to the risk held on the balance sheet, this ratio is regarded as a target, not a minimum requirement, consistent with the RBRF remaining available to absorb losses when necessary. The Board has pursued its policy towards the RBRF for a number of years in anticipation that a large valuation loss was likely to occur at some point, given the constraints faced by the Bank in managing market risk on its assets in a floating exchange rate environment.

Since the transfer of \$680 million from the RBRF in 2009/10 has reduced the balance of this reserve to \$6 183 million, a level modestly below that which the Board regards as desirable in the long term, the Board will seek to replenish the reserve from earnings in future years. Consistent with the Reserve Bank Act, such transfers to the RBRF are determined by the Treasurer in consultation with the Board. The loss taken to the RBRF in the latest year is slightly larger than the transfer of \$577 million to this reserve from earnings in 2008/09.



Composition and Distribution of Reserve Bank Profits

\$ million

	Composition of Profits				Distribution of Profits				Payments to Government		
	Underlying earnings	Realised gains and losses(-)*	Unrealised gains and losses(-)	Accounting profit or loss(-)	Transfer to/from(-)				Payment from previous year's profit	Payment delayed from previous year	Total payment
Unrealised Profits Reserve					Asset revaluation reserves	Reserve Bank Reserve Fund	Dividend payable				
1997/98	1 750	966	1 687	4 403	1 687	-558	548	2 726	1 700	-	1 700
1998/99	1 816	2 283	-2 773	1 326	-2 349	-1	-	3 676	2 726	-	2 726
1999/00	1 511	-708	1 489	2 292	1 489	-	-	803	3 000	-	3 000
2000/01	1 629	1 200	320	3 149	320	-5	-	2 834	803	676	1 479
2001/02	1 400	479	-11	1 868	-11	-10	-	1 889	2 834	-	2 834
2002/03	1 238	1 157	-222	2 173	-222	-2	133	2 264	1 889	-	1 889
2003/04	882	-188	1 261	1 955	1 261	-	-	694	1 300	-	1 300
2004/05	997	366	-1 289	74	-1 289	-	-	1 363	374	964	1 338
2005/06	1 156	4	933	2 093	933	-17	-	1 177	1 063	320	1 383
2006/07	1 381	72	-2 846	-1 393	-2 475	-3	-	1 085	1 177	300	1 477
2007/08	2 068	614	-1 252	1 430	27	-	-	1 403	1 085	-	1 085
2008/09	2 150	4 404	2 252	8 806	2 252	-	577	5 977	1 403	-	1 403
2009/10	866	-128	-3 666	-2 928	-2 248	-	-680	-	5 227	-	5 227
2010/11	..	..	..	..	..	..	..	..	-	750	750

* Excludes gains or losses realised from the sale of fixed assets that had been held in asset revaluation reserves

Source: RBA

As noted above, a component of the unrealised loss in 2009/10, amounting to \$2 248 million, was absorbed in the Unrealised Profits Reserve, so that the balance of this reserve was nil at 30 June. As with the transfer from the RBRF, this transfer is consistent with the Reserve Bank Act and in line with the purpose of this reserve.

In addition to these reserves, the Reserve Bank holds balances in asset revaluation reserves, which, although not available to absorb losses, do count towards its net worth. These reserves reflect valuation gains on non-traded assets. The balance in these reserves at 30 June 2010 totalled \$4 087 million, \$779 million higher than a year earlier. The main factor was the increase in the Australian dollar value of the Bank's holdings of gold.

The balance of the RBRF plus asset revaluation reserves stood at 12 per cent of total assets on 30 June 2010.

The Reserve Bank's financial statements (and accompanying Notes to the Accounts) are prepared in accordance with AIFRS, consistent with the Finance Minister's Orders issued under the *Commonwealth Authorities and Companies Act 1997*.

