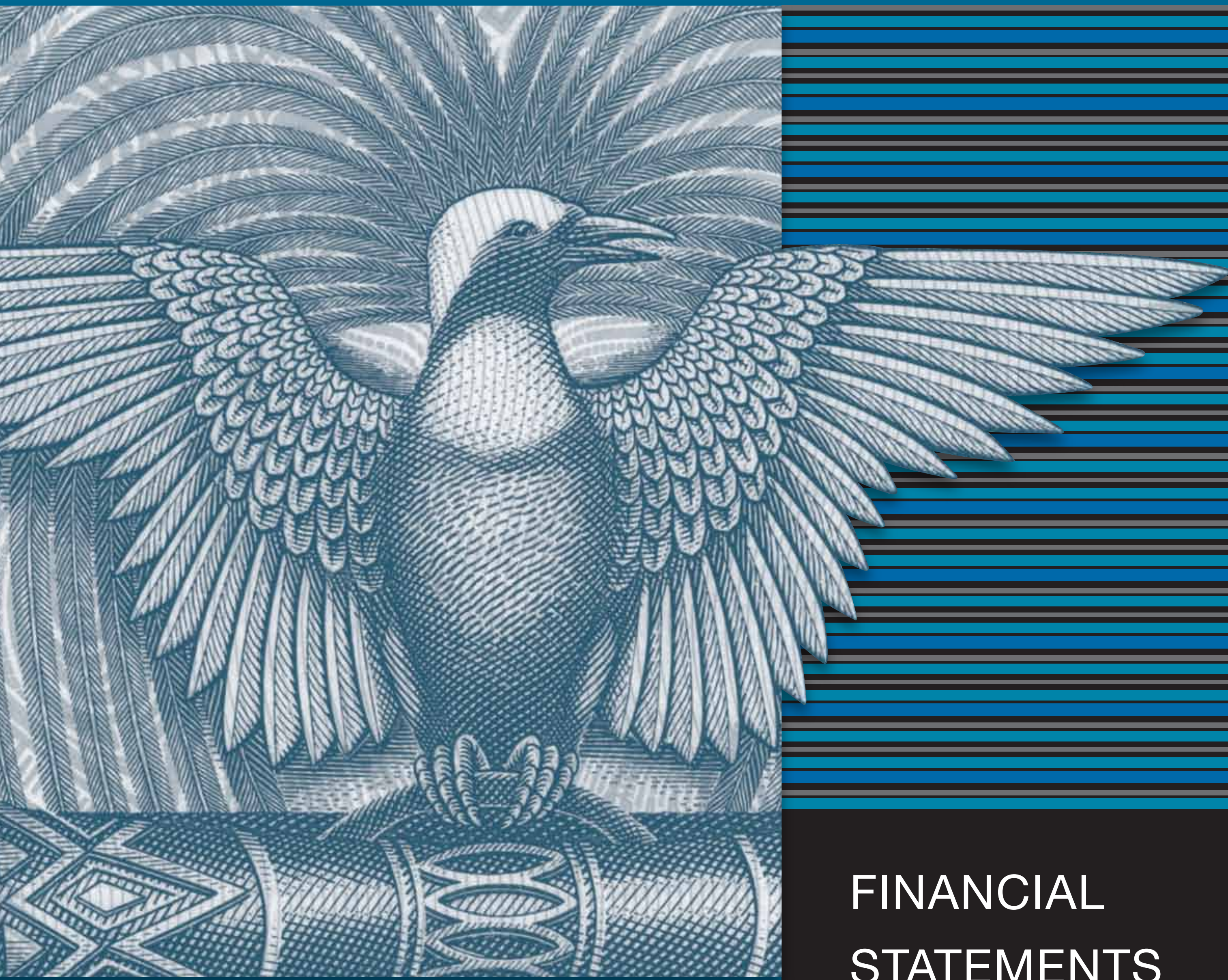
Bank of Papua New Guinea



FINANCIAL STATEMENTS

31 DECEMBER 2012

Bank of Papua New Guinea

REPORT AND FINANCIAL STATEMENTS FOR THE YEAR ENDING 31 DECEMBER 2012

For the advantage of the people of Papua New Guinea, the objectives of the Central Bank are:

(a) to formulate and implement monetary policy with a view to achieving and maintaining price stability; and

(b) to formulate financial regulation and prudential standards to ensure stability of the financial system in Papua New Guinea; and

(c) to promote an efficient national and international payments system; and

(d) subject to the above, to promote macro-economic growth in Papua New Guinea.

Central Banking Act, 2000

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Governor's Foreword

Mr Loi M. Bakani, Governor and Chairman of the Board

2012 was the first year of implementation of the Bank of Papua New Guinea's second Strategic Plan (2012 to 2015), which intends to build on the achievements of the first Strategic Plan (2005 to 2008). The Plan sets the strategic direction the Bank needs to follow to continue improving performance in its mandated functions.

2012 was also the first full year the new top management structure was in effect, aimed at fostering effective leadership for the core functional areas of the Bank. The structure features four new Assistant Governor positions, one each in charge of the three core functions of monetary policy formulation and implementation, financial system supervision, payment system operation and the fourth Assistant Governor in charge of corporate affairs of the Bank.

We have changed the format of the Annual Report. For this Report we report by functional areas. Previously we have provided detailed segments on the functions and activities of each Department. While this information was relevant for reporting on the Bank's core functional areas, it did lead to some duplication of details.

For example, our first core function is formulation and implementation of monetary policy to achieve and maintain price stability. In previous Annual Reports we recorded the separate operations of our Research, Economics and Financial Markets Departments, each of which had a hand in the process. In this Report we describe what was involved in formulating and implementing monetary policy.

I trust readers will find this approach more meaningful.

I now turn to an overview of the economic climate the Bank operated in during 2012, the challenges they created, the impact on the economy and how we responded.

Global economic activity was weak in 2012 due to sluggish growth in the major industrialised economies, reflecting the ongoing Euro-zone crisis, the weak growth in the United States and Japan and a moderation of growth in emerging markets and developing economies. The International Monetary Fund, in its April 2013 World Economic Outlook Update, estimated global economic growth for 2012 to be 3.2 percent, down from an earlier projection of 4.0 percent.

Weak global activity led to a decline in international commodity prices for most of PNG's agricultural exports, including logs and marine products. However increased demand for mineral exports resulted in higher commodity prices for gold, copper and crude oil compared to the prices in 2011. The decline in international commodity prices for non-mineral exports combined with lower export volume of all major commodity exports resulted in lower export receipts in 2012.

The Kina exchange rate appreciated in the first half of 2012, but with the fall in foreign exchange inflows the trend reversed. In the second half of the year the Kina depreciated against the US and Australian dollar. At the end of December 2012 the gross foreign exchange reserve at the Bank was US$4,006.0 (K8,340.8) million, down from US$4,350.1 (K9,226.1) million at the end of 2011. Foreign exchange inflows totalled US$875.6 million, compared to outflows of US$1,194.1 million over the year.

Despite the sluggish growth in the global economy, domestic economic activity remained buoyant, mainly due to continued construction work on the PNG LNG project and its flow-on effects on a few sectors of the economy, such as transportation, building and construction and the hotel and services sectors. As a result, PNG recorded its eleventh year of uninterrupted growth. The Bank estimated that real Gross Domestic Product (GDP) grew by 8.0 percent in 2012.

A major issue for the Bank during the year continued to be the high liquidity level in the banking system, arising from an expansionary fiscal policy and the inflow of foreign exchange. The Bank used open market operations and direct instruments to diffuse some of the excess liquidity. The Cash Reserve Requirement (CRR) was increased from 6.0 percent to 7.0 percent in March and 8.0 percent in June 2012, which assisted in diffusing some of the excess liquidity. With the high liquidity level, market interest rates remained low throughout the year.

The Bank also reintroduced the Tap Facility, this time for Central Bank Bills, following an arrangement with the Treasury Department whereby K200 million in Treasury bills were bought to be sold as Central Bank Bills. The Facility provides an alternative investment opportunity for individual Papua New Guineans as well as to assist in liquidity management.

Despite the high liquidity and solid economic growth, inflation stayed low in 2012. The annual inflation rate for 2012 was 1.6 percent, compared to 6.9 percent in 2011.This was largely attributed to the lag effect of the strong Kina and low imported inflation. This prompted the Bank to ease monetary policy progressively by reducing the Kina Facility Rate (KFR) from 7.75 percent in December 2011 to 6.75 percent in December 2012.

In line with the Bank's Strategic Plan 2012–2015, a number of key projects designed to enhance the Bank's ability to perform its functions and deliver on its objectives either commenced or continued in 2012.

Work on the new automated national payment system, the Kina Automated Transfer System (KATS), progressed further during the year. KATS is designed to connect the banking system and other Government agencies together to settle transactions on a real time basis, thereby increasing the efficiency of the payment system.

By the end of 2012 the system was successfully installed and tested and the training of staff from BPNG and the commercial banks was successfully completed. Once the commercial banks upgrade their core banking systems to communicate with KATS, the system will be fully automated. It is planned for the system to go live in 2013.

In line with the Bank's Strategic Plan 2012–2015, a number of key projects designed to enhance the Bank's ability to perform its functions and deliver on its objectives either commenced or continued in 2012.

The Bank continued its focus on financial inclusion over the course of 2012, with the aim of extending access to financial services to the unbanked population through the network of microbanks, savings and loans societies and other products like mobile phone and agent banking. The Bank hosted the very successful inaugural Financial Inclusion Expo in Lae, Morobe Province towards the end of the year, attracting the participation of more than thirty of PNG's financial institutions. Around 8,000 people attended the Expo, a clear indication of the importance of this initiative.

I acknowledge the good working relationship the Bank of Papua New Guinea maintains with our international partners, including the IMF, the World Bank, the Reserve Bank of Australia, the Reserve Bank of New Zealand, SEACEN Centre, SEANZA, the Australian Prudential Regulatory Authority (APRA), the Pacific Technical Assistant Centre (PFTAC), the Alliance of Financial Inclusion and the Asian Development Bank.

I am hopeful that with the focus on implementing our Strategic Plan and keeping our mission, vision and core values firmly in mind, the Bank will continue to deliver on its core objectives. Our ability to do so requires a dedicated and skilled staff. As in previous years, the Bank provided a wide range of learning and development opportunities to help our staff meet their potential and discharge their duties effectively. During 2012, a good number of Bank staff attended industry-related courses, seminars, workshops and conferences while a few others undertook further studies, both in PNG and overseas.

I wish to thank my fellow Board members for their valuable contribution and support during the year, and the staff for their continued dedication to work. Together we will continue to improve in our performance to meet our vision of being "a contemporary central bank and regulator excelling in performing its core functions and making a distinct and valuable contribution to the financial stability and economic prosperity of Papua New Guinea".

Loi M. Bakani
Governor and Chairman of the Board

Highlights

Financial Inclusion Expo

Over 8,000 visitors attended the inaugural Financial Inclusion Expo held in Lae, Morobe Province on 29 November and 30 December. 34 organisations, representing the majority of the PNG financial system, took part in the Expo hosted by the Bank of Papua New Guinea.

KATS implemented

The Kina Automated Transfer System progressed further in 2012, and is expected to be launched in 2013. (See Projects, page 13.)

Microfinance Expansion

The development of a viable microfinance sector in PNG continued to gain momentum during 2012 with the achievement of a number of important milestones. (See page 26.)

Financial Diaries Survey

120 households in Kimbe, Goroka and NCD participated in the survey. Results will be used to develop financial literary programs. (See page 26.)

New K50 note

The Bank released a new K50 banknote in 2012 with the signature of the current Governor, Mr Loi M. Bakani.

Data Warehouse

Superannuation funds and insurance companies are now able to submit quarterly data to the Bank electronically, as part of the Bank's Data Warehouse project. (See page 13.)

Sovereign Wealth Fund

Parliament passed the Organic Law on Sovereign Wealth Fund (SWF) in February 2012. Under the law all future mining, oil and gas revenues for the Government will be deposited into the SWF, held offshore. An independent Board will oversee and decide on the investment policy and guidelines of the SWF, which will be subject to rigorous governance, transparency and asset management rules.

In August an SWF Implementation Secretariat (SWFIS) was set up at the Department of Treasury, staffed by officers seconded from the Bank of PNG, the Departments of Treasury and National Planning & Monitoring and Justice & Attorney General. The SWFIS' activities included developing various policy papers and assisting the work of the SWF Technical Working Group and Secretaries Committee. As well, the SWFIS met with various Technical Assistance and donor partners, including the IMF, World Bank, Australian Futures Fund and the Australian Government.

SEANZA

SEANZA (South East Asia, New Zealand, Australia) aims to promote cooperation among central banks by providing appropriate training courses and workshops for staff of member central banks. Through its Forum of Banking Supervisors, which has 20 member countries, SEANZA also facilitates information exchange on issues of common interest.

The Bank of Papua New Guinea hosted the SEANZA Forum of Banking Supervisors in 2012.

Attendees at the 2012 SEANZA Forum.

Mission
Vision
Values

Mission

The Bank of Papua New Guinea's MISSION is to serve the people of Papua New Guinea by conducting effective monetary policy and maintaining a sound financial system. We will act at all times to promote macro-economic stability, provide a first class payments system and help foster economic growth of our country.

Vision

A contemporary central bank and regulator excelling in performing our core functions and making a distinct and valuable contribution to the economic well-being of Papua New Guinea.

Values

With **INTEGRITY** we build good governance and credibility.

With **EFFICIENCY** we produce quality results, on time and on budget.

With **TRANSPARENCY** our decisions stand scrutiny.

Through **ACCOUNTABILITY** we take responsibility for our decisions and actions.

Through **TEAMWORK** we benefit from sharing skills, knowledge and experience.

Through **PROFESSIONALISM** we strive for best practice.

Governance

The Bank's governance practice starts with the Board and its responsibility to ensure the Bank's policies (other than monetary policy and financial system regulations, which are the exclusive responsibility of the Governor) are directed to the greatest advantage of the people of Papua New Guinea.

To this end, Board members are drawn from a range of interest groups within the PNG community – civil, church, regulatory, workers union and industry bodies.

There were a number of changes to the composition of the Board during 2012.

Fr Denny Bray Guka was appointed as an *ex officio* member in February 2012, in his capacity as President of the PNG Council of Churches, the position formerly held by Reverend Sir Samson Lowa KBE.

Mr Douglas Uyassi, in his capacity as Chairman of the Securities Commission, served on the Board from the beginning of the year until his replacement by Mr Alex Tongayu in November 2012.

Upon his election to Parliament in June 2012, Mr Michael Malabag ceased to be President of the PNG Trade Union Congress and accordingly resigned his *ex officio* position on the Board.

As at 31 December 2012 there were four vacant positions on the Board of the Bank of Papua New Guinea – the *ex officio* position held for the President of the PNG Trade Union Congress and the three National Government nominees.

THE BOARD

Governors

Governor and Chairman

Loi M. Bakani

Mr Bakani was appointed Governor of the Bank of Papua New Guinea and Chairman of the Bank Board in December 2009.

He is also a Member of the Board of South East Asian Central Banks (SEACEN), the Alternative Governor for IMF Annual Meetings, Chairman of the Microfinance Expansion Project, Director of the PNG Institute of Directors (PNGID), Director of the PNG Institute of Banking & Business Management and Member of the Advisory Board of Port Moresby Senior AFL competition.

He holds a Bachelor of Economics from the University of Papua New Guinea and a Masters degree in Commerce majoring in Economics from the University of Wollongong, Australia.

Deputy Governor

Benny Popoitai MBE

Mr Popoitai was appointed Deputy Governor and Member of the Board in November 2000. He is also President of the PNG Institute of Directors.

Mr Popoitai holds a Bachelor of Economics with Honours from the University of Papua New Guinea.

Members of the Board *At 31 December 2012*

Mr John Leahy

Mr Leahy was appointed *ex officio* to the Board in March 2008, in his capacity as President of the PNG Chamber of Commerce and Industry.

Mr Leahy is also a Director of a number of companies, including Bougainville Copper Ltd (until May 2012), Brands International Ltd, Tasman Construction Ltd, Abelia Investments Ltd and Orion Project Services (PNG) Ltd.

He holds a Bachelor of Laws Degree and a Bachelor of Jurisprudence Degree from the University of NSW, Australia and a Graduate Certificate in Management from the Monash Graduate Business School, Australia.

He has been admitted to practise law in both NSW and PNG. He is presently in private practice as a lawer in PNG.

Members of the Board of the Bank of Papua New Guinea

31 December 2012

Standing L-R Mr Alex Tongayu, Dr Ken Ngangan, Mr Benny Popoitai MBE (Deputy Governor)
Seated L-R Mr John Leahy, Mr Loi M. Bakani (Governor), Fr Denny Bray Guka

Dr Ken Ngangan

Dr Ngangan was appointed *ex officio* to the Board in April 2011 in his capacity as President of CPA PNG.

He is also Chairman of the Board of National Teachers Insurance Limited (NTIL) and Deputy Chairman of National Development Bank.

Dr Ngangan holds a Bachelor of Arts degree in Commerce with Honours from the University of Papua New Guinea, a Masters degree in Accounting from the University of Glasgow, Scotland, a Doctor of Philosophy from the University of Newcastle, Australia and a Post-Doctoral Fellowship from the University of Aberdeen, Scotland.

Fr Denny Bray Guka

Fr Denny Bray Guka was appointed as an *ex officio* member in February 2012, in his capacity as President of the PNG Council of Churches.

He is the Vicar General/Archdeacon of the Anglican Diocese of Port Moresby and is Vice-Chairman of Anglicare PNG. He is a Director of the Papua New Guinea Medical Board and the PNG Bible Society and Vice-Chairman of Coronation Primary School.

Fr Guka's educational qualifications include Certificates in Theology and in Teaching.

Mr Alex Tongayu

Mr Tongayu was appointed *ex officio* to the Board in November 2012 in his capacity as Acting Chairman of the Securities Commission of PNG.

Mr Tongayu holds a Bachelor of Laws degree from the University of Papua New Guinea.

Governance

Board Meetings

The Board meets at least once every three months. The April 2012 meeting was held in Alotau, Milne Bay Province. Two meetings were held in Port Moresby (July and December) and the September meeting was held in Goroka, Eastern Highlands Province.

Board Member	Meetings Eligible to Attend	Meeting Attended
Mr Loi M. Bakani	4	4
Mr Benny Popoitai MBE	4	4
Rev. Sir Samson Lowa KBE	1	0
Mr John Leahy	4	2
Mr Michael Malabag	1	1
Dr Ken Ngangan	4	3
Mr Douglas Uyassi	1	1
Fr Denny Bray Guka	2	2
Mr Alex Tongayu	1	1

Board Audit Committee

The Board Audit Committee is charged with assisting the Board to ensure the Bank's performance in financial reporting, internal control and governance meets the required standards and expectations.

During the year Dr Ken Ngangan chaired the Committee, which also comprised Mr Benny Popoitai, Mr John Leahy and Mr Alex Tongayu as members.

Transaction transparency and ethical conduct

Internal committees

The composition of the Bank's internal committees was restructured during 2012 to reflect the new organisational structure.

Several internal committees were convened during 2012 to establish and review operational frameworks and benchmarks and to oversee, consider and authorise specific aspects of the Bank's activities. These included the Monetary Policy Committee, the Money Market Operations Committee, the Investment Committee, the Tender Committee and the Budget Committee. Each committee has specific roles and responsibilities designed to ensure the probity of the Bank's various activities.

External checks and balances

In addition to the committee system, the Bank has in place a number of other measures as part of its commitment to good governance. For example, the Bank must meet the statutory obligation of presenting its annual financial statements to the Auditor-General of Papua New Guinea for detailed inspection and audit.

An external agency, the Salaries and Conditions Monitoring Committee, is charged with the responsibility of ratifying changes to staff employment conditions, including pay increases.

Internal audit

Over the course of 2012 the internal audit function concentrated on ensuring the effectiveness and security of the Bank's internal controls and operating environment, including the areas of foreign exchange reserves and outsourced funds, foreign exchange settlements, financial management, banking and currency.

Peer review

The Bank of PNG actively seeks peer review on key decisions from the Reserve Banks of Australia and New Zealand and other regulatory authorities, such as the Australian Prudential Regulatory Authority (APRA).

The Bank's participation in SEACEN activities provides another valuable forum through which to discuss central banking matters.

Co-operation with Government Agencies

The Bank also works with other Government agencies to mitigate the risk of fraud and other such threats to the financial and payments systems.

Setting the right example

The Bank's Values Statement provides clear guidance to Bank employees that all staff members are required to conduct themselves with the highest standard of behaviour.

Financial Performance

Under the terms of the *Central Banking Act 2000* the Board in consultation with the Minister determines the distribution of the Bank's operating profit.

Non-operating profit, comprised of net gains or losses from revaluation of foreign currency assets and liabilities, is not available for distribution to the Government.

Operating Income

Total operating income for the year ended 31 December 2012 was K279 million. The income was derived mainly from interest on overseas investments, fees and commissions on foreign exchange trading and domestic government securities.

Operating Expenditure

Total operating expenditure, comprising interest expense and general administration costs, was K255 million, down K25 million from 2011. The savings in expenditure was largely due to a reduced issuance of Central Bank Bills for monetary policy operations, complemented by an increase in the issuance of Treasury bills by the Government for budgetary requirements.

Net Operating Profit

The Bank recorded a net operating profit of K24.3 million for the 2012 year, compared to an operating loss of K7.6 million in 2011.

Unrealised Gain/ (Loss)

The Bank recorded a net foreign and domestic financial assets revaluation gain of K8.2 million for the year ended 31 December 2012, which was transferred to the Unrealised Profits/(Loss) Reserve. This was a direct result of the depreciation of the Kina against most major currencies during the financial year. In addition, gold valuation gain of K7.2 million was transferred to the Gold Reserve.

Appropriation

The provisions of the CBA give the Board of the Bank of PNG the responsibility to determine the Bank's net profit. These provisions require the Board to consult with the Minister on the amount to be placed to the credit of the Reserve Funds, with the balance of net profits to be paid into the Consolidated Revenue Fund.

However, if the Board believes the assets of the Bank are less than the sum of its liabilities and paid up capital, or would be after payment, no amount is to be paid into Consolidated Revenue. In addition, under the terms of Section 50(1) of the CBA, net profits arising from revaluations of the Bank's assets and liabilities and/or from foreign exchange movements shall not be available as a dividend to the Government or paid into Consolidated Revenue.

Net Profit Available for Appropriation

K million	2009	2010	2011	2012
Total comprehensive income/(loss)	196.2	195.1	(1,737.1)	39.7
Unrealised profit/(loss)	(148.6)	(173.2)	(1,729.5)	15.4
DISTRIBUTABLE PROFIT/(LOSS)	**47.6**	**21.9**	**(7.6)**	**24.3**
Transferred to:				
Currency Movement Reserve	47.6	–	–	–
Unrealised Profits Reserve	–	–	(1,714.13)	8.2
Gold Reserve	–	31.8	(15.2)	7.2
Retained Profit/(Loss)	–	–	(7.6)	24.3
Capital Reserve	–	–	–	
Consolidated Revenue (dividend to Govt)	–	21.9	–	

2013 Budget Forecast

	Budget 2013 (K million)	Actual 2012 (K million)
Operating Income		
Interest received (overseas)	186.1	215.8
Interest received (domestic)	63.7	53.3
International trading/forex fees	5.2	5.7
Other income	4.4	4.4
TOTAL INCOME	**259.4**	**279.2**
Operating Payments		
Interest expenses	134.0	159.1
Currency	11.9	18.4
Financial Markets	1.4	1.7
Outsourced investments fees & charges	5.0	3.5
Audit fees	1.3	1.4
Board fees & meeting expenses	0.8	0.5
Legal & consultancy fees	5.2	4.0
Depreciation & amortisation	4.0	6.2
Property, plant & equipment	10.6	10.3
Staff employment	44.0	34.7
Staff training & development	4.9	2.1
Staff Housing Scheme	2.8	1.4
Travel	5.3	4.8
Insurance	0.9	1.1
Security	2.0	1.5
Cafeteria operations	0.3	0.2
Special projects	5.0	1.8
Other expenses	6.8	2.2
TOTAL PAYMENTS	**246.2**	**254.9**
NET OPERATING POFIT/(LOSS)	**13.2**	**24.3**

Projects

In 2012, the Bank of Papua New Guinea commenced as well as continued implementing a number of strategic projects. These included:

Kina Automated Transfer System (KATS)

Further advances to the development of KATS, the new payment system for the country continued in 2012.

Milestones reached:

- a working group convened to implement KATS for local payments with representatives from all commercial banks and key Government Departments such as Finance;
- Payments Unit established within the Bank to oversee KATS;
- the initial report by the system vendor accepted;
- the system software and banking support services accepted as suitable for the retail banking operations;
- the drafting of the *National Payments System Act* by the First Legislative Counsel completed for submission to Parliament; and
- discussions with Department of Finance to introduce direct funds transfers by the Bank to payees' commercial bank accounts.

Data Warehouse

The Data Warehouse project continued and covered the Superannuation and Life Insurance Supervision Department. The project, completed in October 2012, involved developing a new system to allow superannuation funds and life insurance companies to enter and submit quarterly returns to the Bank electronically. The Bank conducted training on the new system for the life insurance companies and superannuation funds at the end of November, in preparation for full rollout in 2013.

Land Acquisition in Lae for a Regional Centre

Following the purchase of a piece of land in Lae in 2011, the Bank commenced discussions with industry experts in 2012 on the design stage of development of a regional Currency Distribution Centre (CDC). When completed, the Lae CDC will operate as a currency storage, processing and distribution centre for the Highlands, Islands and Northern regions of Papua New Guinea.

Strategic Plan 2012-2015 implementation

Implementation Monitoring

During 2012 the Bank developed a reporting framework to monitor the implementation of the Strategic Plan 2012-2015.

The process involves departments aligning their strategic actions to the Bank's primary and secondary objectives set out in the Strategic Plan. These strategic actions are planned and included in the department's annual work plans. For efficient management of staff capacity building, the department's annual training plans were linked to the work plans and coordinated through the Human Resource Department.

Each Department is required to report on the progress of their strategic actions to the Bank's Strategic Management Office (SMO). From these department reports SMO produces a master report for the Bank's Executive Committee and Board.

To ensure the effectiveness of the monitoring process and the completeness of the reports from the departments, the Bank developed a report template in 2012, which will be used from the start of 2013.

Budget Management

During the year the Bank also implemented a rolling eight-quarter budget process to link the work plans and training activities of each department to the Strategic Plan. The new process gives better guidance on planning effectiveness, project implementation and budget control.

The process not only facilitates a forward-looking approach to achieving the Bank's strategic goals within budget, but it also enables the two year work plans and budgets produced in 2012 by each department to be reviewed every quarter.

Core Functions

MONETARY POLICY

Formulation of monetary policy

The Bank formulates and implements monetary policy with a view to achieving and maintaining price stability as stipulated under the *Central Banking Act 2000*. The Bank released two Monetary Policy Statements, as required under the Act, the first on 31 March and the second on 30 September 2012.

Expected developments in the global economy and their implications for the domestic economy, through the balance of payments, fiscal operations of the Government, monetary aggregates, real sector (economic activity), exchange rate and ultimately the impact of these variables on inflation are considered in the formulation of monetary policy.

On a monthly basis the Bank considers developments in the same areas for the setting of the policy signalling rate, the Kina Facility Rate (KFR). Analysis of the quarterly Consumer Price Index (CPI), released by the National Statistics Office (NSO), and the Bank's own Retail Price Index (RPI) are key inputs for the determination of the KFR.

The RPI is compiled from data collected by BPNG each month from selected major supermarkets in Port Moresby, as well as data on the price-controlled items from the ICCC. The Bank also collects other price data on various items such as electricity, telecommunication, transport, water and sewerage, and postal charges.

The Bank's estimates and projections of gross domestic product, balance of payments, and inflation were discussed in the consultative meetings with the Treasury Department for the latter's formulation of fiscal policy, specifically the National Government's 2013 National Budget.

The construction phase of the PNG Liquified Natural Gas (LNG) project peaked in 2012. Its spin-off effect of increased business activity in the building and construction, transportation, manufacturing and services sectors was also a major contributor to economic activity in 2012, and accordingly was considered in the formulation of monetary policy.

Implementation of monetary policy

The open market operation, with the auction of Central Bank Bills (CBB), Treasury bills, and Inscribed stock, is the main instrument for implementation of monetary policy, after the release of the six-monthly Monetary Policy Statements and the monthly announcement of KFR. In addition, the Bank can use direct instruments such as the Cash Reserve Requirement (CRR) for conducting monetary policy.

Liquidity levels in the banking system continued to be high, from increased foreign exchange inflows as a result of high commodity prices in recent years and in the first half of 2012, from capital inflows associated with the PNG LNG project. The amounts of CBB, Treasury bills and Inscribed stocks used in the open market operations are given under the Registry Operations section (page 15).

The inflation rate was high in the December quarter of 2011 and in the first quarter of 2012. The Bank therefore maintained its tight stance of monetary policy by keeping the KFR at 7.75 percent from January to August. Following a low headline inflation of 1.4 percent in the June quarter and subdued inflationary pressures, the Bank eased monetary policy by reducing the KFR to 6.75 percent in September and maintained this rate to December 2012.

The commercial banks responded to this reduction by lowering their Indicator Lending Rates (ILR), with the spread at 11.20 – 11.70 by the end of December 2012 compared to 11.45 – 12.20 percent in 2011.

In October 2012 the Bank reintroduced the Tap Facility for CBBs, with the aim of encouraging savings by providing an alternative investment opportunity and encouraging competition in the retail deposit market.

This Facility was made possible by the Bank's purchase of K200.0 million Treasury bills from the Government, onsold to the public as CBBs with a maturity of one year.

The CBBs were made available to small retail investors, with a minimum amount of K10,000 and a maximum of K100,000.

Terms of 63 days and 91 days were offered at yields of +1.00% margin above the weekly CBB weighted average rates. Tap demand has been increasing at a slow pace since its introduction.

As an additional measure to diffuse excess liquidity, the Bank increased the Cash Reserve Requirement (CRR), initially from 6.0 percent to 7.0 percent in March 2012 and again in June to 8.0 percent. This resulted in a total diffusion of K318.0 million.

The Minimum Liquid Asset Ratio (MLAR) remained at zero throughout the year.

Registry Operations

The Bank of Papua New Guinea acts as an agent for the Government in the sale and registration of domestic debt instruments. As part of its liquidity management the Bank underwrites issues and acts as a market maker in these instruments. The Bank's services include:

- issuing, transferring and registering securities;
- maintaining ownership records;
- reporting to investors and stakeholders on periodical payment of interest and redemption of securities at coupon and maturity date.

Government debt

At the end of 2012 total borrowing by the Government from the public amounted to K6,118 million, which comprised K3,367 million in Inscribed stock and K2,751 million in Treasury bills.

Inscribed stock

Issued in 2012	K606 million
Matured in 2012	K106 million
Net issuance	K500 million

Total holdings 31 Dec 2012	K3,367 million
Total holdings 31 Dec 2011	K2,867 million
Increase in total holdings	K5.0 million

BPNG portfolio holdings Dec 2012	K501 million
BPNG portfolio holdings Dec 2011	K418 million
Increase in BPNG holdings	K83 million

Treasury bills

Outstanding at 31 Dec 2011	K2,254 million
Issued in 2012	K3,470 million
Matured in 2012	K2,973 million
Outstanding at 31 Dec 2012	K2,751 million

The Bank held no Treasury bills in its portfolio by the end of 2012.

Central Bank Bills

Balance as at 31 Dec 2011	K5,715 million
Total sales in 2012	K28,584 million
Total maturities in 2012	K28,936 million
Closing balance at 31 Dec 2012	K5,362 million

Central Bank Bill Tap Facility

Opening stock at Oct 2012	K200,000
Total sales	K4,639
Closing stock at 31 Dec 2012	K195,361
Total stock outstanding	K4,432
Total amount retired	K207

Foreign Reserves Operations

The *Central Banking Act 2000* provides the mandate for the Bank to manage gold, foreign exchange and other international reserves of Papua New Guinea. The management of foreign exchange reserves is crucial to achieving the Bank's price stability objective.

The Bank's main reasons for holding foreign exchange reserves are to:

- support price stability
- service the Government's foreign debt obligations
- protect the domestic economy from external shocks.

Core Functions
Monetary Policy

The Bank's investment of foreign reserves involves fulfilling these internal objectives as well as controlling the risks associated with their management. In this regard the Bank's primary objectives are to:

- preserve the capital value of the foreign exchange reserves
- maintain adequate liquidity
- manage credit risk conservatively
- earn an acceptable rate of return on the assets.

The foreign exchange reserves have increased substantially over the past decade. Since the end of 2007 foreign reserves have increased from US$2.1 billion (K5.89 billion) to US$4.0 billion (K8.34 billion) at the end of 2012.

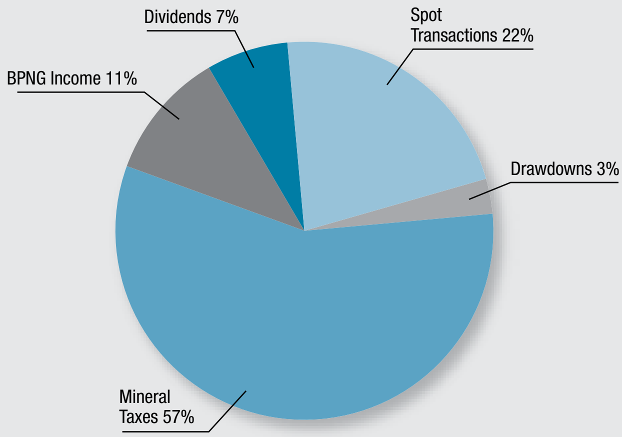
In 2008 the Bank decided to outsource part of its foreign exchange reserves. The main considerations leading to the decision were benefits associated with diversification, return, benchmarking and staff capacity building. The outsourcing program commenced with the engagement of four external fund managers, Clariden Leu, Schroders, Deutsche Bank and HSBC. Each was given US$200 million to manage. A further US$200 million was outsourced to Black Rock in 2011, bringing the total outsourced funds to US$1.0 billion. In June 2012, Pictet replaced Clariden Leu as asset manager and custodian.

At the end of 2012 the foreign exchange reserves were US$1,097.2 million managed by the external fund managers and US$2,100 million managed in-house. The management of both the in-house and externally-managed funds are subject to the Bank's primary objectives but different guidelines. The external fund managers' guidelines include a broader range of products in which they are allowed to invest, while the in-house managed funds are limited to high grade supra nationals and sovereign issuers.

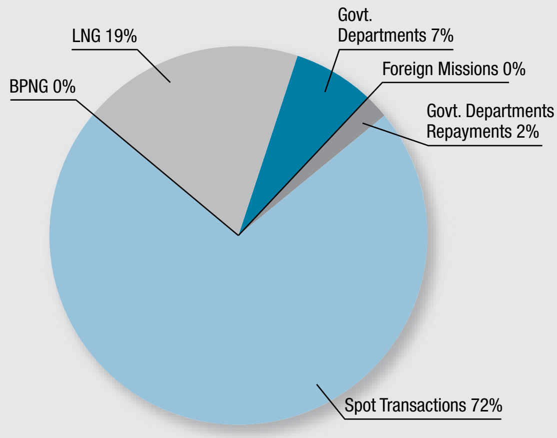
Foreign Exchange Reserves

December 2012	US$4.00 billion (K8.24 billion)
December 2011	US$4.35billion
Decrease	US$0.35 billion
Reason – The sale of foreign exchange through intervention and the funding shortfall of the LNG project, which more than offset inflows via the purchase of foreign currency from the market and mineral tax receipts by Government.	

Foreign Exchange Inflows 2012



Foreign Exchange Outflows 2012

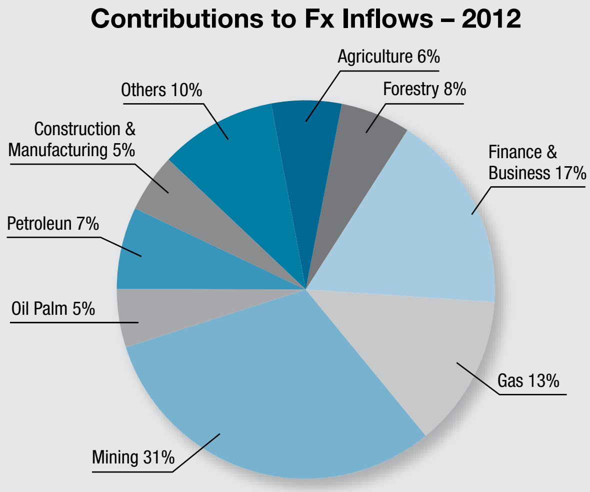


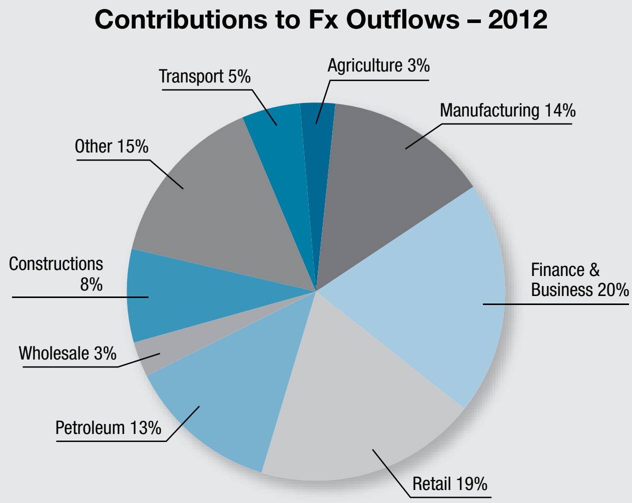
Domestic Foreign Exchange Market

The Kina was supported mainly by good mining inflows and interventions by the Central Bank. These inflows more than offset outflows dominated by the retail, finance/business and manufacturing sectors.

In trade-weighted terms, the Kina appreciated against the currencies of its major trading partners.

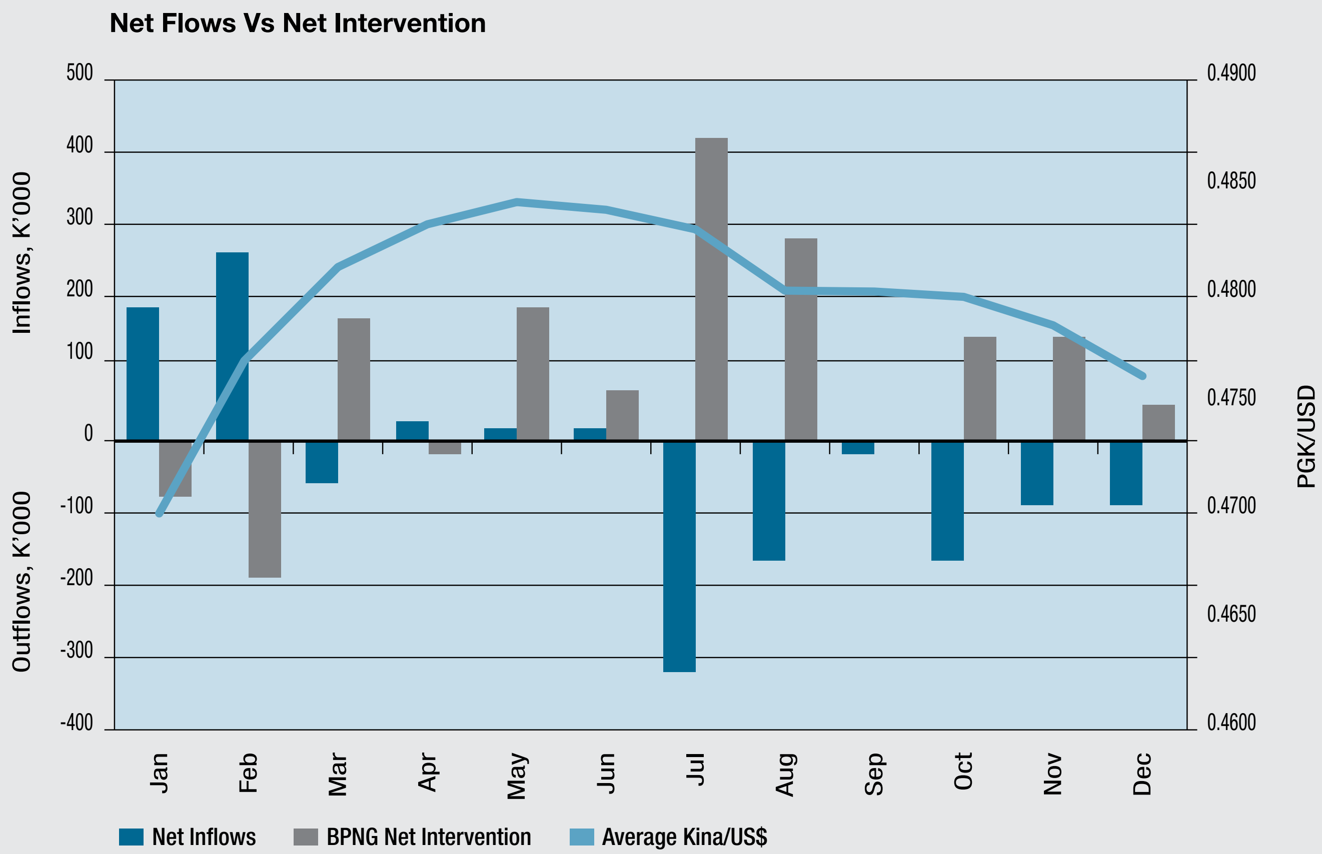
	2012 – January	2012 – December	Percentage Change
PGK/USD	0.4665	0.4755	1.9%
PGK/AUD	0.4591	0.4580	-0.3%
PGK/EUR	0.3605	0.3602	-0.1%
PGK/GBP	0.3026	0.2944	-2.7%
PGK/JPY	36.17	40.96	13.2%
PGK TWI	37.31	37.64	0.9%





In 2012 the Bank was a net buyer of US$570.1 million in the domestic foreign exchange market. This is equivalent to a net injection of K1.18 billion into the domestic market compared with a net injection of K939.5 million in 2011.

The total turnover in the foreign exchange market in 2012 increased slightly to K36.6 billion, compared to K36.4 billion in 2011.



Summary of foreign exchange flows, the Bank's intervention and exchange rate movements 2012.

Foreign Currency and Interest Rate risks

2012 was a year of heightened volatility in the financial markets. The macro issues that led to this included:

- the on-going European Debt Crisis
- fears of a global economic slowdown in emerging markets
- geopolitical events
- natural disasters
- downgrades of major banks in the Eurozone and
- the so-called 'fiscal cliff', defined as the potential sharp decline in the budget deficit, beginning in 2013, due to increased taxes and reduced spending as required by previously enacted laws.

Global bond market yields increased in the first quarter of 2012, in line with expectations of improved global economic growth and signs of recovery in the United States. Following the first quarter, global yields remained flat for the remainder of the year, with both short and long term yields trading in a tight range. Episodes of risk on and risk off continued to drive the yield curves, influenced by long term resolutions to the European debt crisis and the fiscal cliff in the United States. As a result, the US dollar was volatile against most major currencies during 2012.

Responding to the ongoing uncertainty associated with the European Debt Crisis and the threat of continued global economic slowdown, the Bank widened the duration range for all portfolios. The widening of the duration ranges was designed to accommodate high volatility and gave the Bank flexibility to take advantage of the declining yields. In the second half of 2012 the Bank decided to take a neutral stance across all currencies, leveling the long US dollar and the Euro short positions to a neutral position.

Funds Performance

In-house Managed Funds

The in-house managed funds generated portfolio returns of 2.84 percent over the year to December 2012. The positive returns were mainly due to high coupon bonds in the AUD portfolio and trading of bonds by portfolio managers. The main limitations on investments were the low interest rates offered on short dated instruments. The portfolio managers addressed this challenge by targeting short dated corporates as opposed to low yielding Government Treasury bills.

Outsourced Funds

The total value of outsourced funds at the end of December 2012 was US$1,097.2 million, (2011: US$1,082.6 milion), an increase of US$14.6 million and the equivalent of an annual return of 1.35 percent. The underperformance compared to in-house managed funds was mainly due to currency hedging undertaken by external fund managers. Under the Investment Management Agreement (IMA) all external fund managers are required to hedge their portfolios to the US dollar. The in-house funds are allowed to remain in the currency of investment.

International Transactions Monitoring

During the year the Bank conducted a foreign exchange transactions audit in the major centres of PNG.

Foreign Currency Accounts

The Bank reviewed four applications to open foreign currency accounts (FCA) outside PNG during the year. Of these three were new applications and one was to replace an existing FCA.

All were approved.

Gold Export Licences

While the Bank allows residents and non-residents to buy and sell gold freely within PNG, they must obtain a licence from the Bank to sell gold outside the country. Subject to complying with its conditions, the licence is renewable on application each year.

Applications received in 2012	13
Applications approved and renewed – Au Pacific Gold Limited – Gold Exports Limited – Golden Valley Enterprises Limited – Issacc Lete Lumbu Gold Buyers Limited – Italpreziosi South Pacific Limited – Nuigini Au Exports Limited – Repax (PNG) Limited – Vertic Limited – Wanaka No. 5 Limited	9
Applications requiring more information	3
Licences not renewed – Wingold Limited	1

Domestic Lending in Foreign Currency

Lending by Authorised Dealers in any foreign currency to residents of PNG requires prior approval of the Bank.

Applications approved in 2012	4
Value of transactions	K224.18 million

Contingent Guarantees in Favour of Non-Residents

The Bank's approval is required to issue guarantees or indemnities for the benefit of non-residents.

Applications received in 2012	20
Applications approved	17*
Value of transactions	K11.69 million**

**Approval was not required for two applications as the funds secured were used to fund projects in PNG. One application was not approved.*

*** From approved applications.*

Cash Taken Abroad

The Bank's approval is required to take cash and numismatic bank notes in excess of K20,000.00 out of the country.

Applications received and reviewed in 2012	45
Applications approved	39
Value of approved cash transactions	K1.664 billion
Value of approved numismatic notes export	K0.787 million

PNG LNG Project Exemption

Companies engaged in transactions related to the PNG LNG Project sponsored by ExxonMobil and its partners are exempted from the operation of the *Central Banking (Foreign Exchange and Gold) Regulation*. To be entitled to this exemption, a company must demonstrate that its engagement, or a transaction, is primarily for the PNG LNG Project or Project Operations.

In 2012, based on the information provided, exemption status was reviewed and confirmed for one PNG LNG Project company.

Research Activities

The Bank undertakes a number of tasks necessary to aid policy analysis and decisions. In 2012 these included:

Expansion of Monetary and Financial Data Coverage

The final report of the International Monetary Fund's (IMF) Technical Assistance (TA) mission in June 2010 made several recommendations on the Monetary and Financial Statistics project, mainly on data issues and coverage. Data quality issues are ongoing matters that staff resolve with the reporting institutions as they arise. In terms of expanding data coverage, the Bank engaged the support of the Office of Insurance Commissioner (OIC) to require general insurance companies and brokers to report their monetary and financial data. There were two meetings during the year (in October and November), which included a presentation to OIC staff on the new reporting form (FC1). This was a major breakthrough towards collecting data from institutions not under the supervision of the Central Bank.

In view of the progress on some of the recommendations that have been made, the Bank will liaise with the IMF for a TA mission to assess and complete the project. This will enable a full coverage of reporting institutions using the new Standardised Reporting Forms (SRF).

Ongoing Research Activities

Regular research activities, including ongoing surveys and specific research projects, were undertaken to aid policy decisions of the Bank.

Surveys

Business Liaison Survey: The Bank surveys 412 companies each year. Of these, 94 large private companies are surveyed quarterly.

Employment Survey: All 412 companies are surveyed each quarter.

The Bank carries out analysis of both surveys to:

- inform the public about developments in the real sector, through the Quarterly Economic Bulletin;
- estimate and forecast growth in gross domestic product (GDP); and
- contribute to the formulation of monetary policy.

Research Papers

Following intense surveys and in-house analysis 5 new research papers reached the final drafting stage during 2012, in preparation for publication in 2013. These were:

- Supply Response of Cocoa in Papua New Guinea
- Supply Response of Coffee in Papua New Guinea
- Supply Response of Palm Oil in Papua New Guinea
- Determinants of Real Exchange Rate in Papua New Guinea
- Constructing an Output Gap for Papua New Guinea

Research Collaboration with Pacific Financial and Technical Assistance Centre (PFTAC)

The collaboration between the Bank and PFTAC continued in 2012 on various economic modelling projects, including Forecasting and Policy Analysis System (F-PAS) model, quarterly output gap calculation, real exchange rate calculation and estimation of Philips curve.

These culminated in the IMF's flagship work, Financial Programming, in which all sectors (fiscal, monetary, balance of payments, real sector, etc) are considered together to give an understanding of changes in the economy given various shocks. Treasury Department officials also participated in some of the workshops on macroeconomic modelling. Good progress has been made in this area of macroeconomic modelling work to be applied in policy analysis in the Bank and the Treasury Department. The work on Financial Programming is expected to lead to application of the model as a component in monetary policy formulation in 2013.

Core Functions

FINANCIAL SYSTEM STABILITY

FINANCIAL SYSTEM STABILITY

The financial system discussed in this Report covers only institutions authorised, regulated and supervised by the Bank of Papua New Guinea. The financial system includes financial institutions regulated by other authorities.

The Supervision Departments of the Bank conduct prudential supervision of the authorised, licensed institutions to ensure stability of the financial system. This is achieved through:

– setting strict licensing requirements;

– promoting proper standards and conduct;

– setting prudential guidelines for sound and prudent business practices; and

– ensuring compliance consistent with the relevant legislation and prudential standards.

The financial system

Type of institution	31 Dec 2012	31 Dec 2011
Commercial banks	4	4
Licensed financial institutions including micro-banks (LFIs)	10	10
Savings & loans societies (SLSs)	22	22
Authorised superannuation funds (ASFs)	4	5
Licensed investment managers (LIMs)	3	2
Licensed fund administrators (LFAs)	4	4
Life insurance companies (LICs)	5	5
Life insurance brokers (LIBs)	4	4
Authorised money changers	4	4
Money remitter	2	1
Foreign exchange dealers	2	-
Authorised mobile network operator	1	-
Total assets	**K34.0 billion**	**K30.1 billion**
Banking industry	76.8%	78.1%
ASFs	21.9%	20.6%
LICs	1.3%	1.3%
Total deposits	**K20.3 billion**	**K18.1 billion**
Commercial banks	93.9%	93.7%
LFIs	4.1%	4.2%
SLSs	2.0%	2.1%
Total loans outstanding	**K10.0 billion**	**K8.7 billion**

Licences and Approvals

In 2012 the Bank assesed and made decisions on applications received for new licences, expansion, closure and relocation of operations, changes to controlling interests and name changes.

During the year the Bank granted 3 new licences (mobile banking, money remitter and foreign exchange dealer), issued a 'no objection' notice allowing the national rollout of a mobile money product, approved the opening of 7 new branches and 2 relocations of existing branches of financial institutions, as well as assessing an additional 12 new and ongoing licence applications.

Prudential Standards

During the year the Bank initiated a major review of existing prudential standards relating to the banking industry, with technical assistance from the World Bank's Financial Sector Reform and Strengthening Initiative Group.

Corporate Governance for Superannuation and Life Insurance Industries

After extensive industry consultation between June and October 2012, the Bank approved the prudential standard at the end of November. It will become effective on 1 January 2013, with full compliance required by 1 January 2014.

Mobile Banking

The Bank issued a prudential standard on Mobile Banking and Mobile Payment Services in January 2012.

Legislative Developments

Savings & Loans Societies

At the end of November 2012 the savings and loans industry met in Lae and continued its discussions on the proposed amendments to the *Savings & Loans Societies (Amended) Act 1995*. The draft Bill was then circulated within the industry for final review.

Superannuation

The Bill containing the proposed amendments to the *Superannuation (General Provisions) Act 2000* is still to be passed by Parliament, in spite of support for it from the National Executive Council.

Review of the Life Policy Definition

The review of the life policy definition under the *Life Insurance Act 2000* continued in 2012, with no resolution reached with the Insurance Commissioner.

Regulation of Mobile Banking and Mobile Payment Services

The Bank made a submission on the Regulation of Mobile Banking to the Minister for Treasury for presentation to the National Executive Council. The Regulation was ratified by the Council in 2012.

Supervisory Enforcement Actions

Reviews

As part of the Bank's supervisory role in strengthening the risk management systems and compliance capacities of the authorised institutions and licensed entities, 10 on-site prudential reviews or examinations were conducted in 2012. These included eight full scope reviews and two reviews specifically targeting credit risks.

Reviews were conducted on 3 banks, 2 LFIs, 5 S&LSs, 1 LFA, 1 ASF and 2 LIMs, one of which was visited twice. Five new applicants – 3 banking licence, 1 money changer and 1 money remitter – received pre-licence visits.

The Bank also conducted an on-site prudential review under the Pacific Technical Exchange Program with technical assistance from the Australian Prudential Regulatory Authority (APRA). This full scope review of Nasfund Contributors SLS covered all operational aspects of the institution. The review team involved officers from the Bank of PNG, the Reserve Bank of Fiji and the Central Bank of Solomon Islands. The Bank also participated in two similar programs in Vanuatu and Fiji.

Statutory Administration, Management and Liquidation Activities

Sios Workers Ritaia Fund (SWRF)
The Fund was transferred to Nasfund on 1 December 2012.

Workers Mutual Insurance (PNG) Limited (WMI)
The liquidation process continued through 2012.

Eastern Highlands Savings and Loans Society
The liquidation process continued through 2012.

Sovereign Community Infrastructure Treasury Bill (SCITB)
The Bank continued to implement the recommendations arising from its review in 2011 of Nasfund's investment in SCITB. These included the appointment of a consultant to Nasfund to review and improve its corporate governance practices and internal structures to ensure the additional conditions imposed by the Bank are carried out.

Public Awareness

During 2012 the Bank continued to implement the ongoing press campaign to raise public awareness of how to differentiate between authorised financial institutions and illegal money scams.

PAYMENT SYSTEM

The Bank has statutory responsibilities for the national payment system, which is part of the core financial infrastructure that underpins the economy as a whole. In this context the Bank of Papua New Guinea provides:

- banking services to the National Government and other statutory authorities;
- the National Government with the Temporary Advance Facility to cater for mismatches in cashflow;
- cheque matching and cheque clearance services; and
- issuance of currency banknotes and coins.

Banking Services

The financial activities of the National Government are carried out by the Department of Finance through the Waigani Public Account, from which transfers of funds are initiated and executed to the various accounts of Government department, provincial Government and statutory authority drawing accounts.

The National Government opened five new trust accounts during 2012, bringing to 76 the number of trust accounts held at the Bank of PNG.

Managing the continuing high level of liquidity in the PNG banking system was again made more challenging by the transfer of funds from the main trust accounts to subsidiary accounts held at commercial banks. The Bank continued to lobby the Department of Finance to close these accounts and transfer the funds back to the main accounts held with the Bank. No trust funds were transferred to BPNG during 2012.

Temporary Advance Facility

The National Government operates a Temporary Advance Facility (TAF) with the Bank to meet short-term cash flow mismatches during the year.

In 2012 the Government sought financing under the TAF, which the Bank approved on 18 April. A total of K53.4 million was drawn down and fully repaid on 20 June. For the rest of 2012 the Government's cash position was in net credit.

Cheque Processing

No major incidents of fraud in Government drawing accounts were reported in 2012. This positive result is attributed to the effectiveness of the Bank's cheque matching process and overall improvements to the general cheque processing system.

Telling Services

Cash handled by tellers

2012	2011	2010
Inward receipts K128,215,042	Inward receipts K99,398,730	Inward receipts K74,545,826
Outward payments K126,509,734	Outward payments K98,175,120	Outward payments K74,000,486

Cheques and vouchers processed

2012	2011	2010
K352,843	K380,900	K382,125

Source of presented cheques in 2012

Government drawing accounts	K210,502
Commercial bank cheques	K100,702
Staff accounts	K34,732
BPNG cheques	K6,907
Total	**K352,843**

Total value of cheques processed

2012	K23,871,962,947
2011	K21,391,944,380

Currency Banknotes and Coins

The Bank issues currency banknotes and coins, ensures an adequate supply of quality currency is in circulation, withdraws damaged banknotes from circulation and monitors the overall supply of currency in the financial system.

An important ongoing activity is the Clean Banknote Policy Awareness program, which seeks to educate the general public on proper ways of handling banknotes, the different security features on the banknotes, how to identify different characteristics of unfit banknotes and how to tell genuine banknotes from counterfeits. Since the introduction of polymer notes in 1991, no counterfeit of any polymer note has been detected.

During 2012 the Clean Note Awareness program involved television spots and public presentations conducted by Bank staff, including sessions at the Kokopo Show, the Morobe Agricultural Show and the Financial Inclusion Expo in Lae.

The value of soiled notes withdrawn from circulation and destroyed totalled K492.8 million in 2012, compared to K364.0 million in 2011. The increase is attributed to the commercial banks returning a higher number of notes as a result of increased awareness of the Clean Banknote Policy.

Currency

Notes and coins in circulation as at 31 December 2012

Notes Denomination	Value K'm 2012	Value K'm 2011	Value K'm 2010
K2	45.8	46.2	38.6
K5	44.4	44.4	36.5
K10	66.3	77.8	70.3
K20	213.9	213.9	154.2
K50	417.0	452.2	363.9
K100	822.7	635.4	475.1
Sub Total	**1,610.1**	**1,469.9**	**1,138.6**
Coins Denomination			
K2	0.3	0.3	0.3
K1	9.9	16.5	12.8
50 Toea	6.5	6.5	5.9
20 Toea	18.6	16.8	15.1
10 Toea	18.0	16.5	14.8
05 Toea	5.9	5.6	5.1
Sub Total	**69.2**	**62.2**	**54.0**
Total	**1,679.3**	**1,532.1**	**1,192.6**

Destruction of soiled notes

Note denomination	Value of soiled notes destroyed in 2012 (K'm)	Value of soiled notes destroyed in 2011 (K'm)	Value of soiled notes destroyed in 2010 (K'm)
K2	19.8	13.2	21.5
K5	22.4	16.4	13.3
K10	43.1	26.8	30.7
K20	101.1	62.2	118.0
K50	171.9	109.1	115.3
K10	134.5	136.3	160.0
Total	**492.8**	**364.0**	**458.8**

New notes and coins issued in 2012

Notes Denomination	Value K'm 2012	Value K'm 2011	Value K'm 2010
K2	21.3	22.2	20.7
K5	19.8	21.8	22.2
K10	28.0	33.9	41.5
K20	86.6	118.8	139.9
K50	114.0	199.0	200.8
K100	280.0	291.0	306.1
Sub Total	**549.7**	**686.7**	**731.2**
Coins Denomination			
K2	0.00	0.00	0.00
K1	3.14	3.20	.50
50 Toea	0.00	0.36	.04
20 Toea	1.75	1.57	.08
10 Toea	1.49	1.51	1.10
05 Toea	0.26	0.33	.38
Sub Total	**6.64**	**6.97**	**7.10**
Total	**556.34**	**693.67**	**38.30**

Supporting Economic Growth

SUPPORTING ECONOMIC GROWTH

As well as its three core functions, the Bank of Papua New Guinea has an indirect role in supporting and contributing to economic growth and development of the nation. The Bank believes strongly that improvement in financial inclusion and financial literacy can assist greatly in empowering the rural people to participate in economic activities.

The Bank undertook several activities during 2012 as part of its Financial Inclusion Program. These included the continuing implementation of the Microfinance Expansion Project, as well as support for mobile banking initiatives, financial literacy and education and other products to provide the unbanked section of the PNG population with access to financial services.

Microfinance Expansion Project

The Bank continued the implementation of the Microfinance Expansion Project in 2012. Key activities undertaken during the year included:

- Signing of Memorandum of Understanding by five Partnering Financial Institutions (PFIs)
- Development of new products based on market research and costings by the PFIs
- Development of strategies and five teaching modules for financial education and business development services. Around 100 people trained in financial literacy using those modules.
- Initial work to establish the Centre for Excellence in Financial Inclusion (CEFI). This institution will develop, promote and monitor industry standards and serve as the coordinating body to promote financial inclusion in the country.
- The conduct of a comprehensive review of the microfinance institutions regulation
- Production of a paper on risk-based classification of institutions
- Drafting of a concept note on risk share facility in consultation with stakeholder experts.

Financial Diaries Project

The Bank implemented the Financial Diaries Project, funded by UNDP, through the Pacific Financial Inclusion Program (PFIP) during 2012.

The project was a 12 month survey on income and expenditure in 120 households in Kimbe, Goroka and National Capital District. The methodology aimed to map the financial lives of the unbanked and low income households, seeking to understand their financial behaviour in regard to indebtedness, the use of social grants, savings, their response to unexpected events and the management of micro businesses.

The outcome of the survey will be used to formulate policies on financial literacy programs in PNG.

Financial Literacy Competency Study

PNG is one of eight countries that participated in this study funded by the Russian Trust Fund, administered through the World Bank and overseen by the Bank of PNG. After trials and testing of the survey instrument, the pilot stage of the project was completed in June 2012. The results of the pilot study were presented at an international conference held in St. Petersburg, Russia in July 2012. The nationwide deployment of the survey is expected in 2013, under a different funding arrangement as the arrangement with the Russian Trust Fund has expired. The study aims to examine and understand households' money management behaviour and capability. From this information the authorities will develop appropriate policy.

Financial Inclusion Expo 2012

The Bank successfully hosted the Expo in Lae, Morobe Province over the two days 30 November and 1 December 2012. More than 30 institutions participated in the Expo, which was attended by approximately 8,000 people.

More than 8,000 people visited the inaugural Financial Inclusion Expo held in Lae, Morobe Province, hosted by the Bank of Papua New Guinea. It was a very successful forum for discussion and information about financial services for all Papua New Guineans.

The Papua New Guinea financial system was well represented at the Bank of Papua New Guinea's Financial Inclusion Expo, with exhibitors including a range of commercial banks, savings & loans societies, mobile banking operators, superannuation funds, microbanks and other financial institutions.

Support Services and Other Activities

Organisational re-structure

2012 was a year of re-shaping the Bank's organisational structure. As well as the creation of the four Assistant Governor positions and the alignment of their respective departments along functional lines, the areas that support the Bank's core activities were comprehensively reviewed. Corporate Services and Human Resources Departments were restructured to provide efficency in service delivery, better cost management and enhanced operational management.

The Bank's organisational restructure and creation of the Assistant Governor positions has enabled the Governor to delegate many day to day administrative responsibilities, allowing him to focus on strategic management and external relationships with key stakeholders.

In line with this restructure, the Corporate Affairs Group went through a major reorganisation to closely align itself with the Bank's strategic plan. The restructure resulted in a more focused approach on functional accountability for the Information Technology, Corporate Services and Human Resource Departments. As part of the review, Building and Properties Maintenance Department and Communications & Publications Unit were established and Cafeteria management was outsourced.

Over the next year or two, the remaining three groups (Financial System Supervision, Monetary & Economic Policy and Finance & Payments) will undergo the same exercise. The expected result is an increased focus on efficiency and productivity.

Comprehensive Security Review

An external consultant was engaged to assist the Bank to carry out a detailed review and audit of the Bank's security systems and infrastructure.

LAN Upgrade Project

The LAN Upgrade project was a major undertaking that commenced at the end of 2011 and continued into 2012. It involved the merging of the Bank's dual network into a single network with appropriate segmentation to ensure a flexible but secure IT network. Actual implementation took place in 2012. By year end re-cabling in ToRobert House was completed, with wireless-based extensions to the new disaster recovery site at Daltron. The Active Directory that manages user access profiles was reconfigured to manage a new single network.

BPNG in the Community

The Bank of Papua New Guinea supports a number of business, cultural, sporting and health-related causes, in line with its leadership position in the PNG business sector and broader community. During 2012 the Bank and its staff contributed to the development activities of a range of business and community organisations.

As part of its ongoing commitment to foster best practice and build professional capacity, during the year the Bank made contributions to Transparency International (PNG) Walk Against Corruption and ISACA.

Health, medical research and welfare charities and initiatives supported by the Bank included the Sir Buri Kidu Heart Institute, World TB Day, PNG Nurses Association Symposium, White Ribbon, the PNG Cancer Relief Society and the Papua New Guinea and Solomon Islands Bishops Conference.

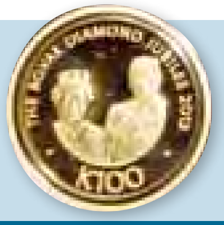
The Bank also contributed to Papua New Guinea's Paralympic effort, as well as staff participation in corporate sporting challenges.

Numismatic activities (sales)

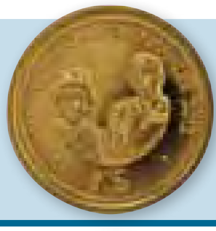
2012	K316,603.92
2011	K307,846.28
2010	K154,366.91

Numismatic coins

The Queen's Diamond Jubilee celebrations, including the official visit of Prince Charles of Wales and Camilla, Duchess of Cornwall to Papua New Guinea in November, were marked with issuance of K100, K50 and K5 commemorative coins.



K100 Gold Coin*	
Diameter	17.53mm
Weight	1/10 oz
Alloy	99.9% Gold Proof
Quantity	250



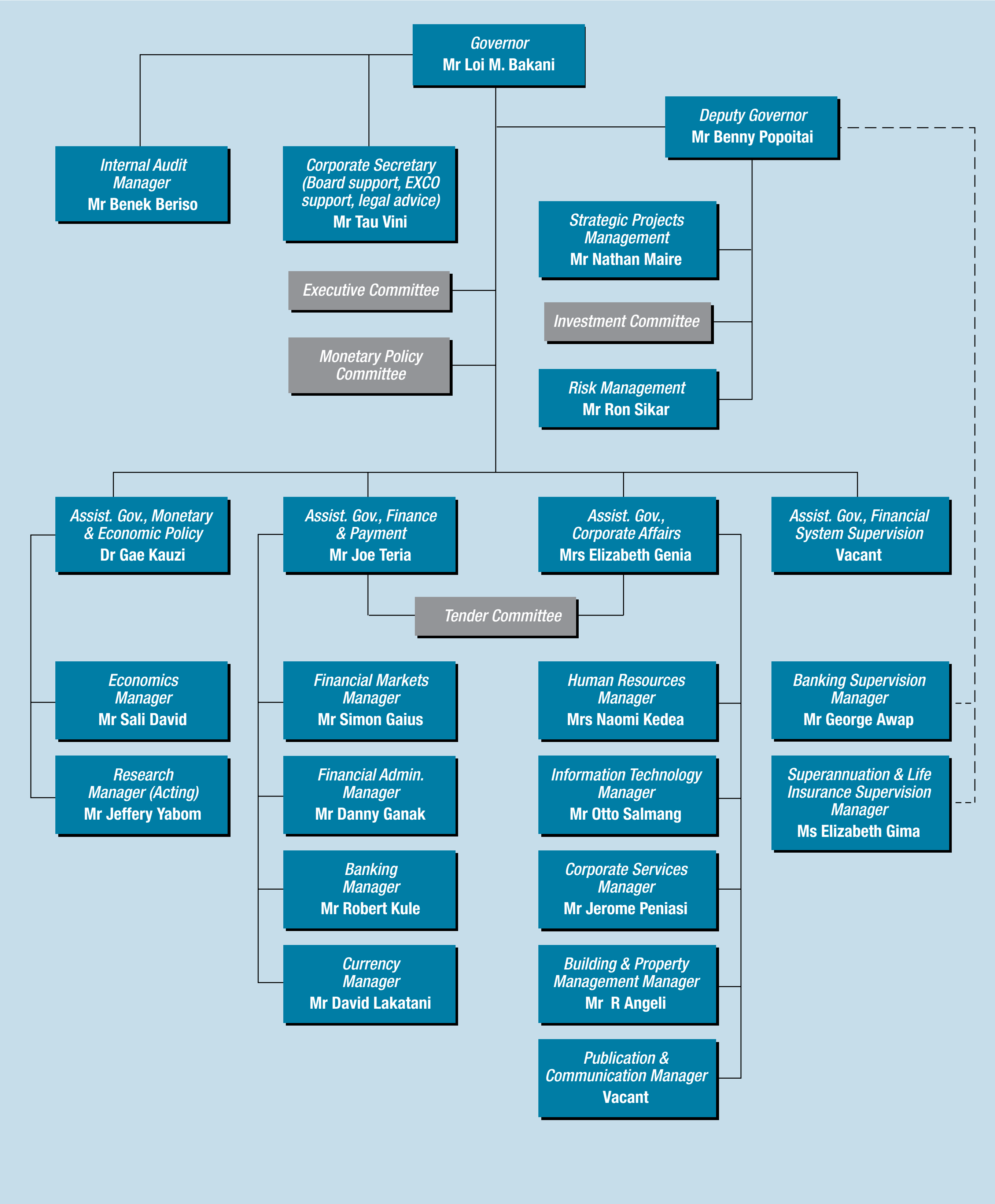
K5 Nordic Gold Coin*	
Diameter	40.0mm
Weight	31.1gm
Alloy	Nordic Gold (Base Metal)
Quantity	500

K50 Silver Coloured Coin*	
Diameter	38mm
Weight	20.0gm
Alloy	99.9 Silver Proof
Quantity	1,500

**Coins not pictured at actual size.*

Organisational Chart

As at 31 December 2012



Staffing

Staff numbers

	31 Dec 2012	31 Dec 2011
Governors	2	2
Assistant Governors	3	3
Secretariat	11	14
Audit	13	10
Economics	38	42
Research	10	10
Financial Markets	25	25
Banking Supervision	27	28
Superannuation & Life Insurance Supervision	18	17
Banking	32	28
Currency	23	23
Corporate Services	49	49
Information Technology	20	17
Human Resources	11	11
Finance & Accounting	39	39
TOTAL	**321**	**318**
Males	164	167
Females	157	151
Nationals	319	316
Non-nationals	2	2
	321	**318**

Senior officers	
Governor	**Loi M. Bakani**
Deputy Governor	Benny Popoitai MBE
Assistant Governor, Monetary and Economic Policy	Gae Kauzi
Assistant Governor, Finance and Payments	Joe Teria
Assistant Governor, Corporate Affairs	Elizabeth Genia
Assistant Governor, Financial System Supervision	Vacant
Secretariat	
Corporate Secretary	Tau Vini
Internal Audit	
Manager	Benek Beriso
Monetary & Economic Policy	
Economics	
Department Manager	Sali David
Manager, Monetary Policy and Analysis Unit	Wilson Jonathan
Manager, Balance of Payments	Gaona Gwaibo
Manager, Public Information	Maryanne Kani
Manager, International Transactions Monitoring Unit	Elim Kiang
Research	
Department Manager (Acting)	Jeffrey Yabom
Manager, Economic Analysis Unit	Vacant
Manager, Projects Unit	Boniface Aipi
Finance & Payments	
Financial Markets	
Department Manager	Simon Gaius
Manager, Foreign Reserves	Rowan Rupa
Acting Manager, Money Markets	Winnie Linken
Manager, Registry	Marie Martin
Financial Administration	
Department Manager	Danny Ganak
Manager, Management Reporting	Noine Noine
Manager, Accounting & Payments	Oliver Kludapalo
Manager, Settlements	Soms Yankey

Staffing

Senior officers *(continued)*	
Banking	
Department Manager	Robert Kule
Acting Manager, Customer Services	So'on Drewei
Manager, Clearing Accounts	Aiva Aku
Manager, Government Accounts	Jason Tirime
Currency	
Department Manager	David Lakatani
Manager, Control Unit	John Yenas
Manager, Processing Unit	Edward Kisakau
Corporate Affairs	
Manager, Human Resources	Naomi Kedea
Manager, Information Technology	Otto Salmang
Manager, Corporate Services	Jerome Peniasi
Manager, Building & Property Management	Richard Angeli
Manager, Publication & Communication	Vacant
Manager, General Services	Bridgit Kubak
Manager, Security	Slim Rupusina
Manager, Cafeteria	Vacant
Financial System Supervision	
Banking Supervision	
Department Manager	George Awap
Manager, Banks & Finance Companies Unit	Boas Irima
Manager, Savings & Loans Development Unit	William Sagir
Manager, Licensing & Policy Unit	Sabina Deklin
Manager, Micro-Finance Unit	Nickson Kunjil
Superannuation & Life Insurance Supervision	
Department Manager	Elizabeth Gima
Manager, Superannuation Unit	Tom Milamala
Manager, Policy and Licensing Unit	John Topal
Acting Manager, Life Insurance	Peter Samuel

Bank of Papua New Guinea

FINANCIAL STATEMENTS
FOR THE YEAR ENDING
31 DECEMBER 2012

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Statement of Comprehensive Income

For the year ended
31 December 2012

	Notes	2012 K'000	2011 K'000
Revenue from foreign currency investments			
Interest revenue	**2**	174,001	212,882
Realised gain/(loss) on financial assets		41,785	14,521
Foreign exchange fees and commissions		5,697	447
Total revenue from foreign currency investments		221,483	227,850
Expenses on foreign currency investments			
Interest expense on liabilities with IMF		(287)	(1,913)
Custodian and investment management fees		(3,545)	(3,752)
Total expenses on foreign currency investments		**(3,832)**	**(5,665)**
Net foreign currency income		**217,651**	**222,185**
Revenue from domestic investments			
Interest revenue	**3**	53,327	40,480
Other income	**4**	4,384	4,650
Total revenue from domestic investments		**57,711**	**45,130**
Expense on domestic liabilities			
Interest expense	**5**	(158,827)	(184,384)
Total expenses on domestic liabilities		**(158,827)**	**(184,384)**
Net domestic expense		**(101,116)**	**(139,254)**
Total operating income		**116,535**	**82,931**
Operating expenses			
General and administration expenses	**6**	(92,263)	(90,511)
		24,272	**(7,580)**
Other unrealised income and (expense)			
Fair value and foreign exchange revaluation loss on foreign currency investments		(68,328)	(1,702,814)
Fair value revaluation gain/(loss) on domestic investments		76,602	(11,511)
Profit/(loss) for the year		**32,546**	**(1,721,905)**
Other comprehensive income			
Gain/(loss) on gold asset revaluation		7,202	(15,197)
Other comprehensive income/(loss) for the year		**7,202**	**(15,197)**
Total comprehensive income/(loss) for the year		**39,748**	**(1,737,102)**

The above statement forms an integral part of these financial statements.

Statement of Financial Position

For the year ended
31 December 2012

	Notes	2012 K'000	2011 K'000
Assets			
Foreign currency financial assets			
Cash and cash equivalents	8	493,631	1,251,573
Gold		149,251	142,049
Financial assets at fair value	9	7,786,828	7,838,787
Assets held with IMF	7	30,643	34,200
Total foreign currency financial assets		**8,460,353**	**9,266,609**
Local currency financial assets			
Government of Papua New Guinea securities	10	807,623	444,680
Loans and advances	11	9,935	9,717
Total local currency financial assets		**817,558**	**454,397**
Total Financial Assets		**9,277,911**	**9,721,007**
Non financial assets			
Property, plant & equipment	13	131,926	124,264
Inventory notes and coins		34,861	39,550
Other non financial assets	12	3,034	3,591
Total non financial assets		**169,821**	**167,405**
Total Assets		**9,447,732**	**9,888,411**
Liabilities			
Foreign currency financial liabilities			
Liabilities with IMF	7	406,813	412,950
Financial liabilities	17	12,505	5,232
Total foreign currency financial Liabilities		**419,318**	**418,182**
Local currency financial liabilities			
Deposits from banks and third parties	14	2,150,623	1,733,287
Deposits from Government and Government entities		985,402	1,718,749
Debt securities issued	15	5,345,946	5,686,557
Currency in circulation	16	1,679,329	1,532,447
Total local currency financial liabilities		**10,161,300**	**10,671,040**
Total financial liabilities		**10,580,618**	**11,089,222**
Non-financial liabilities			
Other non financial liabilities	18	68,117	39,939
Total non financial liabilities		**68,117**	**39,938**
Total Liabilities		**10,648,735**	**11,129,161**

Statement of Financial Position

	Notes	2012 K'000	2011 K'000
Equity			
Capital	**19**	145,540	145,540
Gold revaluation reserve		129,516	122,314
Property revaluation reserve		83,074	83,074
Unrealised loss reserve		(1,642,502)	(1,650,775)
Retained earnings		83,369	59,097
Total Equity		**(1,201,003)**	**(1,240,750)**
Total Liabilities and Equity		**9,447,732**	**9,888,411**

The above statement forms an integral part of these financial statements.

Statement of Distribution

For the year ended 31 December 2012

	Notes	2012 K'000	2011 K'000
Profit/(loss) for the year		**32,546**	**(1,721,905)**
Transfer (to)/ from unrealised profit/(loss) reserve		(8,274)	1,714,325
Realised loss		–	7,580
Earnings available for distribution		**24,272**	**–**

Statement of Changes in Equity

For the year ended
31 December 2012

In Kina (K'000)	Property Revaluation Reserve	Unrealised Profit/(loss) Reserve	Gold Reserve	Capital earnings	Retained	Total
Balance at 1 January 2011	**83,074**	**63,549**	**137,511**	**145,540**	**88,678**	**518,352**
Loss for the year	–	(1,714,325)	–	–	(7,580)	(1,721,905)
Other comprehensive income/(loss) for the year	–	(15,197)	–	–	(15,197)	
Dividend paid	–	–	–		(22,000)	(22,000)
Balance at 31 December 2011	**83,074**	**(1,650,776)**	**122,314**	**145,540**	**59,097**	**(1,240,751)**
Profit for the year	–	8,274	–	–	24,272	32,546
Other comprehensive income/(loss) for the year	–	–	7,202	–	–	7,202
Balance at 31 December 2012	**83,074**	**(1,642,502)**	**129,516**	**145,540**	**83,369**	**(1,201,003)**

The above statement forms an integral part of these financial statements.

Statement of Cash Flows

For the year ended 31 December 2012

	Notes	2012 K'000	2011 K'000
Cash Flows from Operating Activities			
Interest received – foreign currency		182,787	210,762
Interest received – local currency		49,758	40,968
Fees, commissions and other income received		51,866	5,099
Interest paid – foreign currency		(287)	(1,914)
Interest paid – local currency		(172,761)	(170,529)
Payments to employees		(32,321)	(37,247)
Payments to suppliers		(20,355)	(36,491)
Fees and commissions paid		(3,545)	(3,752)
Net proceeds from/(payments for) foreign investments		(17,883)	(3,665,029)
Net Cash Flow from Operating Activities	**20**	**37,259**	**(3,658,133)**
Cash Flows from Investing Activities			
Net increase/(decrease) in foreign deposits including IMF		(6,137)	(99,042)
Net increase/(decrease) in deposits from Banks		417,336	915,585
Net deposit from/(payment to) Government		(733,566)	663,028
Net increase/(decrease) in assets held with IMF		(3,556)	9,439
Net payment for/(proceeds from) investment in Government Securities		(282,772)	(39,206)
Purchase of property, plant and equipment		(13,920)	(3,705)
Proceeds from the sale of property and equipment		599	79
Net (decrease)/increase in other assets & liabilities		6,609	21,932
Net Cash Flow from Investing Activities		**(615,407)**	**1,468,110**
Cash Flows from Financing Activities			
Net issue of currency in circulation		146,883	339,735
Net (decrease)/increase in debt securities issued		(326,677)	1,078,198
Dividend paid to the Government		–	(22,000)
Net Cash Flow from Financing Activities		**(179,794)**	**1,395,933**
Net Increase/(Decrease) in Cash and Cash Equivalents		**(757,942)**	**(794,090)**
Cash and cash equivalent at 1 January		1,251,573	2,045,663
Cash and Cash Equivalent at 31 December	**8**	**493,631**	**1,251,573**

The above statement forms an integral part of these financial statements.

Notes to the Financial Statements

For the year ended
31 December 2012

Note 1: SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The principal accounting policies applied in the preparation of these financial statements are set out below. These policies have been consistently applied to all the years presented, unless otherwise stated.

(a) Basis of preparation

The accompanying financial statements have been prepared in accordance with International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB), and in accordance with the *Central Banking Act (CBA) 2000* (the "Act"). In the event of any conflict between the requirements of the Act and the Accounting Standards, the Bank (BPNG) is required to comply with the Act.

All amounts are expressed in Kina rounded to the nearest thousand unless otherwise stated. Fair value accounting is used for all BPNG major assets, including domestic and foreign marketable securities, gold and foreign currency, as well as for land and buildings. In all other cases, a historical cost basis of accounting is used. Revenues and expenses are brought to account on an accrual basis.

Going concern

The Bank is exposed to significant valuation losses in its foreign currency reserves as a result of the appreciation of the PNG Kina against other major currencies. The Bank recorded a total comprehensive profit of K39.7 million (2011: loss of K1,737.1 million) and experienced operating cash flows of K37.3 million (2011: negative cash flow of K3,658 million) for the year. In addition, total liabilities of the Bank exceeds its total assets by K1,201 million (2011: K1,241 million). The Bank envisages this net deficiency position to continue as a result of ongoing appreciation of the PNG Kina over the foreseeable future and the combined high cost of monetary policy management stemming from high domestic liquidity. This condition results in material uncertainty that may cast significant doubt on the Bank's ability to continue as a going concern and therefore it may not be able to realise its assets and discharge its liabilities in the normal course of business.

Section 50(2) of the *Central Banking Act 2000* (CBA Act 2000) provides that where the Bank incurs a loss due to a change in the value of assets or liabilities, the Minister shall cause to be paid to the Bank such amount out of the Consolidated Revenue Fund as is necessary to avoid the loss.

Subsection 50(4) of that Act further provides that the Minister may create and issue to the Central Bank non-interest bearing non-negotiable notes for an amount not exceeding any payment made by the Minister to the Central Bank out of the Consolidated Revenue Fund in accordance with Subsections (1) and (2) of the Act.

The above provisions of the Act effectively require the Government to provide financial support to the Bank. On this basis, the Governor, Deputy Governor and the Board of Directors of the Bank believe that the preparation of the financial statements of the Bank on a going concern basis is appropriate.

The Bank has brought this matter to the attention of the Minister and has submitted a letter dated 9 May 2012 to the Minister requesting a promissory note for K1.74 billion. However this promissory note has not been provided to the Bank at the current time.

(b) Revised standards, amendments to existing standards and interpretations adopted by the Bank

The following new standards and amendments were applicable for the first time during the accounting period beginning 1 January 2012:

- Amendments to IFRS 7 'Financial instruments: Disclosures' on transfers of assets introduces additional disclosures in respect of risk exposures arising from transferred financial assets. The amendments mainly affect entities that sell, factor, securitise, lend or otherwise transfer financial assets to other parties. The Bank has applied the revised standard from 1 January 2012.

Standards, amendment and interpretations issued but not yet effective in 2012 or adopted early

The following standards, amendments and interpretations to existing standards have been published and are mandatory for the entity's accounting periods beginning on or after 1 January 2012 or later periods, but the Bank has not early adopted them:

- Amendments to IAS 19, 'Employee benefits' (effective 1 January 2013) require the recognition of all re-measurements of defined benefit liabilities/assets immediately in other comprehensive income (removal of the so-called 'corridor' method) and the calculation of a net interest expense or income by applying the discount rate to the net defined benefit liability or asset. The Bank is considering the implication of IAS 19, the impact on the Bank and timing of its adoption.
- IFRS 9, 'Financial Instruments' (effective 1 January 2013) is the first phase of replacing IAS 39, 'Financial Instrument' with a standard that is less complex and principles based. The new standard addresses the classification, measurement and derecognition of financial assets and financial liabilities. The standard is not expected to change the entity's existing accounting policy for its financial assets and liabilities.
- IFRS 13, 'Fair value measurement' (effective 1 January 2013) aims to improve the consistency and reduce complexity by providing a precise definition of fair value and a single source of fair value measurement and disclosure requirements for use across IFRSs. The requirements do not extend the use of fair value accounting but provide guidance on how it should be applied where its use is already required or permitted by other standards. Application of the new standard will impact the type of information disclosed in the notes to the financial statements.
- Amendment to IFRS 7, 'Financial instruments: Disclosures' on offsetting financial assets and financial liabilities (effective 1 January 2013) enhance current offsetting disclosures. It is unlikely to affect the accounting for any of the entity's current offsetting arrangements, but will require a number of additional disclosures in relation to those arrangements.
- 'Annual improvements 2011' (effective 1 January 2013) includes minor changes to IFRS 1, IAS 1, IAS 16, IAS 32 and IAS 34. The entity does not expect that any adjustments will be necessary as of result of applying the revised rules.

(c) Foreign currency

Transactions in foreign currency are translated to Kina, being the functional and presentation currency of the Bank at the foreign exchange rate prevailing at the date of the transaction. Monetary assets and liabilities denominated in foreign currencies at the reporting date are translated to Kina at the foreign exchange rate prevailing at reporting date. Foreign exchange differences arising on translation are recognised in the statement of comprehensive income.

Non-monetary assets and liabilities denominated in foreign currencies that are stated at fair value are translated to Kina at foreign exchange rates prevailing at the dates the values were determined.

(d) Financial assets and liabilities

Definition of financial instruments

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 Bank's financial instruments are its domestic government securities, foreign government securities, gold holdings, Central Bank Bills issued, bank deposits, cash and cash equivalents, deposit liabilities and currency in circulation.

The Bank accounts for its financial instruments in accordance with IAS 39 – Financial Instruments: Recognition and Measurement and reports these instruments under IFRS 7 – Financial Instruments: Disclosures.

(i) Domestic government securities

The Bank holds inscribed stocks with fixed coupon rates issued by the Government. They are accounted for on a fair value basis with reference to prices determined using valuation models, with valuations occurring on a monthly basis with all changes in fair value taken to profit in accordance with IAS 39. Interest earned on the securities is accrued over the term of the security and included as revenue in the statement of comprehensive income. Interest is received biannually at the coupon rate and the principal is received at maturity.

(ii) Foreign exchange holdings

Foreign exchange holdings are invested mainly in securities (issued by the Governments of Australia, the United Kingdom, United States of America, Germany, France and Japan) and bank deposits (with highly-rated international banks, Central banks and international agencies). These instruments are classified as 'financial assets held for trading" in accordance with IAS 39. Accordingly, these assets are measured at their fair value. External fund managers engaged by the Bank also enter into forward exchange contracts to hedge the returns of portfolios under their management to the US Dollar. No PNG Kina forward contracts are entered into.

(iii) Foreign exchange translation

Assets and liabilities denominated in foreign currency are converted to Kina equivalents at the prevailing exchange rate on balance date in accordance with IAS 21 – The Effects of Changes in Foreign Exchange Rates. Realised and unrealised gains or losses on foreign currency are taken to profit or loss, but only realised gains are available for distribution.

(iv) Foreign government securities

Foreign government securities comprise coupon and discount securities and rarely securities held under repurchase agreements. Coupon securities have biannual or annual interest payments depending on the currency and type of security; the principal of these securities is received at maturity. Interest earned on discount securities is the difference between the actual purchase cost and the face value of the security; this is amortised over the term of the securities. The face value is received at maturity. Foreign securities, except those contracted for sale under repurchase agreements, are classified under IAS 39 as 'at fair value through profit and loss', as they are held for trading. In accordance with this standard, the securities are valued at market bid prices on balance date; realised and unrealised gains or losses are taken to profit. Only realised gains are available for distribution. Interest earned on securities is accrued over the term of the security as revenue in the profit & loss.

(v) Foreign deposits

The Bank invests part of its foreign currency reserves in deposits with highly-rated international banks; it also maintains working accounts in foreign currencies. Deposits are classified as 'loans and receivables' under IAS 39 and recorded at their face value, which is equivalent to their amortised cost using the effective interest method. Interest is accrued over the term of deposits and is received periodically or at maturity. Interest accrued but not received is included in interest receivable in the statement of financial position.

Foreign exchange holdings, foreign Governments and private securities and foreign bank deposits are included in foreign investments in note 9 to the financial statements.

(vi) Foreign currency forward contracts

External fund managers engaged to manage part of the Bank's investment portfolio enter into forward foreign exchange contracts to hedge the return of portfolios under their management to the US dollar. Gains/(losses) on this portfolio are treated as unrealised by the Bank as they remain as part of the overall portfolio under the management of external fund managers. These forward contracts are accounted for on a fair value basis, with all changes in fair value being reflected in the statement of comprehensive income in accordance with IAS 39. The fair values are determined with reference to prevailing exchange rates at balance date.

(vii) Repurchase agreements

(a) Buy repurchase agreements

In the course of its financial market operations, the Bank engages in repurchase agreements involving foreign and domestic marketable securities. Securities purchased and contracted for sale under buy repurchase agreements are classified under IAS39 as 'loans and receivables' and valued at amortised cost. The difference between the purchase and sale price is accrued over the term of the agreement and recognised as interest revenue.

(b) Sell repurchase agreements

Securities sold and contracted for purchase under sell repurchase agreements are classified under IAS 39 as 'at fair value through profit and loss', as they are held for trading, and reported on the Balance Sheet within the relevant investment portfolio. The counterpart obligation to repurchase the securities is reported in Other Liabilities at amortised cost; the difference between the sale and purchase price is accrued over the term of the agreement and recognised as interest expense.

(viii) Deposit liabilities

Deposits include deposits at call and term deposits. Deposits are classified as financial liabilities under IAS 39. Deposit balances are shown at their amortised cost, which is equivalent to their face value. Interest is accrued over the term of the deposits and paid periodically or at maturity. Interest accrued but not yet paid and the deposit liabilities are included in Note 14.

(ix) Central Bank Bills on issue

Since 2006, the Bank has issued Central Bank Bills as part of its money market operations. These are classified as financial liabilities. The Bills issued have maturities ranging from 28 days to 181 days and are recorded at their amortised cost using the effective interest method. Interest is paid at maturity.

(x) Gold

Gold holdings which are on loan to other institutions are valued at the Kina equivalent of the prevailing exchange rate at balance date. Unrealised gains and losses on gold are recognised in the gold revaluation reserve until such time as they are realised whereby they are recognised in profit and loss from ordinary activities. The Bank lends gold to financial institutions participating in the gold market. Gold holdings are a financial instrument and the Bank accounts for these in accordance with IAS 39 and reports these loans under IFRS 7.

(xi) Loans and Advances

Loans and advances are non-derivative financial assets with fixed or determinable repayment terms that are not quoted in an active market. Loans are receivables and initially recognised at fair value which is the cash consideration to originate or purchase the loan including any transaction costs and measured subsequently at amortised cost using the effective interest rate method.

(xii) Assets and Liabilities with the International Monetary Fund (IMF)

As Papua New Guinea is an IMF member nation, special drawing rights (SDR) are periodically allocated. The Bank recognises the allocation as an asset. The IMF assets and liabilities are denominated in SDR which are based on the weighted average of four main trading currencies. These are translated to PGK using the SDR market rate at balance date. These assets and liabilities are accounted for on a fair value basis, with changes to the fair value being taken to the statement of comprehensive income in accordance with IAS39.

(xiii) Currency in Circulation

Currency issued by the Bank represents a claim on the Bank in favour of the holder. It is recorded at face value in the Statement of Financial Position.

(e) Determination of fair value

For financial instruments trading in active markets, the determination of fair values of financial assets and financial liabilities is based on quoted market prices or dealer price quotations. This includes quoted debt instruments on major trading exchanges and broker quotes from Bloomberg and Reuters.

A financial instrument is regarded as quoted in an active market if quoted prices are readily and regularly available from the exchange, dealer, broker, pricing service or regulatory agencies, and those prices represent actual and regularly occurring market transactions on an arm's length basis.

For all other financial instruments, fair value is determined using valuation techniques. In these techniques, fair values are estimated from observable data in respect of similar financial instruments, using models to estimate the present value of expected future cash flows or other valuation techniques, using inputs (for example, foreign exchange rates, volatilities and counterparty spreads) existing at the dates of the statement of financial position.

For more complex instruments, the Bank uses internally developed models, which are usually based on valuation methods and techniques generally recognised as standard within the industry. Valuation models are used primarily to value unlisted debt securities and other debt instruments for which markets were or have become illiquid. Some of the inputs to these models may not be market observable and are therefore estimated based on assumptions.

(f) Property, plant and equipment

Formal valuations of all the Bank's properties are conducted on a triennial basis. The properties are valued by local independent valuers. The most recent independent valuation of the properties was at 31 December 2010. In accordance with IAS 16 – Property, Plant and Equipment, properties are valued at fair value, which reflects observable prices and are based on the assumption that assets would be exchanged between knowledgeable, willing parties at arm's length. Valuation gains and losses are transferred to the Property Revaluation Reserve. Annual depreciation is based on fair values and assessments of the useful remaining life of the relevant asset. Management has assessed the fair value of all property and equipment as at year end and consider them to be appropriate.

The range of useful lives used for each class of assets is:

	Years
Residential Properties	20 & 30
Office Buildings	50
Computer Equipment	5
Vehicles	4
Equipment	5
Intangible – Computer Software License	13

(g) De-recognition

A financial asset is de-recognised when the Bank loses control over the contractual rights that comprise the asset. This will occur when the rights are realised, expired or surrendered. A financial liability shall be de-recognised when it is extinguished.

(h) Offsetting financial instruments

Financial assets and liabilities are offset and the net amount reported in the statement of financial position when there is a legally enforceable right to offset the recognised amounts and there is an intention to settle on a net basis or realise the asset and settle the liability simultaneously.

(i) Inventory – Notes & Coins

The cost of the printing of notes and minting of coins are initially capitalised until such time as they are issued into circulation at which point the related cost is expensed. The weighted average cost method is used to calculate the number of pieces issued into circulation. All other expenditures of a non-capital nature are expensed when incurred.

(j) Cash and cash equivalents

Cash and cash equivalents comprise balances with a maturity of less than three months from the date of acquisition, including cash on hand, deposits held at call with banks, and other short-term highly liquid investments with original maturities of three months or less.

(k) Other receivables

Other receivables are stated at amortised cost.

(l) Employee benefits

(i) Pension Fund

The Governor and Deputy Governor contribute to the Bank's defined benefit pension fund and all other employees contribute to an approved external superannuation fund. Interest is paid on the Bank's pension fund balance half yearly based on the average interest rate of Nasfund and Nambawan Superannuation Fund.

Contributions to the Bank's pension fund and external superannuation fund are recognised as an expense in the Bank's statement of comprehensive income. The value of the Bank's pension fund defined benefit obligations and the fair value of the Bank's pension fund assets are determined with sufficient regularity to ensure that the amounts recognised in the Bank's financial statements do not differ materially from the amounts that would be determined at the balance date.

(ii) Provision for Leave Entitlement

The Bank maintains provisions for accrued annual leave in accordance with IAS 19- Employees Benefits, calculated on salaries expected to prevail when leave is anticipated to be taken. The Bank also maintains provisions for long service leave. The provision of employee benefits for long service leave represents the present value of the estimated future cash outflows to be made resulting from employees' service provided to balance date. The provision is calculated using expected future increases in wages and salary rates, including related on-costs and expected settlement dates based on staff turnover history and is discounted using the rates attaching to PNG Government bonds at balance date which most closely match the terms of maturity of the related liabilities.

(m) Other liabilities

Other liabilities are initially recognised at their fair value and subsequently recognised at amortised cost.

(n) Reserves

The Bank maintains the following reserves. Their purpose and method of operation is to be as follows:

(i) Bank of Papua New Guinea Reserve Fund

The Bank of Papua New Guinea Reserve Fund was created under the *Central Banking Act 2000* Section 42, and represents reserves set aside as determined to meet contingencies which arise in the course of the Central Bank's operations in carrying out its functions.

(ii) Property Revaluation Reserve

The property revaluation reserve reflects the impact of changes in the fair value of property.

(iii) Unrealised Profits Reserve

Unrealised gains and losses on foreign exchange balances and domestic securities are recognised in the unrealised loss reserve until such gains and losses are realised whereby they are recognised in profit and loss from ordinary activities. Such gains and losses are not available for distribution.

(iv) Distributable Profit Reserve

The distributable profit reserve reflects closing distributable profit which may be distributed to the Government of Papua New Guinea after ensuring that the current financial position of the Bank meets the requirements under the *Central Banking Act 2000* Section 49(3).

(v) Gold Revaluation Reserve

Unrealised gains and losses arising from revaluation are recognised in the Gold Revaluation Reserve at end of the accounting period. Realised gains and losses are recognised in profit and loss from ordinary activities.

(o) Determination of distributable profit

Profits of the Bank are determined and dealt with in accordance with Sections 49 and 50 of the *Central Banking Act 2000* as follows:

(i) Section 50 (1) states that net profit arising from revaluation and foreign currency movements shall not be available to be distributed to the Government or paid into the Consolidated Revenue Fund. Accordingly such unrealised profits are transferred to the Unrealised Profits Reserve.

(ii) The Board of the Bank is required to determine the net profit of the Bank and then consult with the Minister for Treasury to determine the amount of profit that is to be placed to the credit of the Bank's reserves.

(iii) The balance of net profit after any transfer in (a) and (b) in accordance with Sections 49(2)(a) and 50(1) of the Act is paid to the Consolidated Revenue Fund.

(iv) No amount shall be paid into the Consolidated Revenue Fund under the above sections where, in the opinion of the Central Bank, the assets of the Central Bank are, or after the payment would be, less than the sum of its liabilities and paid-up capital

(v) The unrealised profit reserve of the Bank represents gains or losses arising from the revaluation of gold, properties and other financial assets of the Bank. These gains and losses are separately classified under the respective reserves in the statement of changes in equity.

(p) Accounting estimates

Fair value of financial instruments that are not traded in an active market (for example over the counter derivatives or PNG Government inscribed stock) is determined using valuation techniques. The Bank uses its judgement to select a variety of methods and make assumptions that are mainly based on market conditions existing at the end of each reporting period. Derivative transactions are entered into on behalf of the Bank by the external fund managers and similar valuation techniques are used in valuing these derivatives.

These financial statements are not considered to contain any significant accounting estimates, as the most significant balance sheet items can be valued with reference to market rates, and revenue and expense recognition criteria are clearly defined.

(q) Tax Exemption

Bank of Papua New Guinea is exempt from income tax under section 87 of the *Central Banking Act 2000*.

(r) Comparatives

Comparative financial information has been rearranged to conform to current year presentation where necessary.

(s) Rounding

Financial information has been rounded to the nearest thousand Kina.

	2012 K'000	2011 K'000
Note 2: INTEREST REVENUE – FOREIGN CURRENCY OPERATIONS		
Foreign securities and bank deposits	**174,001**	**212,882**

Interest income on foreign securities and bank deposits includes income of K44.5 million (2011: K56.9 million) in relation to investments managed by external fund managers.

	2012 K'000	2011 K'000
Note 3: INTEREST REVENUE – DOMESTIC OPERATIONS		
Inscribed stock and other Government securities	**53,327**	**40,481**
Note 4: OTHER INCOME – DOMESTIC OPERATIONS		
Licensing and other fees	2,531	3,157
Numismatic currency	317	308
Property rent	1,536	1,185
	4,384	**4,650**
Note 5: INTEREST EXPENSE – DOMESTIC OPERATIONS		
Central Bank Bills issued	157,289	183,616
Other deposits held	1,538	768
	158,827	**184,384**
Note 6: GENERAL AND ADMINISTRATION EXPENSES		
Staff costs	34,697	34,540
Staff training and development	2,142	2,107
Premises and equipment	13,213	13,467
Depreciation of property, plant and equipment	6,164	3,708
Amortisation of coins production expenses	9,275	6,622
Amortisation of notes production expenses	6,276	10,216
Currency distribution expenses	2,759	4,042
Audit fee	1,400	1,275
Travel	4,827	3,631
Legal & consultancy fees	4,049	3,032
Board & meeting expenses	487	677
Other expenses	6,974	7,194
	92,263	**90,511**

	2012 K'000	2011 K'000
Note 7: IMF RELATED ASSETS & LIABILITIES		
Assets		
SDR holding	30,643	34,200
Liabilities		
IMF number 1 and 2 loan accounts	1,557	1,557
SDR allocation	405,256	411,393
	406,813	**412,950**

Papua New Guinea has been a member of the IMF since 1975. The Bank of Papua New Guinea acts as the fiscal agent for the IMF on behalf of the Government. As fiscal agent, the Bank of Papua New Guinea is authorised to carry out all operations and transactions with the Fund.

Special Drawing Rights (SDR) are allocated by the IMF to members on the basis of members' quota at the time of the SDR allocation. The Bank of Papua New Guinea pays interest on its SDR allocations and earns interest on its holdings of SDR.

	2012 K'000	2011 K'000
Note 8: CASH & CASH EQUIVALENTS		
Foreign currency holdings – Nostro accounts	493,631	1,251,573
	493,631	**1,251,573**

The foreign currency holdings represent the Bank's foreign Nostro accounts with corresponding foreign banks.

	2012 K'000	2011 K'000
Note 9: FINANCIAL ASSETS AT FAIR VALUE		
Foreign investments	7,723,001	7,765,983
Derivative assets	20,072	20,263
Accrued interest on foreign Investments	43,755	52,541
	7,786,828	**7,838,787**

Foreign investments include K2.26 billion (2011: K2.28 billion) of investments managed by the external fund managers. The remainder of K5.46 billion (2011: 5.48 billion) is managed directly by the Bank.

	2012 K'000	2011 K'000
Note 10: GOVERNMENT OF PAPUA NEW GUINEA SECURITIES		
Inscribed stock	602,103	437,165
Treasury bills	194,436	-
Accrued interest receivable on domestic securities	11,084	7,515
	807,623	**444,680**
Note 11: LOANS AND ADVANCES		
Agricultural export commodity support loans	1,386	1,386
Loans and advances to staff (including housing loans)	8,549	8,331
	9,935	**9,717**
Note 12: OTHER NON FINANCIAL ASSETS		
Commemorative notes & coins and other receivables	**3,034**	**3,588**

In Kina (K'000)	Land and Buildings	Equipment Vehicles	Motor Equipment	Computer Software	Computer	Total
Note 13: PROPERTY PLANT & EQUIPMENT						
At 31 December 2011						
Cost	110,890	3,094	2,172	5,054	13,004	134,214
Accumulated depreciation	(1,603)	(2,345)	(1,084)	(3,557)	(1,361)	(9,950)
Net Book Amount	**109,287**	**749**	**1,088**	**1,497**	**11,643**	**124,264**
Year end December 2012						
Opening net book amount	109,287	749	1,088	1,497	11,643	124,264
Additions	6,925	1,740	407	929	3,919	13,920
Disposals	–	–	(937)	–	–	(937)
Write-back accumulated depreciation on disposal	–	843	–	–	843	
Depreciation charges	(3,879)	(451)	(441)	(541)	(852)	(6,164)
Closing Book Amount	**112,333**	**2,038**	**960**	**1,885**	**14,710**	**131,926**
At 31 December 2012						
Cost	117,815	4,834	1,642	5,983	16,923	147,197
Accumulated Depreciation	(5,482)	(2,796)	(682)	(4,098)	(2,213)	(15,271)
Net Book Amount	**112,333**	**2,038**	**960**	**1,885**	**14,710**	**131,926**

The properties of the Bank were externally re-valued in December 2010. These revaluations are performed every 3 years. The next revaluation will be performed in 2013.

The deferred cost on computer software is the net cost of the Opics system since going live upon completion in May 2010, plus accumulated cost of work-in-progress for payment and data warehouse systems. These costs will be amortised over a period of 13 years, which is in line with the life of the licence.

	2012 K'000	2011 K'000
Note 14: DEPOSITS FROM BANKS & THIRD PARTIES		
Banks		
Exchange settlement accounts	750,779	778,682
Cash reserve requirement	1,390,852	944,874
Other Deposits	8,992	9,731
	2,150,623	**1,733,287**

	2012 K'000	2011 K'000
Note 15: SECURITIES ISSUED		
Central bank Bills issued	5,328,704	5,654,380
Accrued interest payable on domestic securities	17,242	31,177
	5,345,946	**5,686,557**

Securities issued are debt securities issued by the Bank of Papua New Guinea for terms of twenty eight days, three or six months. These bills are used to manage liquidity in the money market open market operations in the domestic financial markets.

Interest on securities issued varied between 1.90% and 3.50% during the year (2011: 2.4%, 4.8%).

	2012 K'000	2011 K'000
Note 16: CURRENCY IN CIRCULATION – DOMESTIC LIABILITY		
Currency in circulation	**1,679,329**	**1,532,447**

Currency in circulation represents currency issued having a claim on the Bank of Papua New Guinea. The liability for currency in circulation is recorded at its fair value in the statement of financial position.

	2012 K'000	2011 K'000
Note 17: FINANCIAL LIABILITIES		
Derivative liabilities	10,179	644
Foreign currency deposits	2,326	4,588
	12,505	**5,232**

	2012 K'000	2011 K'000
Note 18: NON FINANCIAL LIABILITIES		
Provisions for employee entitlements	13,457	11,082
Expense creditors	46,161	16,369
Other liabilities	8,499	12,488
	68,117	**39,939**

Expense creditors include cheques or warrants issued by the Bank but not yet presented for clearance and subsequent encashment by Government departments, investors and suppliers.

	2012 K'000	2011 K'000

Note 19: SHARE CAPITAL AND OTHER RESERVES

At 31 December 2012, the authorised and subscribed capital of the Bank was K145.5 million (2011: K145.5 million). The capital is fully subscribed by the Government of Papua New Guinea.

	2012 K'000	2011 K'000
At the beginning of the year	145,540	145,540
At the end of the year	**145,540**	**145,540**
Other Reserves:		
Property revaluation reserve	83,074	83,074
Unrealised profit/(loss) reserve	(1,642,502)	(1,650,775)
Gold reserve	129,516	122,314
Retained earnings	83,369	59,097
Total other reserves	**(1,346,543)**	**(1,386,290)**

Note 20: RECONCILIATION OF NET PROFIT TO OPERATING CASH FLOW

	2012 K'000	2011 K'000
Total profit/(loss) for the year	39,748	(1,721,905)
Add /(Subtract) Non-Cash Items		
Depreciation	6,164	3,707
Provisions for staff entitlements	2,376	3,249
Net unrealised gain/(loss) on gold	(7,202)	15,197
Net unrealised market value changes	(76,602)	11,511
Add /(Subtract) Movements in Other Financial Assets		
Decrease/(increase) in interest receivable	5,217	(1,632)
(Decrease)/increase in interest payable	(13,935)	13,855
(Increase)/decrease in foreign investment including derivatives	50,446	(1,976,735)
(Increase)/decrease in other receivable	5,244	15,675
Increase/(decrease) in other payables	25,803	(5,858)
Net Cash Flow from Operating Activities	**37,259**	**(3,658,133)**

Note 21: SEGMENT REPORTING

The Bank's primary function as a Central Bank is the implementation of monetary policy in one geographical area – Papua New Guinea.

Note 22: RISK MANAGEMENT

Note 22(i): Financial Risk Management

International Financial Reporting Standard (IFRS)7 – Financial Instruments: Disclosures – requires disclosure of information relating to financial instruments, their significance, performance, accounting policy, terms and conditions, fair values and the Bank's policies for controlling risks and exposures relating to the financial instruments.

A financial Instrument is defined as any contract that gives rise to both a financial asset of one enterprise and financial liability or equity instrument of another entity. The identifiable financial instruments for Bank of Papua New Guinea are its domestic government securities, its foreign government securities, loans and advances, bank deposits, central bank bills, currency in circulation and deposit liabilities.

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. Bank of Papua New Guinea's recognised instruments are carried at amortised cost or current market value.

The Bank is involved in policy-oriented activities. Therefore, the Bank's risk management framework differs from the risk management framework for most other financial institutions. The main financial risks to which the Bank is exposed include commodity price risk, credit risk, foreign exchange risk, liquidity risk and interest rate risk. In the management of foreign reserves, minimising liquidity risk is the prime consideration in order to ensure the availability of currency as required. Like most central banks, the nature of the Bank's operations creates exposure to a range of operational and reputational risks.

Bank management seeks to ensure that strong and effective risk management and control systems are in place for assessing, monitoring and managing risk exposure. Experienced staff conduct the Bank's local currency, foreign currency reserves management, and foreign exchange dealing operations in accordance with a clearly defined risk management framework, including delegated authority limits as set by the Governor.

The Bank is subject to an annual audit by an external auditor. Auditing arrangements are overseen by an Audit Committee of the Board to monitor the financial reporting and audit functions within the Bank and the Committee reviews the internal audit functions as well. The Committee reports to the Board of Directors on its activities.

The overall risk management framework is designed to strongly encourage the sound and prudent management of the Bank's risk. The Bank seeks to ensure the risk management framework is consistent with financial market best practice. The risks tables in this note are based on the Bank's portfolio as reported in its statement of financial position.

Note 22(ii): CREDIT RISK

Credit risk is the risk of loss arising from a counterparty to a financial contract failing to discharge its obligations.

(a) Credit Risk Management

The Bank manages credit risk by employing the following strategies;

Selection of a counterparty is made based on their respective credit rating. Investment decisions are based on the credit rating of the particular issuer, the issue size, country limits and counterparty limits in place to control exposures.

Foreign currency placements are made in approved currencies with Government, Government guaranteed or other approved counterparties. Geographical exposures are controlled by country limits. Limits are updated periodically where necessary based on the latest market information. Credit risk in the Bank's portfolio is monitored, reviewed and analysed regularly.

(b) Concentration of Credit Exposure

The Bank's end-of-year concentrations of credit exposure by industry type were as follows:

	2012 K'000	2011 K'000
Papua New Guinea Government	807,623	444,680
Other Government Institutions	1,386	1,386
Foreign Governments, Banks and Financial Institutions	8,460,354	9,266,608
Other	8,549	8,331
Total Financial Assets	**9,277,911**	**9,721,005**

The Bank's maximum exposure to credit risk is limited to the amount of financial assets carried in the statement of financial position.

Credit exposures arising from securities under agreements to re-sell (reverse repurchase agreements) are classified according to the issuer of the credit exposure of the security for credit exposure concentration purposes.

44% of the total assets have a credit rating of A-1+ in short term investments and 43% of long term investments have a credit of AA or above.

(c) Credit Exposure by Credit Rating

The following table represents the Bank's financial assets based on Standard and Poor's and Moody's credit ratings of the issuer. Under Standard and Poor's ratings, AAA is the highest quality rating possible and indicated the entity has an extremely strong capacity to pay interest and principal, AA is a high grade rating, indicating a very strong capacity, and A is an upper medium grade, indicating a strong capacity; BBB is the lowest investment grade rating, indicating a medium capacity to pay interest and principal. Other indicates the entity has not been rated by Standard and Poor's and Moody's.

Investment in Financial Assets	2012 K'000	% 2012 Financial Asset	2011 K'000	% 2011 Financial Asset
Short term:				
A-1+	3,436,052	44.1	33,600	0.4
A-1	197,225	2.5	3,865,478	49.9
A-2	15,468	0.2	120,979	1.0
A-3	–	–	–	-
NR	9,234	0.1	–	-
	3,657,979	46.9	4,020,057	51.3
Long term:				
AAA	1,995,505	25.6	2,106,666	27.2
AA+	339,839	4.4	441,172	6.0
AA	1,024,947	13.2	674,233	9.0
AA–	615,914	7.9	327,736	4.0
A+	48,497	0.6	–	-
A	5,158	0.1	166,074	2.0
BBB+	–	–	–	-
BBB	77,999	1.0	28,707	0.3
BBB–	–	–	–	-
BB+	–	–	21,600	0.2
BB	20,990	0.3	–	-
BB–	–	–	–	-
	4,128,849	**53.1**	**3,766,188**	**48.7**
Total Financial Assets	**7,786,828**	**100**	**7,786,245**	**100**

Note 22(iii): Market Risk

Market risk is the risk that the fair value or future cash flows of a financial instrument will fluctuate because of changes in market prices. Market risks arise from open positions in interest rate and currency products, all of which are exposed to general and specific market movements and changes in the level of volatility of market rates or prices such as interest rates, credit spreads and foreign exchange rates.

(a) Foreign Exchange Risk

Currency risk (foreign exchange rate risk) is a form of risk that arises from the change in price of one currency against another, which directly affects the value of foreign exchange reserves as well as investments. At the Bank of Papua New Guinea, foreign exchange reserve management and investment functions are guided by an Investment Committee. The decision of the Investment Committee and dealing practices approved by the Investment Committee serve as operational guidelines for the Bank's reserve management and investments. The guidelines are directed towards managing different types of risks, while earning a reasonable return. There is an approved benchmark for investment in terms of currency composition, portfolio duration and proportion of different assets within a bank. Dealers/ portfolio managers endeavour to comply with this benchmark through rebalancing the investment portfolio following benchmarking daily/weekly as approved by the Investment Committee.

As at 31 December 2012 the Bank of Papua New Guinea's net exposure to major currencies in Kina terms was as follows.

	CURRENCY OF DENOMINATION								
As at 31 December 2012	US Dollar K'000	Gold K'000	Euro K'000	AUD K'000	GBP K'000	JPY K'000	SDR K'000	Other K'000	Total K'000
Foreign Currency Financial Assets									
Foreign currency	181,402	–	66,222	32,436	128,834	83,873	–	864	493,631
Investments	3,918,545	–	1,207,032	2,042,964	282,456	299,425	–	–	7,750,422
Assets held with IMF	–	–	–	–	–	–	30,643	–	30,643
Derivative asset	20,072	–	–	–	–	–	–	–	20,072
Other assets	–	149,251	–	–	–	–	–	16,335	165,586
	4,120,019	**149,251**	**1,273,253**	**2,075,400**	**411,290**	**383,298**	**30,643**	**17,199**	**8,460,354**
Foreign Currency Financial Liabilities									
Liabilities with IMF	–	–	–	–	–	–	406,813	–	406,813
Foreign currency liabilities	12,371	–	–	–	–	–	–	134	12,505
	12,371	**–**	**–**	**–**	**–**	**–**	**406,813**	**134**	**419,318**
Net Foreign Currency Exposure	**4,107,647**	**149,251**	**1,273,253**	**2,075,400**	**411,290**	**383,298**	**(376,170)**	**17,065**	**8,041,036**

As at 31 December 2011	US Dollar K'000	Gold K'000	Euro K'000	AUD K'000	GBP K'000	JPY K'000	SDR K'000	Other K'000	Total K'000
	CURRENCY OF DENOMINATION								
Foreign Currency Financial Assets									
Foreign currency	498,268	–	394,144	235,973	64,169	58,016	–	1,003	1,251,573
Investments	3,996,232	–	957,753	2,073,922	383,236	388,951	–	–	7,800,094
Assets held with IMF	–	–	–	–	–	–	34,260	–	34,200
Derivative assets	20,263	–	–	–	–	–	–	–	20,263
Other assets	–	142,049	–	–	–	–	–	18,430	160,479
	4,514,763	**142,049**	**1,351,897**	**2,309,895**	**447,405**	**446,967**	**34,260**	**19,433**	**9,266,609**
Foreign Currency Financial Liabilities									
Liabilities with IMF	–	–	–	–	–	–	412,950	–	412,950
Foreign currency liabilities	5,225	–	–	7	–	–	–	–	5,232
	5,225	**–**	**–**	**7**	**–**	**–**	**412,950**	**–**	**418,182**
Net Foreign Currency Exposure	**4,509,538**	**142,049**	**1,351,897**	**2,309,888**	**447,405**	**446,967**	**(378,750)**	**19,433**	**8,848,427**

The functional currency of all operations is PNG Kina.

	Balance Total K'000	MATURITY PERIOD 0 to 3 months	3 to 12 months	1 to 5 years	Over 5 years	No specific maturity
As at 31 December 2012						
Liabilities in 2012						
Foreign Currency Financial Liabilities						
Liabilities with IMF	406,813	–	–	–	–	406,813
Foreign currency liabilities	12,506	12,506	–	–	–	-
	419,318	**12,506**	**–**	**–**	**–**	**406,813**
Local Currency Financial Liabilities						
Deposits from banks and third parties	2,150,623	2,150,623	–	–	–	-
Deposits from Government	985,402	985,402	–	–	–	-
Securities issued	5,366,932	3,504,332	1,862,600	–	–	-
Currency in Circulation	1,679,329	–	–	–	–	1,679,329
	10,182,286	**6,640,357**	**1,862,600**	**–**	**–**	**1,679,329**
Other Liabilities						
Other liabilities	68,117	68,117	–	–	–	-
	68,117	**68,117**	**–**	**–**	**–**	**-**
Total Liabilities	**10,669,721**	**6,720,980**	**1,862,600**	**–**	**–**	**2,086,142**
As at 31 December 2011						
Liabilities in 2011						
Foreign Currency Financial Liabilities						
Liabilities with IMF	412,950	–	–	–	–	412,950
Foreign currency liabilities	5,232	5,232	–	–	–	-
	418,182	**5,232**	**–**	**–**	**–**	**412,950**
Local Currency Financial Liabilities						
Deposits from banks and third parties	1,733,287	1,733,287	–	–	–	-
Deposits from Government	1,718,749	1,718,749	–	–	–	-
Securities issued	5,715,100	3,959,700	1,755,400	–	–	-
Currency in Circulation	1,532,447	–	–	–	–	1,532,447
	10,699,583	**7,411,736**	**1,755,400**	**–**	**–**	**1,532,447**
Other Liabilities						
Other liabilities	39,939	39,939	–	–	–	-
	39,939	**39,939**	**–**	**–**	**–**	**-**
Total Liabilities	**11,157,704**	**7,456,907**	**1,755,400**	**–**	**–**	**1,945,397**

Note 22(iv): Sensitivity Analysis

At 31 December 2012, if interest rates had been 100 basis points lower with all other variables constant, profit for the year would have been K1.7 million higher and the net deficiency in equity at year end would have been K1.7 million lower (2011:K8.1 million). Conversely if interest rates had been 100 basis points higher with all other variables held constant, the profit for the year would have been K1.7 million lower and the net assets deficiency at year end would have been K1.7 million higher (2011: K8.1 million).

At 31 December 2012, if the Kina had weakened 10 per cent against the principal currencies in its foreign reserves portfolio with all other variables held constant, profit for the year would have been K804.1 million higher, (2011: K 884.8 million). Conversely if the Kina had strengthened 10 per cent against the same currencies with all other variables held constant the Bank would have experienced a decrease in the profit for the year of K804.1 million, (2011: K884.8 million).

Note 22(v): Fair Value

Fair value represents the amount at which an asset could be exchanged or a liability settled between knowledgeable, willing parties in an arm's length transaction. Fair value has been based on management assumptions according to the portfolio of the asset and liability base. IFRS requires that the fair value of the financial assets and liabilities be disclosed according to their classification under IAS 39. The following table summarises the financial assets and liabilities in accordance with IAS 39 classifications.

	2012 K'000	2011 K'000
Financial Assets		
At fair value through profit/(loss)	8,774,346	8,459,716
Loans and receivables	503,567	1,261,289
	9,277,913	9,721,005
Financial Liabilities		
At fair value through profit/(loss)	419,318	418,182
At amortised cost	10,229,417	10,710,978
	10,648,735	**11,129,160**

Fair values of the above financial instruments are estimated to be the same as their carrying values in the statement of financial position.

FAIR VALUE HIERARCHY

IFRS 7 specifies a hierarchy of valuation techniques based on whether the inputs to those valuation techniques are observable or unobservable. Observable inputs reflect market data obtained from independent sources; unobservable inputs reflect the Bank's market assumptions. These two types of inputs have created the following fair value hierarchy:

- Level 1 – Quoted prices (unadjusted) in active markets for identical assets or liabilities. This level includes listed equity securities and debt instruments on exchanges.
- Level 2 – Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (that is, as prices) or indirectly (that is, derived from prices). This level includes over the counter derivative contracts. The sources of input parameters are Bloomberg or Reuters.
- Level 3 – inputs for the asset or liability that are not based on observable market data (unobservable inputs). This level includes equity investments and debt instruments with significant unobservable components.

This hierarchy requires the use of observable market data when available. The Bank considers relevant and observable market prices in its valuations where possible. The table below shows the Bank's assets and liabilities in their applicable fair value level.

31 December 2012	Level 1 K'000	Level 2 K'000	Level 3 K'000	Total K'000
Financial assets held at fair value through profit and loss				
– Domestic Government securities (Inscribed Stock)	–	–	796,539	796,539
– Foreign Government and semi-Government bonds	2,704,079	–	–	2,704,079
– Money market instruments	–	2,805,385	–	2,805,385
– Derivatives managed by external fund managers	–	20,072	–	20,072
– Investments in bonds and other instruments managed by external fund managers	2,257,293	–	–	2,257,293
– Gold	149,251	–	–	149,251
– Assets held with IMF	30,643	–	–	33,464
Total assets	**5,141,266**	**2,825,457**	**796,539**	**8,763,262**
Financial liabilities held at fair value through profit and loss				
– Derivatives	–	10,180	–	10,180
– Liabilities with IMF	406,813	–	–	406,813
Total liabilities	**406,813**	**10,180**	**–**	**416,993**

Investments managed by external fund managers include foreign Government bonds and other debt instruments for which quoted prices are available as well as derivatives which are valued with reference to observable market data. Accordingly, these are classified under level 1 and 2 respectively.

31 December 2011	Level 1 K'000	Level 2 K'000	Level 3 K'000	Total K'000
Financial assets held at fair value through profit and loss				
Financial assets held for trading				
– Domestic Government securities (Inscribed Stock)	–	–	437,165	437,165
– Foreign Government and semi-Government bonds	2,354,796	–	–	2,354,796
– Money market instruments	–	3,153,020	–	3,153,020
– Derivatives managed by external fund managers	–	20,263	–	20,263
– Investments in bonds and other instruments managed by external fund managers	2,258,167	–	–	2,258,167
– Gold	142,049	–	–	142,049
– Assets held with IMF	34,200	–	–	34,200
Total assets	**4,789,212**	**3,173,283**	**437,165**	**8,399,660**
Financial liabilities held at fair value through profit and loss				
– Derivatives	–	644	–	644
– Liabilities with IMF	412,950	–	–	412,950
Total liabilities	**412,950**	**644**	**–**	**413,594**

The following table presents the changes in Level 3 instruments (excluding the accrued interest) for year ended 31 December 2012

	Level 3 K'000	Total K'000
Opening balance	**437,165**	**437,165**
Investments net of maturities	282,772	282,772
Fair value revaluation gains/(losses) on level instruments	76,602	76,602
Closing balance	**796,539**	**796,539**
Total gains and losses for the period included in the profit or loss for level 3 assets held at the end of the reporting period.	76,602	76,602

The following table presents the changes in Level 3 instruments for year ended 31 December 2011

	Level 3 K'000	Total K'000
Opening balance	**409,470**	**409,470**
Investments net of maturities	16,184	16,184
Fair value revaluation gains/(losses) on level instruments	11,511	11,511
Closing balance	**437,165**	**437,165**
Total gains and losses for the period included in the profit or loss for level 3 assets held at the end of the reporting period.	11,511	11,511

Note 23: EVENTS AFTER THE BALANCE DATE

Subsequent to the balance date, no events have occurred which require adjustments to/or disclosures in the financial statements.

Note 24: CONTINGENT LIABILITIES

The Bank had no material contingent liabilities at 31 December 2012 (2011 Nil) and there are no transactions or events that will have material impact on the financial report during the preparation of this report.

The Bank is a party to a number of litigations, the outcome of which are currency uncertain. The directors, Governor and the Deputy Governor, in consultation with the Bank's legal advisors, consider that these litigations are not expected to result in a material loss to the Bank.

Note 25: CAPITAL COMMITMENTS

The Bank has no material capital commitments.

Note 26: REMUNERATION OF MEMBERS OF THE BOARD AND KEY MANAGEMENT PERSONNEL

IAS 24 – Related party disclosures requires disclosure of information relating to aggregate compensation of key management personnel. The key management personnel of the Bank are members of the Board and senior staff who have responsibility for planning, directing and controlling the activities of the Bank: this group comprises 21 in total (2011: 25), including the Governor, Deputy Governor Regulation, 3 Assistant Governors, 4 non-executive Board members and 12 senior staff. The Salaries and Remuneration Committee (SRC) and Salaries, Conditions & Monitoring Committee (SCMC) determine the terms and conditions on which the Governor and Deputy Governor hold office in accordance with the *Central Banking Act 2000*. The Governor, in consultation with the Salaries, Conditions & Monitoring Committee (SCMC), determines the remuneration of other key executives.

Key Management Personnel Remuneration

	2012 K'000	2011 K'000
Short term benefits	5,966	5,201
Post employment benefits	612	492
Other long term benefits	2,437	2,133
	9,015	7,826

Short term benefits include cash salary and in the case of staff, annual leave and motor vehicle and housing benefits. Post employment benefits include superannuation benefit payments. Other long term benefits include long service leave. The components of benefits are reported on an accruals basis.

As at 31 December 2012, the loans owed by the key management personnel to the Bank were K1,688,387 (2011: K1,948,730)

Note 27: AUDITOR'S REMUNERATION

The total audit fee for the year was K1,400,019 (2011: K1,275,313). This represents the total statutory audit fee paid to the Auditor General's Office and other auditors.

Note 28: TRANSACTIONS WITH GOVERNMENT AND GOVERNMENT CONTROLLED ENTERPRISES

The Bank of Papua New Guinea acts as the banker to the Government and its various Government departments and controlled enterprises. The Government of Papua New Guinea is restricted under the *Central Banking Act 2000* in actively participating in Bank's decision and policy formulations. All related party transactions are carried out with reference to market rates. Transactions entered into include:

(a) Acting as the fiscal agent, banker and financial advisor to the Government; the Bank is the depository of the Government and or its agents or institutions providing banking services to Government and Government departments and corporations.

(b) Acting as the agent of the Government or its agencies and institutions, providing guarantees, participating in loans to Government departments and corporations.

(c) As the agent of the Government managing public debt and foreign reserves.

Declaration by Management

In our opinion the foregoing Statement of Financial Performance and Statement of Financial Position, including the Notes to and forming part thereof, have been drawn up so as to give a true and fair view of the matters to which they relate for the year ended 31 December 2012.

Going concern

The Bank recorded a total comprehensive profit of K39.7 million (2011: loss of K1,737.1 million) and experienced positive operating cash flows of K37.3 million (2011: negative cash flow of K3,658.1 million) for the year. In addition, total liabilities of the Bank exceeds its total assets by K1,201 million (2011 – net assets of K1,241 million). The Bank envisages this net deficiency position to continue as a result of ongoing appreciation of the PNG Kina over the foreseeable future and the combined high cost of monetary policy management stemming from high domestic liquidity.

Safeguard available to the Bank

Section 50(2) of the *Central Banking Act 2000* (CBA Act 2000) provides that where the Bank incurs a loss due to a change in the value of assets or liabilities, the Minister shall cause to be paid to the Bank such amount out of the Consolidated Revenue Fund as is necessary to avoid the loss. This is a statutory obligation imposed on the Minister to ensure the viability of the Central Bank.

Subsection 50(4) of that Act further provides that the Minister may create and issue to the Central Bank non-interest bearing non-negotiable notes for an amount not exceeding any payment made by the Minister to the Central Bank out of the Consolidated Revenue Fund in accordance with Subsections (1) and (2).

The above provisions effectively require the Government to provide financial support to the Bank to the extent determined by the Bank's Board. Such financial assistance need not involve any cash flow.

Steps taken by the Bank and other mitigating factors

Building Capital and Reserves

In 1996, the Board of the Bank had approved the retention of part of the operating profits to build up capital and reserves for the Bank and continues to build its capital and reserves.

The Bank reported a distributable profit of K22 million for the year 2010. The Board recommended retaining that profit as part of the Bank's Capital and Reserves. Subsequent to the Board's endorsement, the Bank corresponded the same with the then Minister for Treasury, citing as well that the Government's 2011 budget had required no dividends from the Bank. However, the Bank was subsequently directed by a National Executive Council (NEC) Decision in September 2011 to pay the K22 million as dividends.

Promissory Note

In the June 2011 meeting the Board of the Central Bank had determined that Section 50(2) of the *Central Banking Act 2000* (CBA) be invoked. There has since been continuous dialogue between the Bank, the Secretary for Treasury and the Minister requesting payment from Consolidated Revenue combined with the issue of a Promissory Note to the Bank.

The Bank has submitted a letter dated 9 May 2012 to the Minister requesting a promissory note for K1.74 billion which is reflective of the forecasted net deficiency position of the Bank as at 31 December 2012.

Operation of TAP facility on behalf of the Government

In 2011 the Bank also initiated dialogue with the Treasury Department on the option of operating a TAP facility on behalf of the Government. This option was put forward as a means of reducing the Bank's major domestic liability of Central Bank Bills, by shifting some liquidity management burden to the Government, thereby easing pressure on the Bank's liquidity management operation, hence a more healthier net position.

Movement of Trust Accounts from Commercial Banks

Externally held trust funds continue to have an adverse impact on the liquidity management operations of the Bank. The Bank has approached the Government to consider moving all trust accounts in commercial banks back to Bank of PNG. The Government conceded and about K200 million was transferred from various commercial bank trust accounts to the Bank during the year.

Resources Sector gains to be held as Reserves by the Bank

Discussions have been underway between the Bank and the Government on the possibility of the Government placing excess funds from the LNG operations and other mining and petroleum operations in the custody of the Bank to manage offshore in addition to the Bank's current in-house managed and externally managed foreign reserves. An outcome of this dialogue is still pending.

The Bank will continue the dialogue with the appropriate Government authorities to ensure the Bank's net deficiency position and ensuing implications on going concern as well as stakeholder confidence are fully appreciated and addressed in a timely manner. On this basis, we believe that the preparation of the financial statements of the Bank on a going concern basis is appropriate.

For and on behalf of the Bank of Papua New Guinea,

Loi M Bakani
Governor

18 June 2013

Benny Popoitai MBE
Deputy Governor

Report of the Auditor-General

AUDITOR-GENERAL'S OFFICE
PAPUA NEW GUINEA

PAPUA NEW GUINEA

Phone: (+675) 3012200 Fax: (+675) 325 2872 Email: agopng@ago.gov.pg Website: www.ago.gov.pg

Reference: 30-13-4

The Honourable Don Polye, MP
Minister for Treasury
Office of the Minister
Vulupindi Haus - 4th Floor
PO Box 542
WAIGANI, NCD

INDEPENDENT AUDITOR'S REPORT ON THE
BANK OF PAPUA NEW GUINEA
FOR THE YEAR ENDED 31 DECEMBER 2012

I have audited the accompanying financial statements of the **Bank of Papua New Guinea** for the year ended **31 December, 2012** as set out on pages **2** to **25** which comprise the statement of financial position as at 31 December, 2012, the statement of comprehensive income, statement of changes in equity and statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory notes.

The Bank Board's Responsibility for the Financial Statements

The Bank's Board is responsible for the preparation and fair presentation of these financial statements in accordance with *International Financial Reporting Standards*, other generally accepted accounting practice in Papua New Guinea and other statutory requirements including the *Papua New Guinea Central Banking Act, 2000*. This responsibility includes designing, implementing and maintaining internal controls relevant to the preparation and fair presentation of financial statements that are free from material misstatements, whether due to fraud or error.

Responsibility of the Auditor-General

My responsibility is to express an opinion on these financial statements based on my audit. I conducted my audit in accordance with the *Audit Act* and *International Standards on Auditing*. These standards require that I comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error.

In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

I believe that the audit evidence I have obtained is sufficient and appropriate to provide a basis for my audit opinion.

AUDIT OPINION

In my opinion:

(a) the financial statements are based on proper accounts and records;

(b) the financial statements are in agreement with those accounts and records and give a true and fair view of the financial position of the Bank as at 31 December, 2012 and its financial performance and cash flows for the year then ended; and

(c) I have obtained all the information and explanation that were required.

PHILIP NAUGA
Auditor-General

24th June, 2013

Report of the Auditor-General

AUDITOR-GENERAL'S OFFICE
PAPUA NEW GUINEA

PAPUA NEW GUINEA

Phone: (+675) 3012200 Fax: (+675) 325 2872 Email: agopng@ago.gov.pg Website: www.ago.gov.pg

Reference: 30-13-4

The Honourable Don Polye, MP
Minister for Treasury
Office of the Minister
P.O Box 542
WAIGANI, NCD

BANK OF PAPUA NEW GUINEA

In accordance with the provisions of *Section 8(2)* of the *Audit Act, 1989 (as amended)*, I have inspected and audited the accounts and records of the financial transactions and records relating to the assets and liabilities and assets in the custody of the **Bank of Papua New Guinea** for the year ended **31 December, 2012**.

My report on the financial statements of the Bank together with a copy of the financial statements was forwarded to you on 24 June, 2013. The report did not contain any qualification.

OTHER MATTER

I wish to bring to your attention the following matter which, in my opinion, is important.

1. Net Asset Deficiency – Going Concern

The Bank has a net capital deficiency as at 31 December, 2012 where the Bank's total liabilities exceeded its total assets by K1.2 billion. The capital deficiency along with other matters set forth in Note 1(a) indicated the existence of a material uncertainty that may cast doubt about the Bank's ability to continue as a going concern and therefore the Bank may be unable to realize its assets and discharge its liabilities in the normal cause of business.

– 2 –

The Bank has brought this matter to the attention of the Minister for Treasury and has submitted a letter dated 9 May, 2012 to the Minister requesting a promissory note for the net asset deficiency. At the time of issuing this report the promissory note has not been provided to the Bank.

PHILIP NAUGA
Auditor-General

24th June, 2013

Notes


BANK OF PAPUA NEW GUINEA