National Reserve Bank of Tonga

ANNUAL REPORT 2011 - 12

Pangike Pule Fakafonua ʻo Tonga

National Reserve Bank of Tonga

Annual Report for the Year Ended 30 June 2012

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Discrepancies between the sum of the constituent items and the total, as shown in some tables, are due to rounding. Revisions to previously published statistics are included as they occur.

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Governor's Foreword

The uncertainty in the global economy and the international markets during 2011/12 continued to pose challenges to the recovery of the Tongan economy. The spillover effects of these international developments contributed to the difficulty in achieving the desired outcome of the Reserve Bank's monetary policy. The Reserve Bank's target was for the Kingdom's foreign exchange reserves to remain above three to four months of import cover and for inflation to remain below 6 percent per annum. Throughout the 2012 financial year, the level of official foreign reserves remained above seven months of import cover and overall inflation remained well below 6 percent in the last 9 months of the year. The Reserve Bank therefore considered it appropriate to retain the highly accommodative policy stance that it had adopted over the 2011 financial year, and made no changes to monetary policy. A more detailed rationale behind the Reserve Bank's monetary policy decisions is published in the Reserve Bank's semi-annual Monetary Policy Statements.

The accommodative monetary policy was implemented mainly through leaving as much liquidity as possible in the banking system targeted at strengthening banks' individual incentives to increase lending. This measure however, was not strong enough to outweigh other forces that have been reducing banks' appetite to lend. At the same time demand for credit continued to be affected by the prolonged impact of the Global Financial Crisis (GFC) through reduced income.

With the Reserve Bank's monetary policy tools at their expansionary limits, and the desired outcomes of credit growth not realized, the Reserve Bank organized an Economic Dialogue in March 2012 with a theme, "**Growing the economy: a collective effort**". The dialogue engaged businesses, large and small and other stakeholders in a discussion of Tonga's economic situation and what could help to stimulate economic activity. The key findings agreed to at the dialogue were presented in a paper to the Government through the Ministry of Finance in March 2012, published in the local newspapers, and posted on the Reserve Bank's website. The Government has since formed a National Growth Committee to consider the strategies and specific actions agreed at this dialogue.

In terms of financial stability, Tonga's banking system remained strong and sound throughout the year, despite subdued activity in the overall economy. Levels of capital adequacy and liquidity remained high, and earnings increased, partly through an improvement in asset performance. However, the level of non-performing loans is still considered high, and the Reserve Bank continued to discuss with the banks their credit risk management systems and recovery processes. The weak economic conditions both globally and domestically contributed to the slow recovery of non-performing loans and continued to affect the growth of credit to the private sector both on the supply and the demand sides.

A new set of prudential returns designed by the Reserve Bank, in collaboration with the Pacific Financial Technical Assistance Centre (PFTAC), was issued in November 2011 to improve the accuracy and timeliness of data reported by the banks. Training on the new prudential returns was conducted and the new reports became effective in January 2012. These new reports will be a valuable addition to Reserve Bank analysis going forward.

The Reserve Bank continued working towards maintaining the quality of notes and coins in circulation at a high standard. In nominal terms the value of notes distributed by the Reserve Bank rose over the year, to its highest level on record. The value of new notes issued rose particularly sharply, with the 'Apifo'ou anniversary and Liahona alumni celebrations contributing to a pick-up in demand.

The Reserve Bank was able to carry out its responsibilities through the commitment and dedication of its staff and the technical assistances received throughout the year. As at the end of June 2012, the total number of staff employed at the Bank was 82, which is a record high. The Reserve Bank actively pursued policies for strengthening staff capacity, with staff receiving training on-the-job, in house, at local institutions, and, abroad. Courses covered a range of central banking functions, and served to enhance the staff's capacity and efficiency in helping the Reserve Bank to meet its mandated goals.

The Reserve Bank financials were audited by Pricewaterhouse Coopers, Fiji and was submitted to the Minister of Finance on the 28th September 2012 together with a summary of the Bank's operations during the year in accordance with the NRBT Act 1988. The size of the Reserve Bank's balance sheet reached T$273.9 million at the end of June 2012, a growth of T$38.9 million over the year. The growth owed mostly to the rise in foreign reserves, reflecting the strong support from Tonga's development partners. The rise in foreign reserves increased the Reserve Bank's interest income at the same time the Bank's interest expense also increased on the rise in domestic exchange settlement accounts (ESA). Since domestic banks' lending continued to decline during the year, their banks' balances in the Reserve Bank continued to rise. Overall, the National Reserve Bank of Tonga's net profit available for distribution fell by $447,003 to $1,971,583 from $2,418,586 last year. Given that the Reserve Bank's overall capital has been built up to twice the amount of paid up capital, the entire net profit for the financial year will be transferred to the Government as required by the NRBT (Amendment) Act 2007.

The domestic economy will remain vulnerable to the developments in the global economy and international markets through trade, remittances, tourism, oil and food prices, let alone natural disasters and climate change. The Reserve Bank will continue to target its policy measures towards maintaining adequate foreign reserves and promoting low inflation in the next 12 months.

The Reserve Bank has commenced a project to review its organisational structure and strategies with the aim to improve the efficiency and effectiveness in the performance of its functions and achieving its objectives. The main thrust of this project will be carried out in the next financial year.

I would like to thank the Board of Directors for their directions and support during the year. I acknowledge the support received from the Ministry of Finance, Government and the domestic banks in pursuing our common goal of promoting macroeconomic stability and economic growth. The assistance from the international organisations, development partners of Tonga and other central banks in the region is acknowledged with appreciation. Finally, I would like to thank the staff of the NRBT for their hard work during the year which contributed to the Reserve Bank achieving its objectives in 2011/2012.

Siosi C. Mafi
Governor

Functions and Objectives

The *National Reserve Bank of Tonga (Amendment) Act, 2007*, sets out the principal objectives of the Bank. It states:

(1) "The principal objectives of the Bank shall be, to-

(a) maintain internal and external monetary stability; and

(b) promote a sound and efficient financial system.

(2) Subject to subsection (1), the Bank shall conduct its activities in a manner that supports macroeconomic stability and economic growth."

Maintaining internal monetary stability is pursued by the Reserve Bank through promoting low and stable inflation over the medium term. The Reserve Bank's benchmark inflation is to average between 6 percent and 8 percent.

Maintenance of external monetary stability is pursued through maintaining adequate amount of foreign currencies (foreign reserves) to meet the country's foreign currency demands to pay for imports, etc. As such, the Reserve Bank's monetary policies aim to ensure that Tonga always has foreign reserve holdings of at least three to four months of import cover.

The National Reserve Bank *Act* also sets out the Reserve Bank's functions:

"The principal functions of the Bank shall be, to-

(a) issue currency;

(b) formulate and implement monetary policy;

(c) regulate as required the supply, availability and international exchange of money;

(d) hold and manage the external reserves of the Kingdom;

(e) provide advisory services to the Minister on banking and monetary matters;

(f) be the principal banker, fiscal agent and depository of the Government;

(g) undertake banking business, in Tonga or elsewhere, subject to the provisions of this Act;

(h) regulate and supervise financial institutions; and

(i) oversee and promote the efficient, sound and safe functioning of the payment system."

Details on how the Reserve Bank applied its functions to meet its objectives are outlined in this report and other publications.

Governance

Key Decision Makers

The Reserve Bank has a Board of Directors that is responsible for the Reserve Bank's policy and affairs. The Board is to constantly review the performance of the Reserve Bank in the conduct of its functions and its use of resources, and may give advice to the Governor on any matter relating to the Bank's functions and the exercise of its powers. The Board must meet at least once every two months, and in 2011/12, the Board held 12 meetings, to discuss and formulate the policies of the Bank and to monitor its operations.

The Board comprises of the Governor, Secretary for Finance, and 5 other non-executive directors. Under the NRBT Act and the Amendment Acts, the Directors are appointed for terms up to five years by the Minister of Finance and may be reappointed. There are two vacancies in the Board of Directors of the Bank and its composition remained unchanged in the financial year 2011/12.

The Governor, who is the Chief Executive Officer of the Bank, is responsible to the Board for the execution of its policy and the management of the Bank. Mrs. Siosi Cocker Mafi was reappointed in May 2008 as Governor.

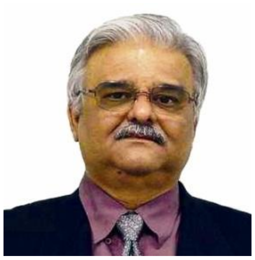
Board of Directors

Mr. Steve Edwards

Chairman

HRH Princess Salote Pilolevu Tuita

Director



Mr. Richard Prema

Director

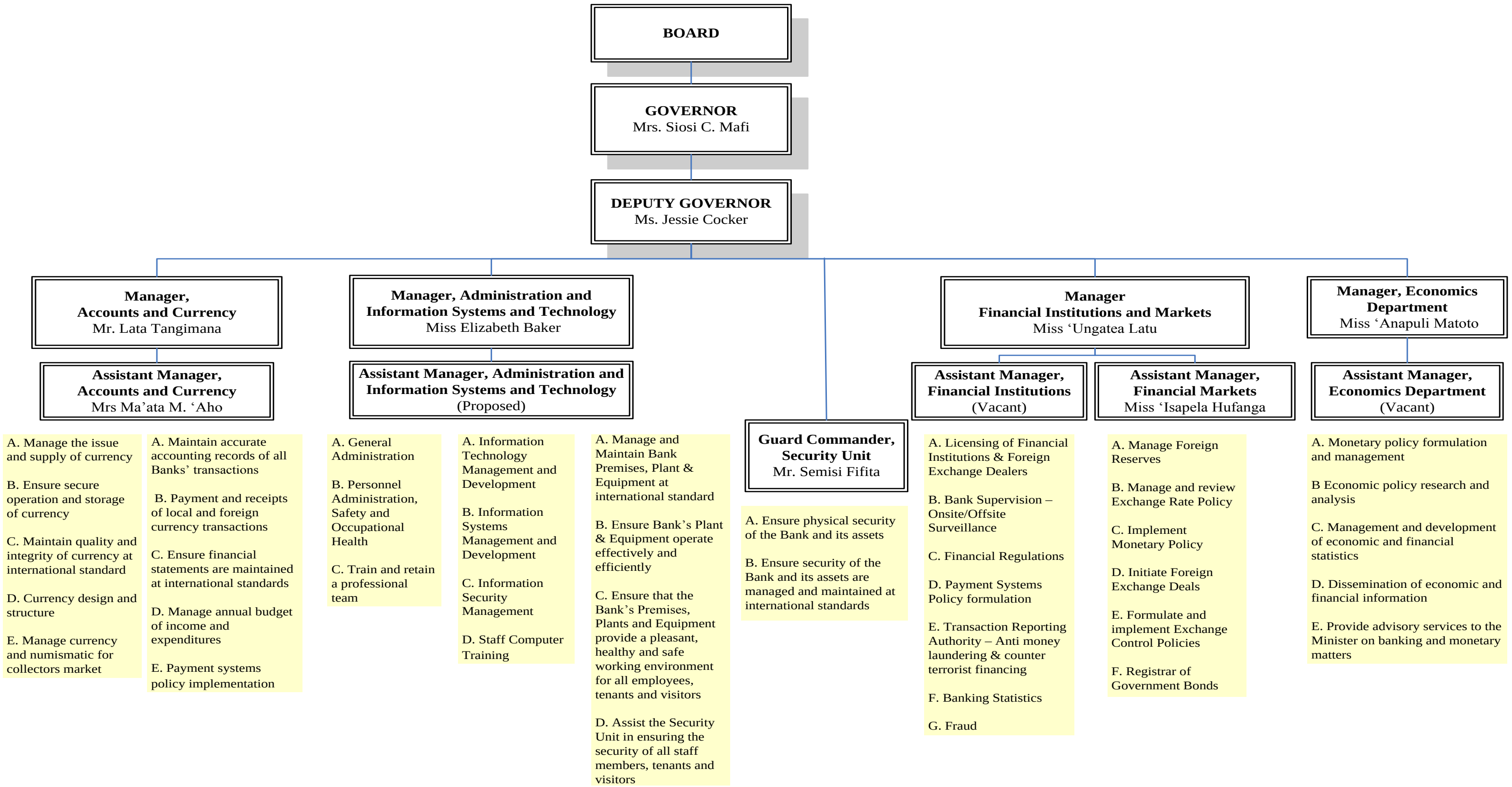
Mr. Tiofilusi Tiueti

Director
(Secretary for Finance)

Mrs. Siosi Cocker Mafi

Governor

Organizational Chart
June 2012



Staff members listed are those that occupied the positions for the majority of the financial year

Accountability

Relationship with Government

The Reserve Bank Act specifies the relationship between the Government and the Reserve Bank. It requires the Reserve Bank to provide advice and statistics when requested by the Minister of Finance, and to inform the Minister of economic developments that are relevant to the achievement of the Reserve Bank goals. The Reserve Bank undertakes the role of being the principal banker, fiscal agent and depository for the Government. Over the 2012 financial year, regular discussions between the Chairman of the NRBT Board, the Governor and the Minister served to keep the Minister informed, as did the provision of various reports. Among the reports provided were the Reserve Bank's weekly foreign reserves and liquidity report, monthly statement of assets and liabilities, monthly monetary policy data, six monthly monetary policy statements, the operations summary together with the audited annual accounts and the annual report for the 2011 financial year.

Other forms of accountability

The Reserve Bank also seeks to ensure a high degree of public accountability for its decisions and processes, which necessitates a high degree of public transparency. The transparency in the 2012 financial year was achieved through regular public communication, in both written and verbal forms.

In written forms, the Reserve Bank published two Monetary Policy statements, which detailed the rationale behind its monetary policy decisions. As required by the NRBT (Amendment) Act 2007, this publication provides a review of economic developments and the conduct of monetary policy in the previous 6 months. It also outlines how the Reserve Bank intends to conduct monetary policy over the coming 6 months to achieve its objectives specified by the NRBT Acts. The Reserve Bank published its monthly statement of assets and liabilities in the Government gazette. The Reserve Bank also published its annual report for the 2011 financial year, containing its audited financial statements, a summary of its operations, an economic overview of Tonga, and a detailed assessment of the condition of Tonga's financial system. It disseminated quarterly economic statistics in its quarterly Bulletin publication as well. With the rationale for the Reserve Bank's monetary policy decisions now regularly outlined in the Monetary Policy Statements, the Annual Reports will no longer contain an economic overview.

In verbal forms, the Governor made several public addresses over the 2012 financial year. In July 2011, for instance, the Governor spoke to the Tonga Research Association Conference on the Economy of Tonga and in August 2011, at the annual conference of the Tonga Australia Alumini Association on Development Partners and Economic Development. Leading up to the Economic Dialogue, the Governor hosted over 20 meetings with stakeholders from various groups in the society to brief them on the objectives of the Dialogue and to prepare them to bring specific proposals for discussion at the Dialogue. In March 2012, the Governor presented at the Economic Dialogue on the Current Economic Conditions, Outlook and Macroeconomic Challenges. The Chairman of the Board and the Governor also held a press conference in May 2012 on the release of the Bank's Monetary Policy Statement for March 2012.

Financial Stability

Financial Sector

The Reserve Bank is responsible for the promotion of a sound and efficient financial system. These objectives are pursued through the licensing, regulating and supervising of financial institutions (banks).

There are 4 banks licensed to operate in Tonga.

	Australia and New Zealand (ANZ)	Westpac Bank of Tonga (WBOT)	MBf Bank Limited	Tonga Development Bank (TDB)
Branches (including Head Office at Nuku'alofa)	3	5	2	6
ATMs	10	8	-	-
Internet Banking	Yes	Yes	No	No
Other Services	ANZ Pacific Money Transfer Card, Customer Experience Portal	Financial Education Programs – Financial First Steps Program, Women in Business Program, Business Basics Program, Financial Management	-	Microfinance

Source: NRBT

The Westpac Bank of Tonga (WBOT) and the Tonga Development Bank maintained its head office and branches on Tongatapu, as well as branches on the islands of Vava'u, Ha'apai, and 'Eua. The MBf Bank Limited maintained its head office on Tongatapu and a branch on the island of Vava'u. The ANZ Bank also maintained its head office on Tongatapu and a sub-branch in Vava'u. Tonga Development Bank continued to be the only bank serving the outermost islands of Niuatoputapu and Niuafo'ou.

During the year, the banks continued with their current banking services, introduced some new banking services, and at the same time ceased their more costly operations. ANZ and WBOT both launched mobile banking during the year, mainly to cater for customers' banking needs from remote areas. Furthermore, WBOT advised that it will introduce 'Instore Banking' through eftpos mobile service. This service will benefit customers living in rural villages. On the other hand, ANZ and WBOT both closed their Ma'ufanga branches in November 2011 and March 2012 in an attempt to reduce their operational costs given the continued weak economic conditions. In October 2011, ANZ announced the distribution of the National Pacific Insurance Loan product in the ANZ General Insurance product suite currently distributed to ANZ customers. This insurance loan product would strengthen the ANZ credit administration and provide insurance cover for personal loans. Meanwhile, the Tonga Development Bank continued to provide its Business Advisory training program for many of its small business customers.

In promoting lower remittance costs, WBOT reduced the cost of over the counter money transfer from Australia to the Pacific in July 2011 and ANZ launched the ANZ Pacific Money Transfer Card in March 2012.

WBOT commenced the distribution of eStatements for its customers which enhanced the disclosure requirements outlined on the Prudential Statement No. 4 "Disclosure" on customer's Statement of Accounts.

Supervision and Regulation of Licensed Financial Institutions

In 2011/12, Tonga's banking system remained strong and sound despite subdued activity in the overall economy. The banking system maintained a strong capital and liquidity position and improved earnings and asset quality over the year.

During 2011/12, the Reserve Bank continued to focus its supervisory activities on reducing the vulnerability of the financial system in regards to credit and liquidity risks. There were no major concerns with liquidity risks given the high level of liquidity in the system. Although the level of non-performing loans has improved compared to the previous year, it continued to remain at high levels and the Reserve Bank continued to discuss with banks their credit risk management systems and recovery process. The weak economic conditions and continuing decline in private remittances contributed to the slow recovery of non-performing loans in the banking system and continued to affect the growth of credit to the private sector both on the supply and the demand sides. The level of non-performing loans and the banks' asset and capital management continues to be a challenge in this economic and financial environment. The Reserve Bank continues to monitor these areas through offsite analysis and onsite visits.

During the year, competition from the Retirement Fund Board (RFB) personal loans and the South Pacific Business Development (microfinance) loans contributed to the fall in banks' lending interest rates. Lending interest rates fell by up to 2.5 percent compared to reductions of up to 2.4 percent in the previous year. Deposit rates also fell by up to 0.8 percent during the year. The fall in deposit rates was driven mainly by the high level of liquidity in the banking system. Unfortunately, the decline in interest rates has not resulted in a corresponding increase in credit and economic activity as anticipated.

In June 2012, the Reserve Bank responded to a Cabinet Decision for the Reserve Bank to advise measures to control interest rates given their concern about the high level of interest rates and the borrowers' difficulties in servicing their loans. The Reserve Bank maintained its position that it is in the best interest of the public that interest rates be determined by market forces in a transparent and accountable manner. Regulating interest rates would be detrimental to the economy both in the short term and long term. In addition, lower interest rates have not resulted in positive credit growth. Reports from some members of the public on the high level of interest rates have also been submitted to the Reserve Bank and have been addressed through the relevant financial institution. The Reserve Bank has liaised with the Ministry of Labour, Commerce & Industries to consider how best to address banking services complaints and the setting of a cap on interest rates for all financial service providers including money lenders under the Consumer Protection Act. This work is carried out on the advice from Crown Law department that financial services are covered by the Consumer Protection Act as the financial service providers are deemed to be traders who provide a service.

A new set of prudential returns designed by the Reserve Bank in collaboration with the Pacific Financial Technical Assistance

Centre (PFTAC) was issued in November 2011 to improve the accuracy and timeliness of data reported by the banks. Training on the new prudential returns was conducted and the new reports were effective in January 2012. These new reports provide monthly detailed information on the banks' balance sheet, income statement, loans, foreign exchange and interest rate risk exposure, as well as balance of payments information.

The annual review of the prudential statements resulted in revisions to the existing prudential statement requirements, to align them with the new set of prudential returns, and ensure consistency with the Financial Institutions Act 2004 as well as other international best practices. The revised Prudential Statements were issued to the banks and became effective in May 2012.

The Reserve Bank continued to meet with the Association of Banks in Tonga (ABT) to discuss issues that would support a sound and stable financial system. The Reserve Bank supported the ABT and the IFC in the setting up of Tonga's first Credit Bureau to improve the credit and lending environment in Tonga. The Reserve Bank has included in its work-plan the consideration of the Financial Sector Economic Dialogue strategies to improve access to credit, strengthen the institutional capacity of the financial sector, increase transparency and disclosure, improve the credit worthiness of borrowers, and deepen and broaden the financial market. The Reserve Bank is working in collaboration with relevant stakeholders to implement these strategies to contribute to improving the credit environment and to support economic growth in Tonga.

Onsite examination of banks is an integral part of the Reserve Bank's supervisory framework. An onsite examination of one bank was conducted with the assistance of an expert funded by the IMF, focusing on reviewing the bank's credit risk, liquidity and market risks, and verifying compliance with the Reserve Bank's reporting requirements. The Reserve Bank has scheduled onsite visits to the 3 remaining banks in the next financial year.

The Reserve Bank enhanced the enforcement of the Prudential Statements by conducting annual compliance checks as well as spot checks of compliance with the disclosure requirements on effective interest rates under Prudential Statement No. 4.

The Reserve Bank also held regular meetings and trainings with banks in order to discuss specific issues relevant to each bank including clarification of reporting requirements.

Given the significance of the Retirement Fund Board in the country's financial system, the Reserve Bank maintained its correspondences with the RFB in order to incorporate their financial activities in the consideration of the financial system's soundness and stability. The Reserve Bank has proposed to Government to consider including the retirement and pension funds under the supervisory role of the Reserve Bank.

Financial Performance

The total assets of the financial system decreased by $8.5 million to $504 million in 2011/12, a decrease of 1.7 percent. The decline in the banks' assets was mainly due to a decrease of $19.6 million in total gross loans. The decrease in total loans reflected the settlement of major loans as well as the write off of provisioned loans during the year. This was partially offset by a $23 million (20 percent) increase in Exchange Settlement Accounts (ESA), which reflected significant foreign currency aid received by the Government during the year.

At the end of the 2012 financial year, the banks' outstanding loans portfolio comprised of loans to industries and businesses, including agriculture (43.1 percent), private individuals (50.7 percent of which 34.6 percent was for housing) and the Public Enterprises (5.3 percent).

Financial Sector Deposit Accounts

	2010/11	2011/2012
Demand Deposits		
Number of Accounts	2,508	14,852
Value of Deposits ($m)	88.6	109.5
Saving Deposits		
Number of Accounts	39,919	30,335
Value of Deposits ($m)	57.5	48.5
Time Deposits		
Number of Accounts	1,524	2,430
Value of Deposits ($m)	174.9	156.2
Deposit by Other Banks		
Value of Deposits ($m)	19.9	17.4
Total Number of Accounts	**43,951**	**47,617**
Total Value of Deposits ($m)	**340.9**	**331.7**

Source: NRBT

Total liabilities decreased by $20.2 million (4.8 percent) to $406 million. This was due mainly to a $9.2 million (2.7 percent) decrease in total deposits, compared with an increase of $11.3 million (3.4 percent) in 2010/11. The decline in total deposits largely reflected the maturity of time deposits with one of the large banks as well as the drawdown of government deposits and other retirement funds to facilitate members' payouts before June 2012. Furthermore, total provisions fell by $13.8 million (31.2 percent), reflecting the clearance of provisioned loans during the year.

The total number of accounts reported by banks increased by 8 percent to 47,617 reflecting the consolidation of saving accounts to demand accounts by one of the large banks, while the total value of deposits fell by 2.7 percent to $331.7 million.

Profitability

The profitability of the total financial sector slightly improved in the year ended June 2012 from the previous year. The total financial sector as a group showed an after-tax profit of $12.5 million for the year ended June 2012, which is equivalent to 2.4 percent of average assets, compared with a profit of $11.5 million for the previous year, which is equivalent to 2.3 percent of average assets. The slight improvement in profitability compared to the year ended June 2011 was attributed mainly to the increase in non-interest income to 3.9 percent of average total assets compared to 3.5 percent the previous year combined with a decline in total operating expenses from 6.3 percent of average total assets to 5.2 percent this year. This reflects the banks' cost cutting measures during the year. Net interest income on the other hand slightly fell to 3.9 percent of total average assets compared to 4.0 percent the previous year.

Financial Performance

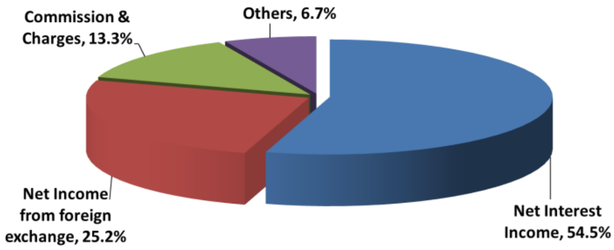
	2010/11 [1]	2011/12
Pre-tax Net Profit (% average total assets)	2.5	3.0
After-tax Net Profit (% average total assets)	2.3	2.4
Total Operating Income (% average total assets)	9.4	8.5
Net Interest Income (% average total assets)	4.0	3.9
Non-interest Income (% average total assets)	3.5	3.9
Total Operating Expenses (% average total assets)	6.3	5.2
Consolidated Risk-weighted Capital Ratio (%)	26.3	31.4

1 Revised to reflect 12 months data

Source: Licensed Financial Institutions

Total operating income decreased to 8.5 percent of average assets from 9.4 percent in 2010/11. The decrease in operating income was attributed mainly to a decrease in net interest income reflecting mainly the reduction of banks' lending interest rates as well as the continued decline in credit growth during the year. The bulk of banks' operating income was derived from the extension of loans. The proportion of total operating income from net interest income declined to 54.5 percent of in 2011/12 compared with 58.7 percent in 2010/11. At the same time, net income from foreign exchange activities and commission income decreased to 25.2 percent and 13.3 percent respectively in 2011/12 from 26.3 percent and 14.2 percent in the previous year.

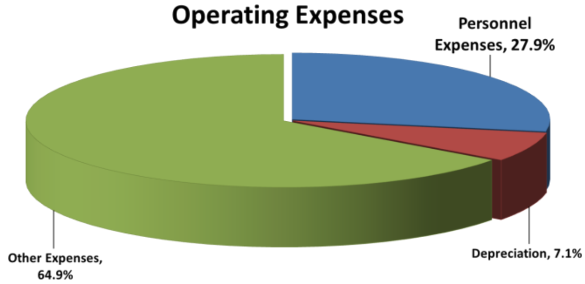
Financial Sector - Components of Operating Income



Source: NRBT

The decrease in operating expenses of the banks to 5.2 percent of average assets in 2011/12, compared with 6.3 percent in 2010/11 offset the decrease in total operating income. This was mainly due to a decrease in the banks' personnel expenses over the year. About 27.9 percent of administrative expenses of the banks were taken up by employees' remuneration, a decrease from 37.6 percent in the previous year. Depreciation and amortisation accounted for 7.1 percent of total administrative expenses and the balance of 64.9 percent was made up of the purchase of various goods and services necessary for the operations of the banks.

Financial Sector - Components of Operating Expenses

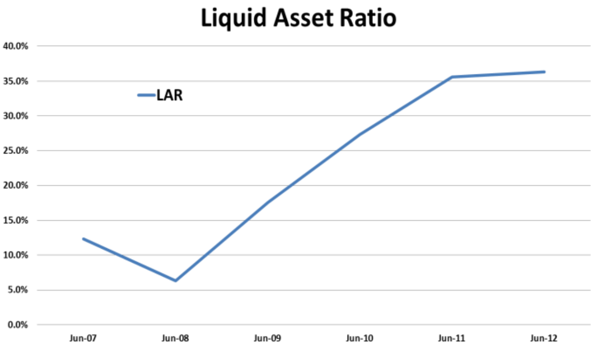


Source: NRBT

Liquidity

Liquidity in the banking system continued to increase during 2011/12, underpinned by the receipt of development partners' funds and the continued decline in loans. Net loans as a proportion of deposits[2] remained at 70.0 percent similar to that in June 2011. Furthermore, the Liquid Asset Ratio increased to 36.3 percent from 35.6 percent in 2010/11, which was well above the minimum Reserve Bank requirement of 5 percent.

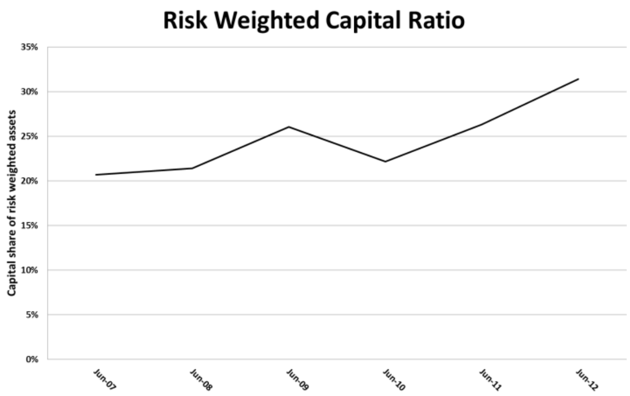
[2] Deposits = non-financial sector deposits + TDB promissory notes



Source: NRBT

Capital

The capital position of the banking industry remained strong and above the minimum ratio required by the Reserve Bank. The consolidated risk weighted capital ratio for all the banks increased to 31.4 percent at the end of June 2012, compared with 26.3 percent at the end of June 2011. This is a significant increase and is the highest level since June 2008. The higher capital position was mainly attributed to the negative growth in lending.

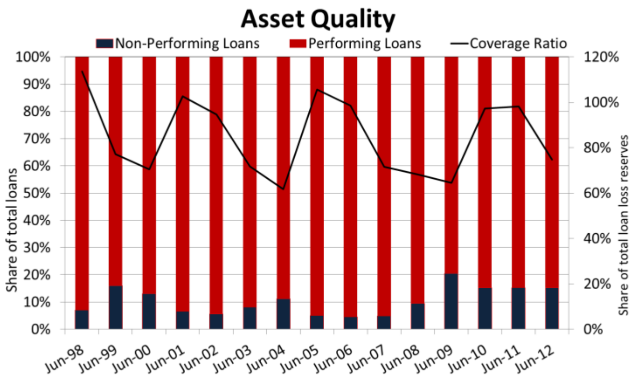


Source: NRBT

Asset Quality

The overall quality of the banks' assets improved over the year ended June 2012 but still remains a concern. Total non-performing loans decreased by $2.9 million (6.8 percent) to $39.9 million, representing 15 percent of total loans for the year ended June. The improvement over the year reflected the clearance of provisioned loans during the year. The total non-performing loans comprised of loans to businesses (65 percent), mainly the wholesale and retail, and hotels and restaurants sectors, as well as housing for private individuals (20 percent).

Total provisions against loans fell by $11 million (28 percent) to $31 million. The coverage ratio of the non-performing loans by total loan loss reserves therefore decreased to 75.7 percent, compared with 98.2 percent in June 2011.



Source: NRBT

Transaction Reporting Authority

The Reserve Bank is the Transaction Reporting Authority (TRA) under the Money Laundering and Proceeds of Crime (MLPC) Act. The TRA's functions ensure the financial system is protected from money laundering and terrorist financing activities. This in turn enables the Reserve Bank to meet its objective of promoting a safe and sound financial system. The TRA's role and functions under the MLPC Act includes policy formulation and enforcement.

During the year, the TRA focused on implementing the requirements of the 2010 legislative amendments, and the recommendations from the Mutual

Evaluation report (MER) as outlined in the Strategic Implementation Plan (SIP) submitted to the Asia Pacific Group on Money Laundering (APG) in May 2011. This included training of banks and foreign exchange dealers on their obligations under the MLPC Act and Regulations. The Australian Transaction Reports and Analysis Centre (AUSTRAC) also assisted with training on conducting risk assessment of their customers, products and services. A general awareness training was conducted in March 2012 for the Designated Non-Financial Business Professionals (DNFBPs) such as the accountants, lawyers, real estate agents and money lenders. The members of the National Committee on ML/TF co-hosted with the APG, AUSTRAC and the Pacific Islands Forum Secretariat (PIFS) a Sub-Regional Workshop on the Control of Cross-Border Movement of Cash and Bearer Negotiable Instruments & Suspicious Transaction Reporting in May 2012. This was a rewarding training opportunity for the local authorities in enhancing their awareness and skills in these areas. The TRA's role was also enhanced after it signed a Memorandum of Agreement with the Association of Pacific Islands Financial Intelligence Units which would facilitate the sharing of information between the regional FIUs and the TRA.

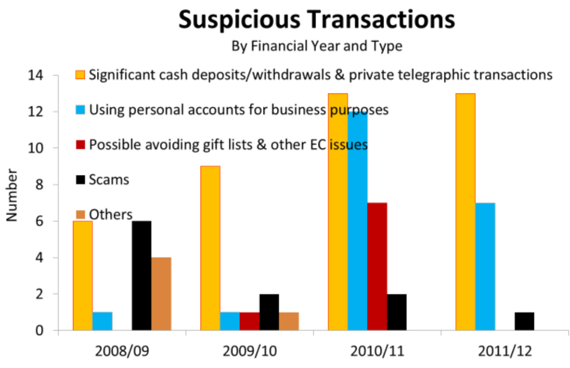
The TRA and the members of the National Committee and the Sub-Committee on Money Laundering and Terrorist Financing (ML/TF) worked together in compiling Tonga's second year MER progress report which was discussed at the APG annual meeting in July 2012. Although Tonga's level of compliance was low according to the Mutual Evaluation in November 2009, sufficient progress has been made in addressing the recommendations of the MER. Tonga is required to submit its third year detailed progress report to the APG by January 2013. This is part of the process of ensuring full compliance with the best practices on anti-money laundering and countering terrorist financing as outlined in the Financial Action Task Force (FATF) 40 recommendations.

Number of Suspicious Transactions Reported (STR) to the TRA

	07/08	08/09	09/10	10/11	11/12
STRs	5	17	14	34	21

Source: NRBT

The TRA received 21 STRs from the commercial banks and authorized restricted foreign exchange dealers during the year, representing a decrease of 38.2 percent from the previous year.



Source: NRBT

The dominant STR indicator continued to be significant cash deposits, withdrawals or telegraphic transfer transactions that were not in line with the customer's profile or source of funds were undetermined (13 STRs). Seven of the 21 STRs were related to the usage of personal accounts for conducting of business transactions, a decrease from 12 reported last year. One STR was scam-related. The Reserve Bank continued to receive information regarding internet or email scams. Some of these emails are alleged to be sent from known countries when in fact they are part of the "Nigerian scams". Public notices were issued to warn the public of these scam activities.

Subsequent to the analysis of these STRs, sixteen of the 21 STRs were reported to the Police (TCU) for further investigations of possible money laundering and other serious offences. Fourteen were reported to the Ministry of Revenue for possible tax evasion. The signing of a Memorandum of Understanding between the members of the Cabinet Committee on AML/CFT would result in the dissemination of STR information to other law enforcement agencies. This would also improve the sharing of information and would assist the enforcement of AML/CFT related laws and regulations.

STRs Disseminated to Law Enforcement Agencies

Law Enforcement Agencies	07/08	08/09	09/10	10/11	11/12
Police	2	11	8	32	16
Ministry of Revenue	1	0	2	14	14
Ministry of Labour, Commerce & Industries (MLCI)	0	0	0	1	0

Source: NRBT

The TRA also continued to disseminate the terrorist list from the Office of Foreign Assets Control's (OFAC) of the United States Department of the Treasury of Specifically Designated Nationals (SDN) and the dissemination list of the Non-Cooperative Countries and Territories and countries that are subject to the Financial Action Task Force's public statements.

Quarterly meetings with the banks and authorized restricted foreign exchange dealers were also conducted to enhance compliance with AML/CFT requirements.

Interbank Cheques Clearance

The Reserve Bank facilitates a daily clearance service for the commercial banks to ensure a safe and efficient clearing system. The commercial banks operating in Tonga have signed an interbank clearing agreement with each other together with the Reserve Bank on their commitment to the clearance of cheques on a daily basis. The total number of cheques presented for clearance at the Reserve Bank clearance center over 2011/12 was 133,531, a decrease of 6 percent from the previous year. The decrease in the number of cheques being cleared may be attributed to the introduction of internet banking, eftpos and other forms of electronic payments by the commercial banks. The weak economic conditions during the 2011/12 year could also be a contributing factor. The clearance of cheques in the center is running well and all participants are committed to settle their dues on time. Reflecting the high level of liquidity available in the domestic market, there were no special cheque clearances between the banks during the year.

Financial Markets Operations

Monetary Policy Formulation

As detailed in recent Monetary Policy Statements, the Reserve Bank's policy target was to maintain the country's foreign reserves above three to four months of import cover and to promote inflation to remain below 6 percent per annum. Throughout the 2012 financial year, the level of official foreign reserves remained above seven months of import cover and overall inflation remained well below 6 percent in the last 9 months of the year. The Reserve Bank therefore considered it appropriate to retain its highly accommodative policy stance. It made no changes to monetary policy throughout the year.

Domestic Market Operations

The Reserve Bank implemented its accommodative policy stance by leaving all of its domestic market tools at settings that supports economic activity as much as was thought possible:

a. The Reserve Bank did not issue any Reserve Bank notes. The idea was to leave as much liquidity in the system as possible, to strengthen banks' individual incentives to increase lending. The last time that the Reserve Bank had notes outstanding was in June 2009.

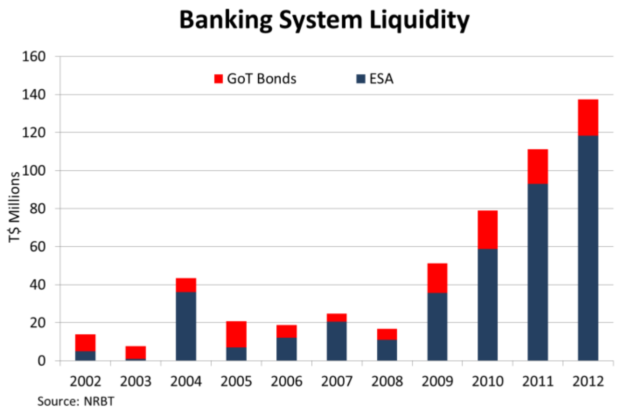
b. The Reserve Bank held the required reserve ratio unchanged at 5 percent. This setting allowed for maximum policy expansion while providing for sufficient protection to depositors. The Required Reserve ratio has been at 5 percent since August 2009.

c. In previous years the Reserve Bank has at times chosen to introduce credit ceilings, to slow what it deemed to be an undesirably high rate of credit growth. No credit ceilings were imposed during the 2012 financial year. The Reserve Bank last imposed a credit ceiling in February 2007.

d. The Reserve Bank in October 2007 required all banks to maintain a minimum holding of 5 percent of liabilities in specified eligible liquid assets. This was to ensure that the banks maintain sufficient liquidity to meet its obligations at all times, while still allowing them adequate room to increase lending. There was no change to this requirement during the 2012 financial year.

As at the end of June 2012, total banking system liquidity stood at $137.5 million. A total of $118.2 million was in the form of bank holdings of Exchange Settlement Accounts, and $19.3 million was in the form of Government of Tonga Bonds held by the banks. The level of overall liquidity was the highest on record, and was $26 million higher than the previous year. Recent growth has been caused by higher level of foreign reserves and negative growth in credit.

The Government did not issue any new bonds in the financial year 2011/2012 apart from rolling over of $3 milllion bonds that matured in September and October 2011. This is due to its debt position and its policy decision of no further borrowings.



Due to the excess liquidity in the banking system, there was no activity in the inter-bank market and there were no applications for repurchase agreements during the 2012 financial year.

Foreign Exchange Operations

The Bank determines the rate at which the Tongan pa'anga is exchanged for foreign currencies on a daily basis, by reference to a weighted basket of currencies of Tonga's major partners in foreign trade and other foreign exchange transactions. The exchange rate currency basket is reviewed annually. The latest review was endorsed by the Board of Directors in April 2012.

The Bank monitors the resulting movement of the exchange rate with a view to ensure that the country's balance of payments position and price stability are maintained at levels that are consistent with the achievement of macroeconomic stability.

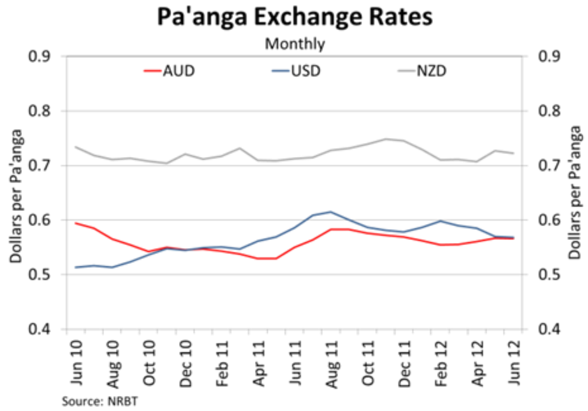
To help implement its exchange rate setting, the Reserve Bank clears the market at the end of every trading day, buying or selling foreign currency to meet any excess supply or demand that has arisen at the daily exchange rate. In this way the target exchange rate successfully forms the basis of the commercial banks' publicly quoted foreign exchange dealing rates. During the year, the Reserve Bank was a net purchaser in the spot foreign exchange market; it made foreign exchange purchases of T$192.8 million and foreign exchange sales of T$150.4 million. Total foreign exchange turnover for the year was T$343.2 million, compared with T$388.8 million for 2010/11.

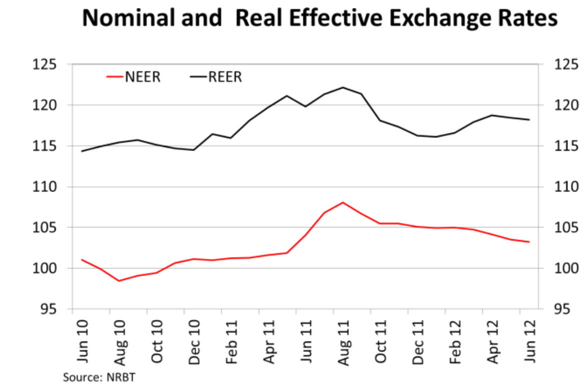
Through its role as the banker for the Government, the Reserve Bank also undertakes foreign exchange transactions on behalf of the Government. The Government purchases foreign currency from the Reserve Bank to meet foreign currency obligations arising mainly from debt repayments and other expenditures for the provision of government services. The Government sells foreign currency to the Reserve Bank that it receives, mainly from development partners.

In addition, the Reserve Bank conducts foreign exchange transactions for its own account and to occasionally change the currency composition of the Reserve Bank's portfolio.

The pa'anga fluctuated against the USD and the AUD in narrower bands in 2011/12 compared with the previous year, reflecting reduced volatility in the USD and AUD. Meanwhile, the pa'anga fluctuated against the NZD in a wider band in 2011/12 compared with the previous year, reflecting increased volatility in the NZD.

The Nominal Effective Exchange Rate decreased by 0.8 percent over 2011/12, which reflected a weakening of the Tongan pa'anga against the currencies of its major trading partners. The Real Effective Exchange Rate fell by 1.3 percent over the same period, as Tonga's inflation was lower than its trading partners during the year.



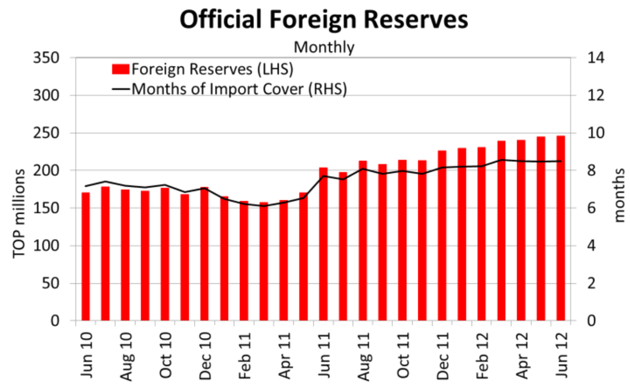


Foreign Reserves Management

The Reserve Bank Portfolio

The Reserve Bank is responsible for the management of Tonga's foreign reserves, which are held primarily to support the bank's ability to manage the exchange rate and, hence, support a stable macroeconomic environment.

The level of gross external reserves increased from T$203.8 million at the start of the 2012 financial year, to a record high of T$246.1 million and 9.2 months of import coverage at the end of June 2012. Volatility in the level of reserves was limited, so throughout the year reserves were always well above the benchmark of 3 to 4 months of imports. The increase in the level of foreign reserves was attributed mainly to aid inflows for the Government as well as deferred import payments reflecting the weak economy.



Holding of foreign reserves generates interest income for the Reserve Bank and exposes the Bank to exchange rate, credit, and liquidity risks. Portfolio return is an input into the management process but, given the overarching policy objective of holding foreign reserves, priority is given to managing risks and ensuring safety and liquidity prior to profitability. As such, the Reserve Bank adopts a very prudent approach to the management of the foreign reserves portfolio.

One of the key Board approved risk-parameters is ensuring that foreign reserves are held with banks that are rated "A" or above by international credit rating agencies. The investment of foreign reserves was fully compliant with this requirement throughout the 2012 financial year. The Board also requires the reserves portfolio to be managed to a pre-defined and diversified benchmark of foreign currencies, consisting mostly of US Dollars, Australian Dollars, and New Zealand

Dollars. The allocation is allowed to deviate from the benchmark, but only by a predefined limit. Again, the Reserve Bank was fully compliant with this limit throughout the financial year.

Generating interest revenues on foreign reserves was challenging over the 2012 financial year, with central banks responding to weak economic conditions by reducing or maintaining exceptionally low interest rates for all of the benchmark portfolio currencies. Nevertheless, the income on the investment of foreign reserves increased from the previous year, mainly due to the higher level of foreign reserves over the 2011/12 financial year.

The foreign reserves portfolio also exposes the Reserve Bank to exchange rate risk. As an estimate, a 5 percent movement of the Tongan pa'anga on the currency composition of foreign reserves would result in an estimated total increase/decrease in equity of T$1.1 million. Over the 2012 financial year, the overall effect of currency movements on the Reserve Bank's equity was an increase of T$537,199. The Reserve Bank will continue to monitor closely the implications of the movements of the exchange rates on the value of the foreign reserves and other policy measures.

Exchange Control Operations

The Foreign Exchange Control (Amendment) Regulations 2000 gives the Reserve Bank the administrative powers of the Foreign Exchange Control Regulations. The Reserve Bank's prior approval is required for all outward current transfers of T$100,000 and above and all capital transfers irrespective of the amount. Current transfers include payments for imports and other services. Capital transfers, on the other hand, include overseas investments, loan repayments and migrant transfers. All outward current transfers of less than T$100,000 have been delegated to the commercial banks and licensed restricted foreign exchange dealers. These requirements were introduced in 2000 to assist the Reserve Bank with the management of the official foreign reserves. The delegated limit for current transfers was increased from T$50,000 in July 2011, following the review of the Exchange Control Policy Guidelines in response to recommendations from the report of the Parliamentary Select Committee on Financial Matters 2010. The Exchange Control policies are developed to support the maintenance of sufficient level of foreign reserves.

During 2011/12, the Reserve Bank approved 648 exchange control applications. The approved exchange control applications amounted to T$184.4 million in 2011/12 (of which 11 percent were classified as capital transactions) compared to the T$218.4 million approved in 2010/11 (again, 11 percent of which were capital transactions). The decrease in exchange control applications is in line with the increase of the delegation limit and a decrease in imports of oil and other goods. The exchange control data on foreign currency payments by large importers are key inputs to the Reserve Bank's foreign reserves forecast and monetary policy decisions.

The Foreign Exchange Control (Restriction on Removal of Cash) Regulations 2009 requires the Reserve Bank's prior approval of the removal of cash, both Tongan pa'anga or foreign currency cash, exceeding T$10,000 from the Kingdom. During the year, the Reserve Bank received 33 applications, with a total value of T$11.0 million, for the removal of foreign currency cash over T$10,000 across the border. All were approved. This is an increase from 11 applications totaling T$1.3 million in 2010/11. This could be due to individuals wanting to take advantage of more favorable exchange rates being offered by institutions overseas and the public becoming more aware of this requirement.

Spot checks were undertaken during the year to ensure banks and authorized restricted foreign exchange dealers were compliant with the exchange control guidelines. The Reserve Bank conducted training with the banks and authorized restricted foreign exchange dealers to improve their understanding of exchange control requirements.

Export Proceeds

As requested by the Board of Directors, the Reserve Bank obtained a policy decision from Cabinet in September 2011 endorsing the sharing of information on exports by relevant government departments with the Reserve Bank. The Reserve Bank has been analyzing the data to better understand what proportion of exports are generating financial proceeds for Tonga, and how long the lag is between the shipment of exports and the receipt of the export proceeds. This will assist the Bank's work towards setting up a framework for increasing the return of export proceeds to Tonga. The Reserve Bank has included in its work plan a review of the Foreign Exchange Control Act and Regulations, with a view to facilitating the establishment of an export proceeds monitoring regime.

Licensing Authorised Restricted Foreign Exchange Dealers

The Foreign Exchange Control (Amendment) Regulations 2000 also assigns the authority of licensing of authorised restricted foreign exchange dealers to the Reserve Bank. The Reserve Bank, in January 2009, introduced the licensing requirement to register foreign exchange businesses that are conducting inward remittance and disbursement in Tongan pa'anga, as well as the conversion of foreign currency notes to/from Tongan pa'anga. All licences and registrations are due for renewal on the 31st of December of every year.

As at 30 June 2012, the Reserve Bank licensed and registered 8 authorised restricted foreign exchange dealers. The Reserve Bank received applications for the renewal of all 8 authorised restricted foreign exchange dealers during the 2012 financial year.

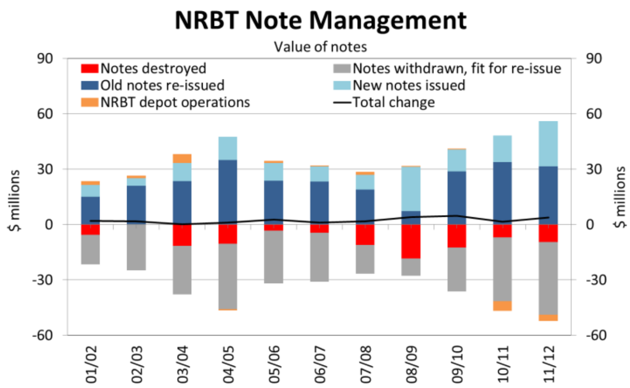
Through a continuous joint effort with the Ministry of Labor Commerce and Industries, the Reserve Bank was able to enforce compliance with the licencing requirements by the businesses that were conducting foreign exchange business without a valid licence. The licence conditions for agency arrangements with the banks were also strengthened, to ensure a level playing field for all foreign exchange businesses. The proposed review of the Foreign Exchange Control Act and Regulations will include the strengthening of the Reserve Bank's enforcement powers in licencing and supervising the authorised restricted foreign exchange dealers.

Currency Management

The Reserve Bank is responsible for ensuring that there is an adequate supply of high-quality banknotes and coins in circulation to meet the public's currency needs.

During the 2012 financial year the amount of notes issued by the Reserve Bank increased by 146,000 pieces or TOP$2.3 million. The increase is similar to previous years. At the end of June 2012, the total value of notes on issue in Tonga was TOP$36.6 million.

The graph below summarizes the Reserve Bank's currency operations. The Reserve Bank's withdrawal of notes from circulation is reflected below the zero line and its issue of notes to the public is reflected above the zero line.



In nominal terms the value of notes distributed by the Reserve Bank rose over the year, to its highest level on record. The value of new notes issued rose particularly sharply, with the 'Apifo'ou anniversary and Liahona alumni celebrations contributing to a pick-up in demand. All currency notes of the Kingdom are printed by De La Rue Currency in the United Kingdom.

The Reserve Bank distributes almost all of its notes via the commercial banks, either by adding to their on-site stocks of notes or to their Note Trust Depots. The Depots hold the NRBT's notes in custody of the commercial banks, ready for distribution via ATMs and tellers when the need arises. The commercial banks have been reducing the amount of notes they hold in their Depots since the 2011 financial year, as they have become more averse to holding large amounts of cash on premises. This has increased the frequency of the commercial banks visits to the Reserve Bank vault. During the 2012 financial year the Reserve Bank conducted surprise checks of the Depots, finding a discrepancy in one of the commercial bank's balances. The discrepancy owed to a miscommunication between the bank's branches and was resolved immediately.

To maintain the quality of banknotes in circulation, the Reserve Bank destroyed almost 900,000 unfit notes over the financial year, worth a total of $9.6 million. Of the notes destroyed, 17 pieces were counterfeit, up from just 1 counterfeit the previous year. These counterfeits were 2 pieces of $20 pa'anga and 15 pieces of $50 pa'anga note. The $20 pa'anga counterfeits shared the same serial number and the $50 pa'anga counterfeits shared two serial numbers. These counterfeits were confirmed to be photocopied notes. The Reserve Bank will continue to issue public brochures on identifying counterfeit notes both in the English and Tongan language.

At the end of June 2012, the face value of coins on issue totaled $1.9 million, compared with $1.8 million of the previous year. During the year the Royal Australian Mint supplied the Bank with 10, 20 and 50 seniti coins to replenish its stock.

The Reserve Bank also conducted a public survey to obtain the views of the public on the coins in circulation. In response to the findings, the Reserve Bank is now working on the development of a new family of coins to replace Tonga's existing coins in circulation.

The Reserve Bank undertakes regular meetings with commercial banks to discuss currency issues and to work together to maintain a high quality of currency in circulation. This has not been as successful as the Reserve Bank anticipated. The Reserve Bank will enhance its measures in the next financial year to improve quality of circulated currency.

Numismatic Notes and Coins

The Reserve Bank receives royalty from the sale of numismatic notes and coins directly to collectors and through agreements with specialised companies. Revenue from coin sales totaled TOP$23,500 over the 2012 financial year, which was similar to the 2011 financial year, but considerably lower than 2010. The delay in obtaining approvals for proposed new coin projects contributed to the decrease in sales of numismatic coins. The Reserve Bank continues to work closely with the Ministry of Finance and the Palace Office to expedite the approval process. This should help the Bank to improve its sales of numismatic coins and increase royalty received from these coin sales.

External Relations

Through participation in various international forums and bilateral relationships with other central banks, the Reserve Bank participates regularly in work aimed at addressing the ongoing challenges facing the global economy, the Pacific Region and Tonga. Particularly important relationships are those with other central banks in the South Pacific, and the International Monetary Fund, which provides technical assistance to countries in the region and visits annually to complete comprehensive assessments of Tonga's economic and financial performance and policies. The participation in international forums requires senior officers of the Reserve Bank to travel overseas. In September 2011, the Governor and Manager Research were part of Tonga's delegation to the IMF/World Bank annual meeting in Washington D.C. In March 2012, the Governor attended the IMF Pacific Islands Conference in Apia, Samoa where she spoke on "How to Promote Broad-based Growth". In November 2011 the Deputy Governor and the Manager Accounts and Currency participated in a commemorative coin conference in Auckland and in April 2012, the Deputy Governor and the Manager Financial Institutions and Markets attended the ANZ Central Bank & Sovereign Wealth Fund Conference in Sydney Australia.

To support its routine analysis of Tonga's domestic economic and financial conditions the Reserve Bank regularly meets with other stakeholders such as the banks, large private companies, development partners and their visiting delegations, as well as the Chamber of Commerce. The Reserve Bank also conducts surveys from large businesses around the country on a semi-annual basis.

An Economic Dialogue

Source: Ministry of Information and Communication

With the Reserve Bank's monetary policy tools at their expansionary limits, and the desired outcome of credit growth not realised, the Reserve Bank organized the Economic Dialogue in March 2012 to engage the businesses and relevant stakeholders in a discussion of Tonga's economic situation and what could help to stimulate economic activity. The Dialogue was a two-day conference that gathered more than 300 prominent members of Tongan communities including government, business industries, media, church, and academia. The discussions focused on the agriculture, tourism, and fisheries sectors, and had three specific aims:

1) To disseminate information on the state of economy, and the outlook;

2) To develop strategies and specific actions that would promote improved livelihoods for all communities; and,

3) To prioritise the strategies given Tonga's available resources.

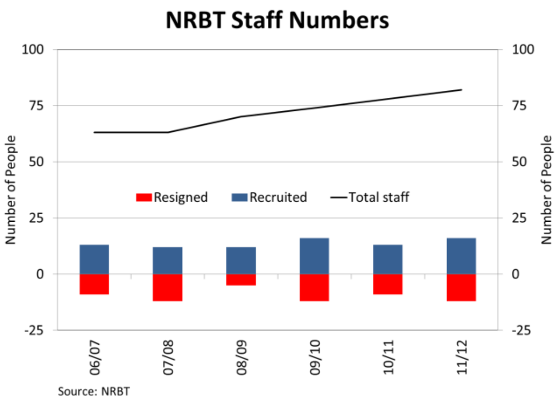
As part of the exercise and the lead up to the dialogue, the Reserve Bank separately conducted more than 20 stakeholder discussions with groups across the economy to clarify the objectives of the dialogue and to attract these groups to bring their ideas to the economic dialogue. And in order to ensure that the views of small businesses are included in the dialogue, the Reserve Bank conducted a survey of small businesses in the villages of Tongatapu. Large businesses were also included in the survey.

The key findings of the dialogue were published in the local newspapers, posted on the Reserve Bank's website and presented in a paper to the Government in March 2012. The Government has since formed a National Growth Committee to consider the agreed strategies and specific actions.

Management of the Reserve Bank

Our People

The Reserve Bank continued to carry out its responsibilities through the commitment and dedication of its staff and the technical assistance received by the Bank during the year. As at the end of June 2012, the total number of staff employed at the Bank was 82, which is a record high. The increase in staff numbers over the year was mainly due to filling of vacant positions and expanding the Bank's daily note-counting capacity.



The Reserve Bank recruited 16 people over the financial year of which most of them were university graduates. In 2010, the Reserve Bank requested the Ministry of Education for an annual allocation of at least one scholarship to assist with the capacity building program for the Bank. In 2011, under the support of NZAid and the Government scholarship scheme, the Bank started to receive a scholarship study program in Accounting and Economics. The Reserve Bank appreciates the support from the Ministry of Education and the continuation of this scholarship arrangement into the future. In May 2012, a TA from the Reserve Bank of Australia commenced working with the Economics Department to assist the Bank in dealing with the challenging economic and financial conditions of the country.

The Reserve Bank supports continuous professional development of its staff, with the aim of ensuring that employees continue to improve their skills, knowledge and experience to enable the Bank to pursue its objectives to the expected standard. The support is provided in a number of forms, including financial support for employees undertaking study in disciplines related to their work, and for full-time, postgraduate studies overseas. In early 2012, one of the NRBT's senior officers pursued further studies in Information Technology at the University of New South Wales, Australia. Other trainings are provided on the job locally and overseas and through formal courses, such as short courses at University of the South Pacific, Tupou Tertiary Institute, and the National Centre for Vocational Studies.

Instances of Training

Excluding official academic studies, by financial year

	Number of training events		Number of participants	
	2011	2012	2011	2012
In-house	2	6	40	98
External	10	10	39	23
Local	6	6	33	17
Overseas	4	4	6	6

Source: NRBT

Instances of Official Study

By Financial Year

	Completed		In Progress	
	2011	2012	2011	2012
Post Graduate		1	2	3
First Degree			1	2
Part time studies			4	3
Diploma	1		2	1
Certificate				1
Online courses				4

Source: NRBT

During the year the Reserve Bank and its staff continued to receive advisory and technical support from a range of overseas organizations, particularly from the Asian Development Bank, the International Monetary Fund, Australian Prudential Regulation Authority (APRA), and Datec (IT Support Consultancy based in Fiji). The Financial Institutions Department also received technical assistance from IMF/PFTAC to enhance the offsite monitoring tools, and to assist with the onsite visits to the banks as well as training on onsite examination of pension funds. The Bank also received legal advisory services and staff training from local companies.

Short Term Consultants and Technical Assistance (TA)	Department	Funding Source
NRBT Act – Commemorative Coins – TMP Law	Currency	NRBT
Economic Dialogue – TA ADB (PEM)	Economics	ADB/NRBT
Onsite Bank Supervision – TA IMF PFTAC	Financial Institutions	IMF
Staff Assessment Process – TA Reserve Bank Fiji	Human Resource	NRBT
NRBT Provident Fund Scheme – Legal Advise – TMP Law	Human Resource	NRBT
Remuneration Review – PWC, Fiji	Human Resource	NRBT
Bank Structure & Process/Strategic Review – TA ADB (PEM)	Human Resource	NRBT
Time Management – S&K Performance Solution	Human Resource	NRBT
IT System TA – Infrastructure Upgrade – Datec, Fiji/Aus	Information Technology	NRBT

Source: NRBT

As part of the endeavor to continuously improve the Bank's performance of its functions, the Bank commenced a corporate structural review in May 2012. This review will be taken on a pace and format that will allow significant involvement by Management and staff of the Bank under the guidance of a Regional Expert who was a former Central Bank Governor. The Bank regularly reviews its policies and procedures to ensure their appropriateness for the effective and efficient delivery of their functions and to keep them in line with best practice. The Bank contracted Pricewaterhouse Coopers, from Suva, Fiji to undertake a staff remuneration review against the Tongan market. This review is expected to be completed in the next financial year.

Our Premises

Level 2 Refurbishment:

New Room for Financial Institutions Department and Transaction Reporting Authority

The Reserve Bank leases its property of five storeys, on Salote Road in Fasi-moe-Afi. The Bank occupies less than 50 percent of the office space and the rest is rented by other institutions.

In addition to routine maintenance, during the 2012 financial year the Reserve Bank through its administration, building and security units worked further to maintain and improve the conditions of its premises. Most of the work was completed under three major projects:

a) renovations to the security control room, and the installation of new emergency telephones and security cameras;

b) a refurbishment of the Level 2 office space, designed to cater for the expanding staff numbers and a secured office for the Transaction Reporting Authority;

c) and a review of the electricity, air conditioning, and plumbing systems, mainly for the safety of the Bank, its staff and the tenants and to ensure environmental efficiency.

Some of the onsite work was supported by external technicians from Chubb NZ, Otis Elevator Company Ltd, NZ, Itrolect Limited, and Trade Air Engineering Ltd. Major projects for the next financial year include the implementation of the air condition and plumbing systems reviews as well as research into cheaper energy costs through solar PV systems.

A crucial component of the Reserve Bank operation is its Information Technology (IT) infrastructure. This (IT) infrastructure supports all the Reserve Bank outputs, including the management of the foreign reserves, management of the exchange rates, the conduct and settlement of foreign exchange deals, management of databases, maintaining of financial records and its internal and external communications. The Information Technology team carried out a number of key projects during the year to develop the infrastructure further:

a) Designing a new, streamlined and user-friendly website, to be launched around March 2013.

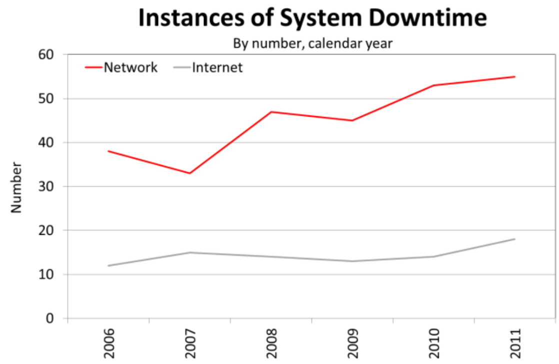
b) Improving systems designed to prevent unauthorised access to Reserve Bank information.

c) Introducing better protection against virus threats and, hence, reducing the frequency of system outages. The frequency of system outages had been increasing over previous years.

d) Developing tools that support more accurate monitoring of system performance.

e) Widening the scope of back-up systems.

In the 2013 financial year the Information Technology team will be undertaking training to enable them to manage these developments and to improve the planning and designing of IT requirements of the Bank for future years.



Source: NRBT

To ensure the safety and security of its premises, staff and tenants, the Reserve Bank's security team continued to carry out its responsibilities at a high standard. Training of the security guards is ongoing, and in the 2012 financial year covered issues such as promoting lift and fire safety. The security team also played a key role in assisting staff evacuations during tsunami, cyclone warnings and practiced fire drills during the year. The practiced fire drills and disaster recovery plan were put to the test in January 2012 when the Security team detected an electrical fire in the Bank's swift room. Fortunately, there were no casualties, and the fire was well controlled with the help of the Fire department. The swift operations were successfully relocated on the same evening and the renovation costs were covered by the Bank's insurance policy.

FINANCIAL STATEMENTS
YEAR ENDED 30 JUNE 2012

DIRECTORS' REPORT

In accordance with a resolution of the Board of Directors, the directors herewith submit the Balance Sheet of the Bank as at 30 June 2012, and the related Statements of Comprehensive Income, Distribution, Changes in Equity and Cash Flows for the year ended on that date and report as follows:

1. DIRECTORS

The following were directors of the Bank at any time during the financial year and up to the date of this report:

Mr. Steve Edwards - Chairman
HRH Princess Salote Pilolevu Tuita
Mr. Richard Prema
Mrs. Siosi C Mafi - Governor
Mr. Tiofilusi Tiueti

2. PRINCIPAL ACTIVITIES

The National Reserve Bank of Tonga's (the Bank) principal objectives as a central bank, as defined in Section 4 of the National Reserve Bank of Tonga (NRBT) (Amendment) Act 2007, shall be, to -

a) maintain internal and external monetary stability; and

b) promote a sound and efficient financial system

The principal functions of the Bank shall be, to -

a) issue currency;

b) formulate and implement monetary policy;

c) regulate as required the supply, availability and international exchange of money;

d) hold and manage the external reserves of the Kingdom;

e) provide advisory services to the Minister on banking and monetary matters;

f) be the principal banker, fiscal agent and depository of the Government;

g) undertake banking business, in Tonga or elsewhere;

h) regulate and supervise financial institutions; and

i) oversee and promote the efficient, sound and safe functioning of the payment system.

3. TRADING RESULTS

The net profit available for distribution of the Bank for the year ended 30 June 2012 was $1,971,583 (2011: $2,418,586).

4. GENERAL RESERVES

In accordance with Section 8(1)(c) of the National Reserve Bank of Tonga (Amendment) Act, 2007, there is no amount transferred to the General Reserve at year end.

5. PAYABLE TO GOVERNMENT

In accordance with Section 8(3) of the National Reserve Bank of Tonga (Amendment) Act, 2007, subject to Section 8(1) and Section 8(2), the amount of $1,971,583 (2011: $2,111,513) is payable to the Government of the Kingdom of Tonga.

6. BAD AND DOUBTFUL DEBTS

The directors took reasonable steps before the Bank's financial statements were made out to ascertain that all known bad debts were written off and adequate provision was made for doubtful debts.

At the date of this report, the directors are not aware of any circumstances which would render the amount written off for bad debts, or the amount of the provision for doubtful debts, inadequate to any substantial extent.

7. PROVISIONS

There were no material movements in provisions during the year apart from the normal amounts set aside for such items as doubtful debts, depreciation and employee entitlements.

8. ASSETS

The directors took reasonable steps before the Bank's financial statements were made out to ascertain that the assets of the Bank were shown in the accounting records at a value equal to or below the value that would be expected to be realised in the ordinary course of business.

At the date of this report, the directors are not aware of any circumstances which would render the values attributable to the assets in the financial statements misleading.

9. DIRECTORS BENEFIT

No director of the Bank has, since the end of the previous financial year, received or become entitled to receive a benefit by reason of contract made by the Bank with the director or with a firm of which the director is a member, or with a company in which the director has substantial financial interest.

10. EVENTS SUBSEQUENT TO BALANCE DATE

Since the end of the financial year the directors are not aware of any matter or circumstances not otherwise dealt with in the report that has significantly affected the operations of the Bank, the results of those operations or the state of affairs of the Bank in subsequent financial years.

11. BASIS OF ACCOUNTING

The directors believe the basis of the preparation of financial statements is appropriate and the Bank will be able to continue in operation for at least 12 months from the date of this statement.

Accordingly the directors believe the classification and carrying amounts of assets and liabilities as stated in these financial statements to be appropriate.

12. OTHER CIRCUMSTANCES

At the date of this report, the directors are not aware of any circumstances not otherwise dealt with in this report or financial statements which render any amounts stated in the financial statements misleading.

13. UNUSUAL TRANSACTIONS

The results of the Bank's operations during the financial year have not in the opinion of the directors been substantially affected by any item, transaction or event of a material and unusual nature other than those disclosed in the financial statements.

For and on behalf of the Board of Directors in accordance with a resolution of the Directors this 28th day of September, 2012.

Mr Steve Edwards **Chairperson**	**Mrs Siosi. C. Mafi** **Governor**

STATEMENT BY DIRECTORS

In the opinion of the Directors:

(a) the accompanying balance sheet is drawn up so as to give a true and fair view of the state of affairs of the Bank as at 30 June 2012,

(b) the accompanying statement of comprehensive income is drawn up so as to give a true and fair view of the results of the Bank for the year ended 30 June 2012,

(c) the accompanying statement of distribution is drawn up so as to give a true and fair view of the distribution of operating profit of the Bank for the year ended 30 June 2012,

(d) the accompanying statement of changes in equity is drawn up so as to give a true and fair view of the movement in equity for the year ended 30 June 2012, and

(e) the accompanying statement of cash flows is drawn up so as to give a true and fair view of the cash flows of the Bank for the year ended 30 June 2012.

For and on behalf of the Board of Directors by authority of a resolution of the Directors this 28th day of September, 2012.

Mr Steve Edwards
Chairperson

Mrs Siosi. C. Mafi
Governor

INDEPENDENT AUDITOR'S REPORT

To the Shareholder of the National Reserve Bank of Tonga

Report on the Financial Statements

We have audited the accompanying financial statements of the National Reserve Bank of Tonga (the 'Bank'). The financial statements comprise the balance sheet of the Bank as at 30 June 2012 and the statement of comprehensive income, distribution, changes in equity and cash flows for the year then ended and a summary of significant accounting policies and other explanatory notes.

Directors' and Management's Responsibility for the Financial Statements

Directors and Management are responsible for the preparation and fair presentation of these financial statements in accordance with the basis of accounting described in note 2 of the financial statements and in the manner required by the National Reserve Bank of Tonga Act, 1988, and the National Reserve Bank of Tonga (Amendment) Act, 2007. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about 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 of financial statements that give a true and fair view 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 directors and management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Emphasis of Matters

Without qualifying our opinion, attention is drawn to notes 2 (a) and (b) to the financial statements which refer to the reporting framework and the policy on the treatment of exchange gains and losses.

Opinion

In our opinion, the accompanying financial statements have been prepared, in all material respects, in accordance with the basis of preparation and the accounting policies described in note 2 of the financial statements and in the manner required by the National Reserve Bank of Tonga Act, 1988, and the National Reserve Bank of Tonga (Amendment) Act, 2007.

Restriction on Distribution or Use

This report is made solely to the Bank's shareholder. Our audit work has been undertaken so that we might state to the Bank's shareholder those matters we are required to state to them in an auditor's report and for no other purpose. To the fullest extent permitted by law, we do not accept or assume responsibility to anyone other than the Bank and the Bank's shareholder as a body, for our audit work, for this report, or for the opinions we have formed.

PricewaterhouseCoopers

28 September 2012
Suva, Fiji

PricewaterhouseCoopers
Chartered Accountants

BALANCE SHEET
YEAR ENDED 30 JUNE 2012

ASSETS	Notes	2012 $	2011 $
Foreign Currency Assets			
Short Term Investments and Current Accounts	8	223,623,829	180,072,472
Accrued Interest		2,635,513	2,171,319
International Monetary Fund (IMF)	9		
- Reserve Tranche Position		4,525,735	4,611,080
- Special Drawing Rights		18,737,316	19,075,162
Local Currency Assets			
Cash on Hand	18	6,492	2,092,242
Accrued Interest		3,181	10,694
Other Assets	10	2,468,191	3,376,984
International Monetary Fund - Currency Subscription	9	13,734,172	14,655,548
Property, Plant and Equipment	11	9,016,894	8,906,855
Total Assets		**274,751,323**	**234,972,356**
LIABILITIES			
Foreign Currency Liabilities			
Accrued Interest		636	13,629
Demand Deposits	12(a)	6,977,278	4,038,733
IMF Special Drawing Rights Allocation	9	17,400,389	17,728,521
Local Currency Liabilities			
Payable to Government	13	1,971,583	2,111,513
Demand Deposits	12(b)	162,703,677	126,211,869
Accrued Interest		318,163	166,286
Other Liabilities	16	879,787	4,159,805
Currency in Circulation	14	38,480,984	34,525,489
Statutory Reserve Deposits	15	16,253,000	15,884,000
International Monetary Fund - Currency Subscription	9	13,734,172	14,655,548
Provisions for Employee Entitlements	17	132,822	115,330
Total Liabilities		**258,852,491**	**219,610,723**
NET ASSETS		**$15,898,832**	**$15,361,633**
CAPITAL AND RESERVES			
Authorised Capital		5,000,000	5,000,000
Paid up Capital		5,000,000	5,000,000
General Reserves		10,000,000	10,000,000
Revaluation Reserve Account		898,832	361,633
TOTAL CAPITAL AND RESERVES		**$15,898,832**	**$15,361,633**

The above balance sheet should be read in conjunction with the accompanying notes.

STATEMENT OF COMPREHENSIVE INCOME
YEAR ENDED 30 JUNE 2012

Income	Notes	2012 $	2011 $
Interest income	4	5,535,690	4,531,919
Other income	5	2,122,446	2,816,537
Total Operating Income		**7,658,136**	**7,348,456**
Expenses			
Interest expense	6	1,156,802	715,217
Administration and other expenses	7	4,529,751	4,214,653
Total Operating Expenses		**5,686,553**	**4,929,870**
Net profit available for distribution		**1,971,583**	**2,418,586**
Net gains/(losses) arising from the translation of foreign currency balances to local currency		537,199	(4,008,799)
Other comprehensive income for the period		**537,199**	**(4,008,799)**
Total comprehensive income		**$2,508,782**	**$(1,590,213)**

The above statement of comprehensive income should be read in conjunction with the accompanying notes.

STATEMENT OF DISTRIBUTION
YEAR ENDED 30 JUNE 2012

		2012 $	2011 $
Net profit available for distribution		**$1,971,583**	**$2,418,586**
Distribution as follows:	2(n		
Transfer to General Reserves as required under Section 8(1)(c) of the National Reserve Bank of Tonga (Amendment) Act, 2007		-	307,073
Balance Payable to Government of Tonga as required under Section 8(3) of the National Reserve Bank of Tonga (Amendment) Act, 2007	13	1,971,583	2,111,513
		$1,971,583	**$2,418,586**

The above statement of distribution should be read in conjunction with the accompanying notes

STATEMENT OF CHANGES IN EQUITY
YEAR ENDED 30 JUNE 2012

	Paid up Capital $	General Reserves $	Revaluation Reserve Account $	Total $
Balance 30 June 2010	**$5,000,000**	**$9,692,927**	**$4,370,432**	**$19,063,359**
Net losses arising during the year from translation of foreign currencies to Tongan currency	-	-	(4,008,799)	(4,008,799)
Transfer to General Reserves (as provided for under Section 8(1)(c) of the National Reserve Bank of Tonga (Amendment) Act, 2007, and approved by the Minister of Finance	-	307,073	-	307,073
Balance 30 June 2011	**$5,000,000**	**$10,000,000**	**$361,633**	**$15,361,633**
Net gains arising during the year from translation of foreign currencies to Tongan currency	-	-	537,199	537,199
Transfer to General Reserves (as provided for under Section 8(1)(c) of the National Reserve Bank of Tonga (Amendment) Act, 2007, and approved by the Minister of Finance	-			
Balance 30 June 2012	**$5,000,000**	**$10,000,000**	**$898,832**	**$15,898,832**

The above statement of changes in equity should be read in conjunction with the accompanying notes.

STATEMENT OF CASH FLOWS
YEAR ENDED 30 JUNE 2012

CASH FLOWS FROM OPERATING ACTIVITIES	Note	2012 $	2011 $
Interest Received		5,079,008	3,705,347
Rental income		1,014,670	1,054,700
Numismatic sales		25,814	85,743
Other income		1,083,276	1,746,466
Purchase of currency		(376,643)	(564,632)
Interest paid		(1,017,916)	(662,196)
Payments to suppliers and employees		(3,787,383)	(2,513,162)
Net cash outflow from operating activities		**2,020,826**	**2,852,266**
CASH FLOWS FROM INVESTING ACTIVITIES			
Purchase of fixed assets		(213,932)	(613,466)
Net movement in IMF accounts		423,191	1,559,853
Net movement in staff loans		375,566	34,919
Net cash inflow from investing activities		**584,825**	**981,306**
CASH FLOWS FROM FINANCING ACTIVITIES			
Net issue of currency in circulation		3,955,496	1,601,180
Net movement in demand deposits		25,786,416	31,319,569
Net movement in statutory deposits		369,000	1,091,000
Net movement in Government of Tonga accounts		11,204,291	(28,209)
Net movement in funds held for clearance		(2,992,446)	3,017,229
Net cash inflow from financing activities		**38,322,757**	**37,000,769**
Net effect of change in exchange rates		**537,199**	**(4,008,799)**
NET INCREASE IN CASH		**41,465,607**	**36,825,542**
CASH AT BEGINNING OF FINANCIAL YEAR		**182,164,714**	**145,339,172**
CASH AT END OF FINANCIAL YEAR	18	**$223,630,321**	**$182,164,714**

The above statement of cash flows is to be read in conjunction with the accompanying notes.

1. GENERAL INFORMATION

The National Reserve Bank of Tonga's principal objectives as a central bank, as defined in Section 4 of the NRBT (Amendment) Act 2007, shall be, to -

a. maintain internal and external monetary stability; and
b. promote a sound and efficient financial system.

The principal functions of the Bank shall be, to –

a. issue currency;
b. formulate and implement monetary policy;
c. regulate as required the supply, availability and international exchange of money;
d. hold and manage the external reserves of the Kingdom;
e. provide advisory services to the Minister on banking and monetary matters;
f. be the principal banker, fiscal agent and depository of the Government;
g. undertake banking business, in Tonga or elsewhere;
h. regulate and supervise financial institutions; and
i. oversee and promote the efficient, sound and safe functioning of the payment system.

These financial statements have been approved for issue by the Board of Directors on 28th September 2012.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES AND STATUTORY REQUIREMENTS

a) Basis of accounting

The financial statements of the Bank have been prepared in accordance with the National Reserve Bank of Tonga Act, 1988 and the National Reserve Bank of Tonga (Amendment) Act, 2007. The Bank's accounting policies are based on International Financial Reporting Standards ("IFRS") except where the Act requires a different treatment, as noted in Note 2 b), in which the Act takes precedence.

The financial statements are prepared on the basis of the historical cost convention, which has no regard to changes in the levels of prices. Unless otherwise stated, the accounting policies adopted are consistent with those of the previous year.

Standards and interpretations issued but not yet effective

The following standards and interpretations have been issued and are mandatory for the bank's accounting periods beginning on or after 1 July 2012 or later periods. Early adoption of these standards and interpretations will not have any significant impact on the Bank's financial statements.

Standard/Interpretation	**Content**	**Applicable for financial years beginning on/after**
IAS 1 Amendment	Financial statement presentation regarding other comprehensive income	1-Jul-12
IAS 19 Amendment	Employee benefits	1-Jul-12
IFRS 13	Fair value measurement	1-Jan-13
IFRS 7 Amendment	Financial Instruments: Disclosures on Offsetting financial assets and financial liabilities	1-Jan-13
IAS 32 Amendment	Financial Instruments: Presentation on Offsetting financial assets and financial liabilities	1-Jan-14
IFRS 9	Financial instruments: Classification and measurement	1-Jan-15

b) <u>Foreign currencies</u>

Foreign currencies have been translated to Tongan currency at rates of exchange ruling at year end.

Exchange gains and losses arising during the year from changes in the valuation of foreign currencies are taken to the Revaluation Reserve Account in accordance with the provisions of Section 33 of the National Reserve Bank of Tonga Act, 1988, the NRBT (Amendment) Act, 2007 and the Miscellaneous Amendments (Privy Council) Act 2010, and are not included in the computation of annual profits and losses of the Bank as required under International Accounting Standard 21, "The effects of changes in foreign exchange rates" (IAS 21). The impact of this in the statement of comprehensive income would be an increase in net profit by 537,199 (2011: decrease of $4,008,799).

Net losses arising from such changes are set off against any credit balance in the Revaluation Reserve Account; if such balance is insufficient to cover such losses, Cabinet shall cause to be transferred to the ownership of the Bank non-negotiable non-interest bearing securities issued by the Government to the extent of the deficiency.

Any credit balance in the Revaluation Reserve Account at the end of each year is applied first, on behalf of the Government, to the redemption of any non-negotiable non-interest bearing notes previously transferred to the Bank by the Government to cover losses. According to the National Reserve Bank of Tonga (Amendment) Act 2007, any balance remaining in the Revaluation Reserves Account shall be carried forward to the next financial year.

c) Critical accounting estimates and judgements

The preparation of the financial statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates.

Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are categorised in the period in which the estimates are revised and in any future periods affected.

In particular, information about significant areas of estimation, uncertainty and critical judgements in applying accounting policies that have the most significant effect on the amounts categorised in the financial statements are included in the following notes:

Note 2 (d) – Provisions for impairment of financial assets
Note 2 (m) – Provisions for employee entitlements
Note 2 (i) – Depreciation

d) Financial Assets and Liabilities

i. Financial Assets

The Bank classifies its financial assets in the following categories: Held to maturity investments and loans and receivables.

- **Held to Maturity Investments**

  Held to Maturity Investments are non-derivative financial assets with fixed or determinable payments and fixed maturities that the Bank's management has the positive intention to hold to maturity.

  Held-to-maturity investments are carried at amortised cost. Any premium or discount on purchase is capitalised and amortised over the term of the investment on a constant yield to maturity basis.

All purchases and sale of investment securities are recognised at settlement date, which is the date that the asset is transferred to the Bank.

- **Loans and Receivables (Staff Loans)**

  Are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market.

  Loans are carried in the balance sheet at historical cost net of impairment provisions.

Impairment of Financial Assets

For financial assets that are not classified as fair value through profit or loss, the Bank assesses as at each balance date whether there is objective evidence of impairment. This would include observable data that comes to the attention of the Bank such as significant financial difficulty of the issuer or counterparty; the disappearance of an active market for financial asset because of financial difficulties or a market downgrade in credit rating of the counterparty.

For loans and receivables an appraisal is carried out at the end of the financial year by management. The amounts of potential losses that have been identified are either written off against provisions in the year in which they are recognised or recognised as an expense in the income statement.

ii. Financial Liabilities

Financial liabilities are recognised at fair value plus transaction costs. They are recognised when an obligation arises and derecognised only when the obligation is discharged, cancelled or expired.

Financial liabilities are recorded at trade date, the date on which the Bank commits to borrow or repay the relevant funds.

- **Demand Deposits**

  Demand Deposits represent funds placed with the Bank by financial institutions and other organisations brought to account on a cost basis. These deposits are at call. Interest is paid on demand deposits of commercial banks held with the Bank.

e) <u>Currency and Numismatics Inventory</u>

Currency and numismatics on hand are recognised in the statement of financial position at cost. Cost includes the cost of bringing currency to the Bank's premises. Currency issuances are determined on a first-in-first-out basis. When currency is issued the value is reduced and amortisation expense is recognised in the income statement.

f) Currency in Circulation

The face value of notes and coins on issue is taken up as a liability in the accounts. Where notes and coins on issue are no longer considered to be in circulation, either through their age or their numismatic value, they are written back to income.

g) Coins sold as numismatic items

The Bank sells, or receives royalties on, coins which are specially minted or packaged as numismatic items. These coins have not been accounted for as currency issued for circulation as they are not issued for monetary purposes. In terms of Section 53(2) of the National Reserve Bank of Tonga Act, 1988 and the Miscellaneous Amendments (Privy Council) Act 2010, Cabinet has specified by notice in the Gazette that the Bank shall not be required to include in its financial statements the face value of these coins in circulation.

h) Income tax

The Bank is exempted from all Government taxes in accordance with Section 55 of the National Reserve Bank of Tonga Act, 1988.

i) Depreciation

Fixed assets are depreciated on a straight line basis so as to write off the cost of each fixed asset over its estimated useful life. The principal annual rates in use are:

Leasehold and buildings	1.01% - 2%
Computer and office equipment	6.67% - 25 %
Furniture and fittings	25%
Motor vehicles	25%

j) Employee Entitlements

The Bank and staff make contributions to a staff provident scheme based on the years of service.

Liabilities for other employee entitlements which are not expected to be paid or settled within twelve months of the reporting date are accrued in respect of all employees at the present value of future amounts expected to be paid.

k) Cash and cash equivalents

For the purposes of the cash flow statement, cash and cash equivalents includes tellers cash, current accounts and short term deposits.

l) Revenue Recognition

Interest income is brought to account on an accrual basis.

m) Provisions for Employee Entitlements

Provisions are recognised when the Bank has a present legal or constructive obligation as a result of past events; it is more likely than not that an outflow of resources will be required to settle the obligation, and the amount has been reliably estimated.

n) General Reserve and Distribution of Profits

- Section 8(1) of the National Reserve Bank of Tonga (Amendment) 2007 states that:

  a) where the General Reserve does not exceed 50% of the authorised capital of the Bank, 100% of the net profit be transferred to the General Reserve;

  b) where the General Reserve exceeds 50% of the authorised capital of the Bank, 50% of the net profit to be transferred to the General Reserve until the General Reserve is equal to the authorised capital of the Bank; and

  c) where the General Reserve exceeds 100% but does not exceed 200% of the authorised capital of the Bank, 25% or a lesser sum to increase the General Reserve to twice the authorised capital of the Bank; Provided that upon agreement between the Minister and the Bank, the General Reserve may be increased.

- Section 8(2) states that subject to Section 8(1), the remainder of the net profits for the financial year shall be applied to the redemption of any securities issued under Section 6 held by the Bank.

- Section 8(3) states that the Board shall, with the approval of the Minister, subject to Section 8(1) and 8(2), allocate to the General Reserve and pay to Government's general revenue the remaining net profit

o) Revaluation Reserve

Unrealised exchange gains and losses arising from revaluation of foreign currencies are transferred to the Revaluation Reserve (refer Note 2 b)) and are not included in the computation of annual profits and losses of the Bank.

p) Segment Reporting

The Bank presents financial assets and financial liabilities, and their associated income and expense streams, by distinguishing between foreign currency and local currency activities. The Bank considers that these reporting approaches provide appropriate segmental reporting of the Bank's activities.

q) Leases

Where the Bank is the lessee, the lease rentals payable on operating leases are recognised in the Income Statement over the term of the lease.

Where the Bank is the lessor, the assets leased out are retained in Property, Plant & Equipment.

r) Functional and Presentation Currency

The Bank's financial statements are expressed in Tongan Pa'anga. Amounts in the financial statements are rounded to the nearest dollar unless otherwise stated.

3. FINANCIAL RISK MANAGEMENT

The majority of the Bank's financial risks arise from the foreign reserves management unit of the Bank's Financial Markets Department. The main financial risks to which the Bank is exposed include credit risk, liquidity risk and market risks and policies for managing these risks are outlined below.

(a) Credit Risk

Credit risk relates to the risk of loss arising from the failure of counterparty to a transaction to perform according to the terms and conditions of the financial contract.

Credit risk or safety is a key criterion in the determination of the composition of the Bank's foreign currency assets. To manage this credit risk, the Bank prescribes minimum credit ratings acceptable for investment and specifies the maximum permissible credit exposure to individual banks and countries. In addition, the number of commercial banks, with whom the Bank may deal with in foreign exchange must have minimum credit ratings of A.

The NRBT uses Standard & Poor's credit ratings of assessing the credit risk of foreign counterparties. The credit ratings of counterparties are on "watch" all the time and are updated as new market information is available.

The concentration of credit risk in the Bank's investment portfolio is as follows:

	2012 $	2011 $
Foreign currency assets		
Short Term Commercial Paper and current accounts	223,623,829	180,072,472
Total financial investments	$223,623,829	$180,072,472

The Bank's end of year concentration of credit exposure, based on the country in which the counterparty is resident, is as follows:

	2012 $	2011 $
Australia	162,463,212	115,869,243
New Zealand	45,734,026	27,808,100
United States of America	14,305,475	24,132,273
Switzerland	933,313	12,130,984
United Kingdom	134,826	91,872
Fiji	52,977	40,000
Total financial investments	$223,623,829	$180,072,472

The following table presents the Bank's financial assets based on Standard & Poor's credit rating of the foreign counterparties based on the country in which the counterparty is resident: N/R indicates that the country has not been rated by Standard & Poor's.

	2012 $	2011 $
AAA	2,069,801	1,343,608
AA1	14,305,475	24,132,273
AA	81,781	283,051
A1	206,180,482	142,142,556
B	52,977	40,000
N/R	933,313	12,130,984
Total financial investments	$223,623,829	$180,072,472

(b) Liquidity Risk

Liquidity risk relates to the difficulty in raising funds at short notice to meet commitments**.** Liquidity is a key criterion in the determination of composition of the Bank's foreign currency assets.

To minimize liquidity risk, the Bank maintains an adequate level of reserves and taking into consideration the transaction demand on foreign exchange, ensures that an appropriate amount is maintained in current accounts at all times. The balances of the investible reserves are placed on term investments of up to 12 months. The composition of foreign currency assets is monitored daily. The Bank manages liquidity on a contractual maturity basis, which is consistent with the expected maturities of financial instruments.

The table below analyses the Bank's liabilities into relevant maturity groupings based on the remaining period at balance sheet date to the contractual maturity date.

Maturity Analysis as at 30 June 2012

	0-3 months	3 - 12 months	1 - 5 years	Over 5 years	No specific maturity	Total
Liabilities						
Foreign Currency Liabilities						
Demand Deposits	6,977,278	-	-	-	-	6,977,278
IMF Special Drawing Rights Allocation	-	-	-	-	17,400,389	17,400,389
Accrued Interest	636	-	-	-	-	636
Local Currency Liabilities						
Payable to Government	1,971,583	-	-	-	-	1,971,583
Demand Deposits	162,703,677	-	-	-	-	162,703,677
Accrued Interest	318,163	-	-	-	-	318,163
Other Liabilities	438,544	1,151	-	-	440,092	879,787
Currency in Circulation	-	-	-	-	38,480,984	38,480,984
Statutory Reserve Deposits	-	-	-	-	16,253,000	16,253,000
International Monetary Fund - Currency Subscription	-	-	-	-	13,734,172	13,734,172
Employee Provisions	93,984	7,771	6,449	24,618	-	132,822
Total Liabilities (contractual maturity dates)	**172,503,865**	**8,922**	**6,449**	**24,618**	**86,308,637**	**258,852,491**

	0-3 months	3 - 12 months	1 - 5 years	Over 5 years	No specific maturity	Total
Liabilities						
Foreign Currency Liabilities						
Demand Deposits	4,038,733	-	-	-	-	4,038,733
IMF Special Drawing Rights Allocation	-	-	-	-	17,728,521	17,728,521
Accrued Interest	13,629	-	-	-	-	13,629
Local Currency Liabilities						
Payable to Government	2,111,513	-	-	-	-	2,111,513
Demand Deposits	126,211,869	-	-	-	-	126,211,869
Accrued Interest	166,286	-	-	-	-	166,286
Other Liabilities	3,396,627	77,867	-	-	685,311	4,159,805
Currency in Circulation	-	-	-	-	34,525,489	34,525,489
Statutory Reserve Deposits	-	-	-	-	15,884,000	15,884,000
International Monetary Fund - Currency Subscription	-	-	-	-	14,655,548	14,655,548
Employee Provisions	93,613	2,947	9,720	9,050	-	115,330
Total Liabilities (contractual maturity dates)	**136,032,270**	**80,814**	**9,720**	**9,050**	**83,478,869**	**219,610,723**

(c) Market Risk

Market risk is the risk that the fair value of future cash flows of a financial instrument will fluctuate because of changes in market prices. In respect of the Bank, market risk comprises interest rate risk and foreign currency risk.

i. Interest rate risk

Interest rate risk refers to the risk of loss arising from changes in interest rates. The Bank limits interest rate risk by modified duration targets. The benchmark modified duration for the total portfolio is capped at 36 months. The duration of the portfolio is re-balanced regularly to maintain the target duration.

ii. Foreign exchange risk

Exchange rate risk relates to the risk of loss arising from changes in the exchange rates against the Tongan Pa'anga. The Bank has adopted a currency risk management policy, which maintains the Tongan Pa'anga value of foreign reserves and minimizes the fluctuations in the Revaluation Reserve Account.

The value of the Tongan Pa'anga is determined by a basket of currencies. To minimize the exchange rate risk, the weights of the currencies in the exchange rate basket is the benchmark for the composition of the Bank's foreign currency assets.

The following tables show the currency concentration of the Bank's assets and liabilities as at 30 June 2012 and 2011 in Tongan Pa'anga equivalents.

At 30 June 2012	**USD**	**EUR**	**AUD**	**GBP**	**NZD**	**Other**	**Total**
ASSETS							
Short Term Investments and Current Accounts	95,065,454	74,197	89,607,130	139,246	38,684,825	52,977	223,623,829
Accrued Interest	347,915	-	1,664,934	1	621,179	1,484	2,635,513
International Monetary Fund	-	-	-	-	-	4,525,735	4,525,735
- Reserve Tranche Position							
- Special Drawing Rights	-	-		-	-	18,737,316	18,737,316
Total Assets	**95,413,369**	**74,197**	**91,272,064**	**139,247**	**39,306,004**	**23,317,512**	**249,522,393**
LIABILITIES							
Demand Deposits	5,943,094	-	1,034,184	-	-	-	6,977,278
Accrued Interest	-	-	-	-	-	636	636
IMF Special Drawing Rights Allocation	-	-	-	-	-	17,400,389	17,400,389
Total Liabilities	**5,943,094**		**1,034,184**	**-**	**-**	**17,401,025**	**24,378,303**
NET POSITION	**89,470,275**	**74,197**	**90,237,880**	**139,247**	**39,306,004**	**5,916,487**	**225,144,090**

At 30 June 2011	USD	EUR	AUD	GBP	NZD	Other	Total
ASSETS							
Short Term Investments and Current Accounts	76,673,114	1,848,568	72,038,231	96,907	29,375,652	40,000	180,072,472
Accrued Interest	252,460	1,274	1,449,309	2	450,731	17,543	2,171,319
International Monetary Fund - Reserve Tranche Position	-	-	-	-	-	4,611,080	4,611,080
- Special Drawing Rights	-	-	-	-	-	19,075,162	19,075,162
Total Assets	**76,925,574**	**1,849,842**	**73,487,540**	**96,909**	**29,826,383**	**23,743,785**	**205,930,033**
LIABILITIES							
Demand Deposits	3,867,009	-	171,724	-	-	-	4,038,733
Accrued Interest	-	-	-	-	-	13,629	13,629
IMF Special Drawing Rights Allocation	-	-	-	-	-	17,728,521	17,728,521
Total Liabilities	**3,867,009**	**-**	**171,724**	**-**	**-**	**17,742,150**	**21,780,883**
NET POSITION	**73,058,565**	**1,849,842**	**73,315,816**	**96,909**	**29,826,383**	**6,001,635**	**184,149,150**

Sensitivity to Foreign Currency Risk

The sensitivity of the Bank's financial assets and liabilities to assumed across-the-board 5% movement of the Tongan Pa'anga against other foreign currencies at 30 June would have increased/decreased equity by the amounts shown below:

	2012	2011
USD	4,473,514	3,652,928
EUR	3,710	92,492
AUD	4,511,894	3,665,791
GBP	6,962	4,845
NZD	1,965,300	1,491,319
FJD	2,649	2,000
SDR	293,176	298,082

4. INTEREST INCOME

	2012	2011
	$	$
Overseas investments	5,516,478	4,509,245
Staff loans	19,212	22,674
	$5,535,690	**$4,531,919**

5. OTHER INCOME

	2012	2011
	$	$
Numismatic coins	25,814	85,743
Rental income	1,013,355	903,155
Gain on sale of assets	-	1,375
Forex sales/ purchases	1,037,350	1,707,286
Bank user fees	15,597	20,037
Information services – publications	1,155	35
Miscellaneous	29,175	98,906
	$2,122,446	$2,816,537

6. INTEREST EXPENSE

Foreign currency accounts	47,571	82,455
Domestic currency accounts	1,109,231	632,762
	$1,156,802	$715,217

7. ADMINISTRATION AND OTHER EXPENSES

Administration	1,488,333	1,442,904
Retirement fund	201,108	187,958
Staff costs	1,504,090	1,392,896
Audit fees	15,345	11,579
Currency issue (refer note 10)	908,195	833,963
Depreciation	412,680	345,353
	$4,529,751	$4,214,653

8. SHORT TERM INVESTMENTS AND CURRENT ACCOUNTS

Current accounts	17,443,347	37,929,916
Short term investments	206,18,482	142,142,556
	$223,623,829	$180,072,472

9. INTERNATIONAL MONETARY FUND

(i) The Bank was designated to serve with effect from 1 July 1989 as the fiscal agent of the Kingdom of Tonga for the purposes of the International Monetary Fund (IMF) by virtue of Section 51(1) of the National Reserve Bank of Tonga Act, 1988, and assumed the financial obligations of the membership of the Kingdom of Tonga as from that date by virtue of section 36(1)(c) of the National Reserve Bank of Tonga Act, 1988.

(ii) As at 30 June 2012, Tonga's membership subscription to the International Monetary Fund was SDR6,900,000 (2011: SDR6,900,000). Of this total amount, SDR 1,711,633 (2011: SDR1,711,633) had been paid in foreign currencies, shown in the Balance Sheet as Reserve Tranche Position, and the remaining balance representing the Currency Subscription portion was satisfied by crediting the demand deposit accounts of the International Monetary Fund with the Bank.

(iii) Special Drawing Rights holdings is an interest bearing international reserve asset created by the IMF and is allocated to members on the basis of their quotas in the Fund. As at 30 June 2012, the Special Drawing Rights holdings had a balance of SDR7,086,453 (2011: SDR7,080,700).

10. OTHER ASSETS

	2012 $	2011 $
Staff loans and advances	59,285	434,851
Currency and numismatics	2,352,570	2,881,307
Other assets	56,336	60,826
	$2,468,191	$3,376,984

The amount charged to the statement of comprehensive income for currency expense is based on the total cost of notes and coins issued for circulation.

11. PROPERTY, PLANT & EQUIPMENT

	Leasehold & Buildings $	Computer & Office Equipment $	Furniture & Fittings $	Motor Vehicles $	Work in Progress $	TOTAL
At 1 July 2010						
Cost	11,702,118	2,208,948	130,468	176,640	124,454	14,342,628
Accumulated depreciation	(4,165,572)	(1,283,500)	(130,468)	(119,300)	-	(5,698,840)
Net book value	7,536,546	925,448	-	57,340	124,454	8,643,788
Year Ended 30 June 2011						
Opening net book value	7,536,546	925,448	-	57,340	124,454	8,643,788
Additions	416,130	145,621	-	-	51,715	613,466
Disposals	(5,046)	-	-	-	-	(5,046)
Transfers in/(out)	124,454	-	-	-	(124,454)	-
Depreciation	(193,453)	(123,107)	-	(28,793)	-	(345,353)
Closing net book value	7,878,631	947,962	-	28,547	51,715	8,906,855
At 30 June 2011						
Cost	12,005,851	2,247,973	127,834	176,640	51,715	14,610,013
Accumulated depreciation	(4,127,220)	(1,300,011)	(127,834)	(148,093)	-	(5,703,158)
Net book value	7,878,631	947,962	-	28,547	51,715	8,906,855
Year Ended 30 June 2012						
Opening net book value	7,878,631	947,962	-	28,547	51,715	8,906,855
Additions	20,775	193,157	-	-	308,787	522,719
Disposals	-	-	-	-	-	-
Transfers in/(out)	14,104	39,695	-	-	(53,799)	-
Depreciation	(209,745)	(175,906)	-	(27,029)	-	(412,680)
Closing net book value	7,703,765	1,004,908	-	1,518	306,703	9,016,894
At 30 June 2012						
Cost	12,040,730	2,480,824	127,834	176,640	306,703	15,132,731
Accumulated depreciation	(4,336,965)	(1,475,916)	(127,834)	(175,122)	-	(6,115,837)
Net book value	7,703,765	1,004,908	-	1,518	306,703	9,016,894

12. (a) FOREIGN CURRENCY DEMAND DEPOSITS

	2012 $	2011 $
Government of Tonga	6,920,445	3,980,574
Other institutions	56,833	58,159
	$6,977,278	$4,038,733

(b) LOCAL CURRENCY DEMAND DEPOSITS

International banks	32,435	27,753
Domestic banks	119,070,627	92,959,434
Government of Tonga	43,600,615	33,224,682
	$162,703,677	$126,211,869

13. PAYABLE TO GOVERNMENT

Amount payable to government in accordance with Section 8(3) of the National Reserve Bank of Tonga (Amendment) Act 2007	$1,971,583	$2,111,513

14. CURRENCY IN CIRCULATION

Notes	36,572,451	32,698,147
Coins	1,908,533	1,827,342
	$38,480,984	$34,525,489

The exclusive rights of national currency issue are vested with the Bank. Currency in circulation comprises bank notes and coins issued by the Bank.

15. STATUTORY RESERVE DEPOSITS

The deposits represent the reserves required to be maintained by each financial institution under Section 39 of the NRBT Act 1988.

16. OTHER LIABILITIES

	2012	2011
	$	$
Other creditors and accruals	717,988	3,694,629
Payable to the National Reserve Bank of Tonga		
Staff Provident Scheme – refer note below	161,799	465,176
	$879,787	$4,159,805

Funds belonging to the National Reserve Bank of Tonga Staff Provident Scheme are held with the Bank in this account.

17. PROVISIONS FOR EMPLOYEE ENTITLEMENTS

	2012	2011
	$	$
Opening balance	115,330	92,535
Entitlements during the year	105,749	87,803
Utilised/reversals	(88,257)	(65,008)
	$132,822	$115,330

18. CASH AND CASH EQUIVALENTS

Cash and cash equivalents included in the cash flow statement comprise the following items in the balance sheet:

	2012	2011
	$	$
Cash on hand	6,492	2,092,242
Short term investments and current accounts	223,623,829	180,072,472
	$223,630,321	$182,164,714

19. RELATED PARTIES

Identity of related parties

The Bank's ultimate parent entity is the Government of the Kingdom of Tonga.

The Board of Directors during the financial year ended 30 June 2012 were Steve Edwards (Chairperson), Siosi Mafi (Governor), HRH Princess Salote Pilolevu Tuita, Richard Prema and Tiofilusi Tiueti.

During the year, the following executives were identified as key management personnel of the Bank: Siosi C Mafi (Governor), Jessie Cocker (Deputy Governor), Lata Tangimana (Manager Accounts and Currency), Elizabeth Baker (Manager Administration and Information Systems), resigned 30/6/12, 'Ungatea Latu (Manager Financial Institutions and Markets), 'Anapuli Matoto, resigned 18/6/12, and Adam Gorajek (Manager Research).

In the normal course of operations, the Bank enters into transactions with related parties identified above.

The transactions with the Government of the Kingdom of Tonga include banking services, foreign exchange transactions and registry transactions.

The Bank contributes to the National Reserve Bank of Tonga Staff Provident Fund in accordance with the Provident Scheme Rules. The contributions in the current financial year were as follows:

	2012	**2011**
	$	**$**
Provident Fund payments made by the Bank	201,108	187,958
	$201,108	$187,958

The funds of the Provident Scheme are invested within the Bank at an average rate of 3.98% (2011: 3.96 %) per annum. The total interest paid by the Bank for the financial year amounted to $14,303.89 (2011: $10,587.65). The Trustees of the Provident Scheme are indemnified by the Bank against all losses, damages or other costs which may be sustained or suffered by or made against a trustee as a result of any act or omission committed by the Trustee or Trustees which is not a breach of trust on the part of the Trustee.

Transactions with director related entities include purchases of goods and services and receipt of rental and utilities income as follows:

	2012 $	2011 $
Rental and utilities income received from Tonga SAT	72,539	70,900
Rent received in advance from Tonga SAT	-	67,852
Purchase of goods	382	379

The Directors are paid fees and sitting allowances for services rendered. The Directors are also entitled to a retirement fund which at year end amounted to $193,469 (2011: $120,740). The Bank also provides non-cash benefits to the Executive officers in addition to their salaries.
Total remuneration below is included in 'administrative costs.'

	2012 $	2011 $
Executive officers	352,483	331,899
Director's fees and remuneration	55,872	46,639
	$408,355	$378,538

20. COMMITMENTS

(a) Operating lease commitments

Lessee Disclosure

Operating lease expenditure and commitments contracted for are payable as follows:

Details of the major operating leases are as follows:

(i) On 28 July 1992 the bank entered into an agreement with His Majesty the King of Tonga to rent the property in Fasi-moe-Afi for 100 years ending 27 July 2091. Under the agreement, rent is payable at $3,000 per year.

(ii) On 6 April 1990 the bank entered into an agreement with His Majesty the King of Tonga to rent the property in Kolofo'ou for 100 years ending 5 April 2089. Under the agreement, rent is payable at $2,000 per year.

Total commitments for future lease rentals which have not been provided for in the accounts are as follows:

	2012 $	2011 $
Due not later than one year	5,000	5,000
Due later than one year but not later than five years	20,000	20,000
Due later than five years	371,000	376,000
	$396,000	$401,000

Lessor Disclosure

The Bank leases its building premises under operating leases to tenants for a term of 2 to 3 years. The minimum lease payments receivable at balance date are as follows:

	2012 $	2011 $
Due not later than one year	863,194	759,959
Due later than one year but not later than five years	851,527	1,382,587
	$1,714,721	$2,142,546

(b) Capital and other commitments

	2012 $	2011 $
Commitment not provided for in the financial statements are as follows:		
Foreign exchange transactions	-	3,598,404
Capital commitment: approved and contracted	693,880	-

21. CONTINGENT LIABILITIES

Contingencies not otherwise provided for in the accounts and which existed at 30 June 2012 comprise:

(i) Contracts for foreign exchange transactions was nil (2011: $nil)

(ii) In accordance with the accounting policy in Note 2 e), numismatic coins are not brought to account in the determination of the Bank's liabilities but a liability may arise if such coins are encashed for their face value. The Bank is of the opinion that in the unlikely event of encashment as legal tender, no significant loss is expected to arise.

22. FAIR VALUES OF FINANCIAL ASSETS AND LIABILITIES

The fair value of an instrument is the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Quoted market values represent fair value when a financial instrument is traded in an organised and liquid market that is able to absorb a significant transaction without moving the price against the trader.

Financial Assets and Liabilities

The valuation of the Bank's financial assets and liabilities are discussed below:

Statutory Reserve Deposits

The carrying value of statutory reserve deposits are considered to approximate their fair value as they are denominated in cash.

Demand Deposits

The carrying value of deposits are considered to approximate their fair value as they are payable on demand.

Currency in Circulation

The carrying value of Currency in Circulation is considered to be its fair value as reported in the accounts.

Other Financial Assets and Liabilities

The reported values of other financial assets and liabilities are considered to be its fair value.

23. EVENTS SUBSEQUENT TO BALANCE DATE

No charge on the assets of the Bank has arisen since the end of the financial year to the date of this report to secure the liabilities of any other person.

No contingent liability has arisen since the end of the financial year to the date of this report.

No contingent or other liability has become enforceable or is likely to become enforceable within a period of twelve months after the date of this report which, in the opinion of the directors, will or may affect the ability of the Bank to meet its obligations as and when they fall due.