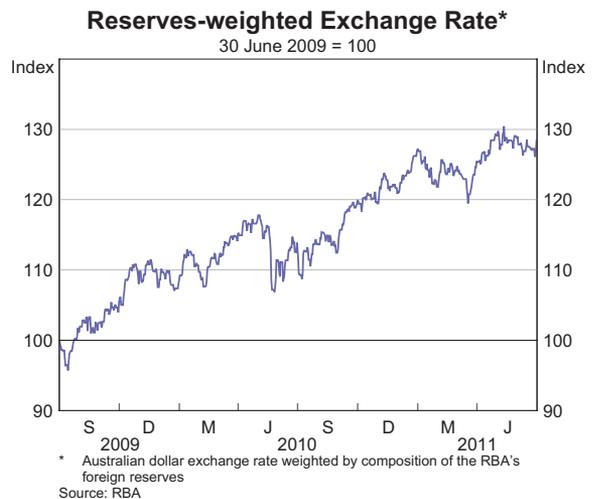


Earnings and Distribution

The Reserve Bank manages a large balance sheet of financial assets that are the basis of its policy and other operations in financial markets. While this balance sheet fluctuates in size according to these operations, total assets averaged \$77 billion during 2010/11. These assets are composed of domestic and foreign assets, with the portfolio of domestic securities used for operations to manage liquidity in Australia and implement monetary policy. As the custodian of Australia's foreign exchange reserves, the Bank operates in the foreign exchange market to manage these reserves and to undertake transactions on behalf of its customers, mainly the Australian Government.

This balance sheet provides two broad sources of income. The first, underlying earnings, is essentially net interest earnings – the difference between interest income and interest paid. Most of the Reserve Bank's assets earn market rates of interest, but no interest is paid on a large component of liabilities, such as banknotes or capital and reserves. Second, the Bank records valuation gains and losses on its assets because their value fluctuates with changes in exchange rates and interest rates. An appreciation of the exchange rate or a rise in interest rates reduces the value of its securities, resulting in valuation losses; a depreciation of the exchange rate or a decline in market yields has the opposite effect, leading to valuation gains. These gains and losses are realised only when the Bank sells the underlying asset; until then they remain unrealised.

Valuation gains and losses are volatile because market interest rates and the exchange rate can fluctuate across wide ranges over time. Accordingly, the Reserve Bank faces substantial market risk on its assets, as discussed in the chapter on 'Risk Management'. Since assets are held for policy purposes, the Reserve Bank has very limited discretion to manage foreign exchange risk and interest rate risk on the portfolio. Consequently, if the exchange rate appreciates, as it did this year and in 2009/10, valuation losses are inevitable. The implications of this volatility for the Bank's profits have been discussed in past annual reports. The potential for such volatility to result in accounting losses is heightened when interest rates around the world are low, as at present.

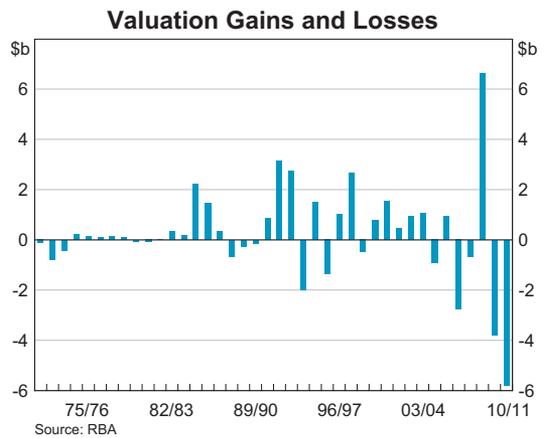
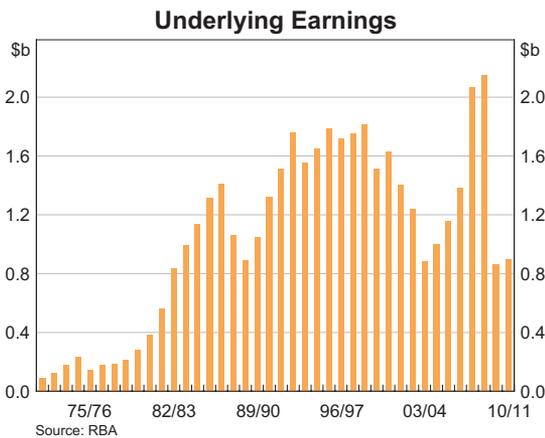


The Reserve Bank follows commercial standards – the Australian equivalents to International Financial Reporting Standards (AIFRS) – in all of its financial disclosures, including on profits. Consequently, all sources of income are included in profits, including underlying earnings and both realised and unrealised valuation gains and losses. The distribution of these earnings is determined by section 30 of the *Reserve Bank Act 1959*. Unrealised gains are not distributed, but are retained in the Unrealised Profits Reserve where they remain available to absorb future valuation losses or until the underlying assets are sold and the gains are realised. Unrealised losses are also transferred to this reserve, to be offset against accumulated unrealised gains when such gains are available. This feature of the legislative framework reflects sound central banking practice, as it prevents the distribution of unrealised gains which would reduce the Bank’s capacity to absorb any future valuation losses. At the start of 2010/11, no unrealised gains were held in the Unrealised Profits Reserve as these had been exhausted by the large valuation loss recorded in the previous year. The Bank has recorded both unrealised and realised losses in 2010/11. These, in the first instance, have been offset against underlying earnings; the remainder has been absorbed by the Reserve Bank Reserve Fund (RBRF), the Bank’s permanent general reserve, significantly depleting this reserve. Accordingly, no dividend is payable to the Australian Government from earnings in 2010/11.

The Reserve Bank’s Earnings

The Reserve Bank recorded an accounting loss of \$4 889 million in 2010/11, following a loss of \$2 928 million the previous year. The loss in 2010/11 comprised:

- Underlying earnings of \$897 million. While this is a modest increase on 2009/10, underlying earnings are at a historically low level as interest rates around the world also remain low by historical standards. The appreciation of the exchange rate during the year also meant that foreign interest earnings were worth less in Australian dollar terms.
- Realised valuation losses of \$1 135 million, arising primarily from foreign exchange transactions associated with managing the portfolio of foreign reserves; valuation losses of \$52 million and \$42 million were realised on the sale of foreign and domestic securities respectively.
- Unrealised valuation losses of \$4 651 million, essentially due to the appreciation of 16 per cent in an index of the basket of currencies in which Australia’s foreign reserves are invested.



As noted, with no unrealised gains held in the Unrealised Profits Reserve for investments, the net accounting loss is fully absorbed by a transfer of \$4 866 million from the RBRF. This transfer reduced the balance of the RBRF from \$6 183 million at the previous balance date to \$1 317 million on 30 June 2011. As a consequence, no earnings are available to pay as a dividend to the Australian Government from the Reserve Bank's earnings in 2010/11.

The composition and distribution of the loss in 2010/11, and of profits and losses in earlier years, is summarised in the Table on page 62.

The Reserve Bank Reserve Fund (RBRF) and Other Reserves

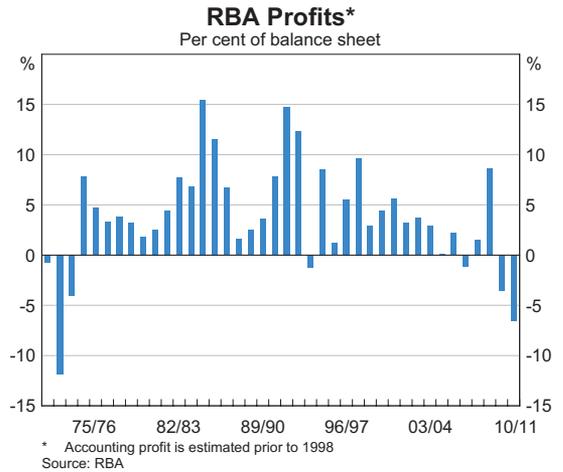
The RBRF is a permanent reserve established by section 29 of the Reserve Bank Act. It has been built up over the years from transfers from profits and is regarded as the Bank's permanent capital. As with any corporate entity, a primary purpose of the Bank's capital is to provide capacity to absorb losses when it is necessary to do so.

The transfer of the loss of \$4 866 million to the RBRF in 2010/11 is in accordance with the purpose of the reserve, in particular that it is available to absorb losses in the value of the Reserve Bank's assets that cannot be absorbed by the Bank's other resources. Importantly, no unrealised gains from previous years were available in the Unrealised Profits Reserve as these had been exhausted by the valuation loss in 2009/10. The transfer from the RBRF in 2010/11 has reduced the balance of the RBRF to a level below that which the Board regards as desirable. Consequently, the Board will seek to replenish the reserve from the Bank's future earnings. Consistent with the Reserve Bank Act, such future transfers to the RBRF will be determined by the Treasurer in consultation with the Board.

The Reserve Bank also has asset revaluation reserves. Although specific to non-traded assets such as gold and property, these reserves contribute to the Bank's net worth. Balances in these reserves represent the difference between the market price of non-traded assets and their cost. The total balance in these reserves stood at \$3 921 million on 30 June 2011, \$166 million lower than a year ago. The main factor was the decline in the Australian dollar value of the Bank's gold holdings.

The balance of the RBRF plus asset revaluation reserves stood at 7 per cent of total assets on 30 June 2011.

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*.



Composition and Distribution of Reserve Bank Profits

\$ million

	Composition of Profits				Distribution of Profits				Payments to Government		
	Underlying earnings	Realised gains and losses(-) ^(a)	Unrealised gains and losses(-)	Accounting profit or loss(-)	Transfer to/from(-)			Dividend payable	Payment from previous year's profit	Payment delayed from previous year	Total payment
					Unrealised Profits Reserve	Asset revaluation reserves	Reserve Bank Reserve Fund				
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	897	-1 135	-4 651	-4 889	-23	-	-4 866	-	-	750	750
2011/12									-	-	-

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

Source: RBA