GLEBE ADMINISTRATION BOARD

BANKING SERVICES

RISK MANAGEMENT POLICIES

CAPITAL ALLOCATION

28 March 2012

GAB Banking Services Capital Allocation Policy

Objectives of this Policy

1. The objective of this Policy is to set out the policies of Glebe Administration Board ("GAB") for the allocation of capital to its Banking Services and the management of that capital. It sets out a framework to calculate the amount of capital required to support Banking Services in line with, so far as it is appropriate that they be applied, the core principles of the relevant standards and guidelines of the Australian Prudential Regulatory Authority ("APRA"), prudent business management, and relevant internal policies.

2. The Policy specifically covers –
   - the requirement that Banking Services holds sufficient capital to support its business and risk profile, and
   - the specification of a prudential capital ratio and the management of capital in a prudent manner and in accordance with the core principles of the relevant APRA Australian Prudential Standards ("APS") and Guidance Notes for authorised deposit-taking institutions ("ADIs") in Australia, prudent business management and relevant internal policies, and
   - the monitoring of capital requirements, and
   - adequate and timely reporting to ensure effective management of the capital requirements.

Capital and Capital Allocation

3. The capital of Banking Services is that portion of the total capital of the Diocesan Endowment which is allocated to Banking Services.

4. Capital primarily supports Banking Services by providing a buffer to absorb unexpected losses from its activities and, in the event of problems, enables operations to continue to operate in a sound and viable manner while the problems are addressed or resolved.

5. Capital management means that sufficient capital is allocated to Banking Services.

6. The allocation of capital to Banking Services also –
   - provides a measure of the equivalent asset class investment amount that is being made in Banking Services, and
   - provides the basis on which the performance of Banking Services can be measured, such as by calculating the return on capital, and
   - forms a basis for determining maximum single loan exposures.

7. The amount of capital allocated to Banking Services is also a key factor in determining the counterparty credit risk limits associated with the treasury investments and the lending activities of Banking Services. It is common practice (and the practice of APRA) to assess exposure size as a percentage of capital.

8. The calculation of the amount of the capital to be allocated to Banking Services will generally follow the core principles set out in APRA's Australian Prudential Standard 111 *Capital Adequacy: Measurement of Capital*.

Regulatory Considerations

Australian Prudential Standards

9. Banking Services operates on the basis of an exemption from the *Banking Act 1959*, with certain conditions. However, GAB has decided generally to adopt the core underlying principles for effective risk management contained in APRA's Australian Prudential Standards (APS) as a basis for good management, in so far as those principles can appropriately be applied.

10. Sufficient capital is required to be held on account of credit risk, operational risk and interest rate risk. In assessing the amount of capital required on account of credit risk, GAB will have regard to the principles set out in APS 112 (*Capital Adequacy: Standardised Approach to Credit Risk*).

11. In APS 114 (*Capital Adequacy: Standardised Approach to Operational Risk*) APRA specifies the principles for determining the appropriate amount of capital to be allocated for operational risk. Given that the total amount of the loans and advances and treasury investments made by Banking Services is relatively stable GAB has determined to apply a fixed amount as a capital charge for interest rate risk, for the purposes of this Policy. The fixed amount of the capital charge will be reviewed annually by GAB with the advice of its consultants.

12. It is also appropriate that sufficient capital be allocated on account of interest rate risk. In APS 117 (*Capital Adequacy: Interest Rate Risk in the Banking Book for Advanced ADIs*) APRA specifies the principles for determining the appropriate amount of capital to be allocated for interest rate risk. Further consideration needs to be given as to the appropriateness of the application of these principles to Banking Services, particularly as GAB does not have many of the attributes of an advanced ADI. Pending such consideration, and acting on the advice of its consultants, GAB has determined to apply a fixed amount as a capital charge for interest rate risk, for the purposes of this Policy. The fixed amount of the capital charge will be reviewed each year.

Components of Capital Management

13. The components of the management of the capital of Banking Services are –
    - the calculation of the amount of capital to be allocated to Banking Services, and
    - thereafter, measuring and monitoring the amount of capital, and its adequacy, and
    - on an ongoing basis, reporting about compliance with this Policy.

Capital Adequacy levels

Calculating the minimum capital requirement for banking services

14. The method adopted to calculate the minimum amount of the capital to be allocated to Banking Services generally follows the core principles of the relevant APRA standards. In brief, the method requires the following steps –
    - The calculation of the total value of the "risk weighted assets" (RWA) of Banking Services.
    - The determination of the Prudential Capital Ratio ("PCR") (expressed as a percentage) applicable to Banking Services. The PCR will be determined according to what would be considered a reasonable PCR for the level of risk within Banking Services.
    - The calculation of the minimum amount of the capital to be allocated to Banking Services by multiplying the total of the RWA by the PCR determined as being applicable to banking services.

Risk weighted assets of Banking Services

Total Risk Weighted Assets

15. The total value of the risk weighted assets of Banking Services comprises the sum of –
    - the value of the risk weighted assets calculated for credit risk, and
    - 12.5 times the amount of the capital charge for operational risk, and
    - 12.5 times the amount of the capital charge for interest rate risk.

Credit Risk

16. The value of the risk weighted assets of Banking Services for credit risk is to be calculated by determining the risk weighted value of each of the assets of Banking Services, and then aggregating those values to determine the total value of the risk weighted assets.
17. For this purpose, an asset includes not only a loan, but a commitment to make a loan. Thus, if GAB has formally offered to make a loan of $1,000,000, the full amount of the commitment is to be regarded as an asset notwithstanding that the loan has not been drawn, or is only partially drawn.

18. The risk weight to be applied to the value of each asset of Banking Services to determine the risk weighted asset value of that asset is to be determined in accordance with the following table –

Asset (including commitments)	Credit-Rating Grade	Risk Weight[1] (%)
1. Cash items in the process of collection (eg cheques, drafts and other items drawn on an authorised deposit taking institution ("ADI") that are payable immediately and are in the process of collection).		20
2. All Australian dollar claims on the Australian Government.		0
3. Claims on state or territory governments (including state or territory central borrowing authorities).	1 2	0 20
4. Claims on ADIs, being claims with an original maturity of 3 months or less.	1, 2, 3	20
5. Claims on ADIs with an original maturity of more than 3 months.	1 2, 3	20 50
6. Other loans – To the extent a loan exposure is up to 10% of the capital allocated to Banking Services.		100
7. Other Large Loans – To the extent a loan exposure is more than 10% of the capital allocated to Banking Services.		200[2]
8. The unsecured portion of any loan that is past due for more than 90 days and/or impaired – a. where the specific provision for any loss or impairment is less than 20% of the outstanding amount of the loan, or b. where the specific provision for any loss or impairment is no less than 20% of the outstanding amount of the loan.		 150 100
9. All other assets and claims.		100

Notes: 1. The risk weights specified in this table are based on the risk weights for equivalent assets specified by APRA for ADIs in APS 112. However the risk weight for the asset referred to in paragraph 7 (Loans – to the extent a loan exposure is more than 10% of the capital allocated to Banking Services) is determined on the basis of GAB's assessment.

2. As at the date of adoption of this Policy, GAB has several large loans where the loan exposure is more than 10% of the capital allocated to Banking Services. As a transitional measure, until 30 June 2013, the risk weighting of the exposure to these loans which is more than 10% of the capital allocated to Banking Services is to be 125%. It is intended that the risk weighting of the exposure to those loans on and from 1 July 2013 be subject to further review.

19. To determine the equivalent credit rating grade for an institution with a rating issued by an external credit rating institution (Standard & Poors, Moodys or Fitch), the mapping set out in Tables 1 and 2 of APRA's Prudential Practice Guide APG112 applies. For the purposes of this Policy, the rating from Standard & Poors is to apply. Where there are different credit rating grades for an institution from Moodys and Fitch and no rating from Standard & Poors, the lowest of those ratings will be the credit rating for the institution for the purposes of this Policy.

20. The risk weighted value of an asset is determined by multiplying its current book value (including accrued interest or revaluations, and net of any specific provision or associated deprecation) by the relevant risk weight.

Examples

The risk weighted value of a $5,000,000, 3 month term deposit with an Australian bank with a short term credit rating from Standard & Poors of A2 is $1,000,000, since this is equivalent to the current book value of the asset ($5,000,000) multiplied by the relevant risk weight (20%).

The risk weighted value of a $5,000,000 loan to a diocesan organisation is $5,000,000, since this is the equivalent to the current book value of the asset ($5,000,000) multiplied by the relevant risk weight (100%).

Operational Risk

21. In undertaking its Banking Services, there is a risk of loss of earnings by reason of operating errors and omissions. Under APS 114 the capital charge for operational risk which Banking Services is required to hold is to be determined as follows –

  a. the last 6 consecutive half-yearly balances (that is, as at 30 June and 31 December) of the total outstanding loans and advances (including treasury investments) made by Banking Services is to be determined, and
  b. an amount equal to 3.5% of the total of the loans and advances (including undrawn commitments) at each observation point, is to be multiplied by a factor of 15%, to produce a result in respect of each observation, and
  c. the average half yearly result is to be determined.

22. Mathematically, this can be represented by the following formula –

$$K = \frac{\sum_{t=1}^{6} (0.15 \times 0.035 \times TLA)}{6}$$

where K is the capital charge for operational risk, and TLA is the total outstanding loans and balances as at each observation point.

23. Given that the total amount of the loans and advances and treasury investments made by Banking Services is relatively stable, GAB has determined that the capital charge for operational risk is to be determined in accordance with the formula as at the date of this Policy and thereafter is to be reviewed annually by GAB with the advice of its consultants. As at the date of this Policy, the capital charge for operational risk is taken to be $894,000.

24. To determine the value of the risk weighted assets attributable to operational risk, the capital charge ($894,000), is to be multiplied by 12.5.

Interest Rate Risk

25. In undertaking its Banking Services, there is a risk of a loss of earnings by reason of the mismatch in the times at which interest rates on the loan and treasury assets, and interest rates on deposit liabilities, change.

26. Further consideration needs to be given as to the appropriateness of the application of these principles set out in APS 117 to Banking Services. Pending such consideration, and acting on the advice of its consultants, GAB has determined that a capital charge of $1.2 million on account of interest rate be adopted for the purposes of this Policy. The appropriateness of this capital charge will be reviewed by GAB each year with the advice of its consultants.

27. To determine the value of the risk weighted assets attributable to interest rate risk, the amount of capital charge for interest rate risk ($1.2 million) is to be multiplied by 12.5.

Prudential Capital Ratio

Minimum Prudential Capital Ratio

28. If Banking Services was a fully regulated ADI it would have to observe a minimum capital ratio, known as the Prudential Capital Ratio (PCR), which would be set by APRA. The setting of this ratio is based on a model used by APRA known as “Probability and Impact Rating System”. Although APRA provides a general outline of how this model works, it does not disclose precisely how the PCR is calculated.

29. The relevant PCR for Banking Services must therefore be estimated. This is difficult as ADIs are not permitted to disclose their specific PCRs. However, the absolute minimum ratio is 8%. In addition, general information indicates that PCRs for ADIs fall within the range of approximately 11% to 14%. This will be used as a basis for determining an appropriate PCR and will take into account specific risks of Banking Services that would most likely have the greatest influence on the PCR including lending concentration (including large exposures). It is also recognised that under the current proposals for change to the APRA standards the minimum ratio will be raised to between 10.5% and 13%.

30. Having regard to the large exposures of Banking Services, GAB considers that a PCR of 14.5% is appropriate to determine the minimum capital required for Banking Services. The main reason for adopting a PCR at the upper end of the benchmark range is the large loan exposures of GAB and the recognition that the current minimum standards for fully regulated ADIs are planned to be raised.

Escalation Trigger

31. GAB also recognises that it is appropriate to have an escalation trigger in relation to the capital allocated to Banking Services. GAB considers that a PCR of 15.0% sets an appropriate escalation trigger. GAB expects that the capital allocated to Banking Services will not be less than the escalation trigger.

Transition

32. However, notwithstanding the above provisions, the nature of the assets of Banking Services as at the date of this Policy and the actual amount of capital allocated to Banking Services, means that the actual PCR of Banking Services is significantly less than 14.5%. GAB recognises that it is necessary for a period of transition before the minimum PCR prescribed by this Policy is able to be reached. The period of transition will allow for the assets of Banking Services to be restructured to reduce the total amount of the risk weighted assets of Banking Services, and allow additional capital to be allocated to Banking Services. Accordingly, for the purposes of this Policy, the following transitional provisions are adopted -

	Minimum PCR	**Escalation Trigger**
From 1 April 2012	7.5%	8.0%
From 1 January 2013	12.0%	12.5%
From 1 January 2014	14.5%	15.0%

Composition of capital

33. For the purposes of this Policy, the capital of Banking Services consists of –
    - the capital of the Diocesan Endowment allocated to Banking Services, and
    - retained earnings from Banking Services, and
    - the amount of any reserves for credit losses in Banking Services.

Monitoring Capital Adequacy

34. The amount of the minimum capital requirement and the escalation trigger are to be calculated in accordance with the Policy on a monthly basis or more frequently if circumstances require.

35. The minimum capital requirement and escalation trigger are also to be calculated each time a treasury investment or other loan is proposed to be made. The request for approval or authorisation of the transaction is to certify that the proposed investment or loan will not cause the amount of capital allocated to Banking Services to fall below the escalation trigger. A proposed investment or loan must not be made if it would cause the amount of capital allocated to Banking Services to fall below the escalation trigger.

36. GAB will undertake capital forecasting and capital planning at least annually and more frequently if circumstances require.

37. The forecast will be used as an input into current and future investment strategies for Banking Services to ensure that –

    - sufficient capital is planned to be allocated to Banking Services to meet the future forecast capital requirements, and
    - that Banking Services will always have a capital allocation at least equal to the capital requirement calculated under this Policy.

Reporting

38. Each month, reports about the following matters are to be provided to GAB –

    - the minimum capital amount required by this Policy to be allocated to Banking Services as at the end of the previous month, and
    - the actual amount of the capital allocated to Banking Services as at the end of the previous month.

39. If the capital allocated to Banking Services falls below the escalation trigger, the members of GAB are to be notified of that fact forthwith and be advised of the action proposed by management to rectify the matter.

Staff Training

40. All staff involved in monitoring and reporting about capital allocation are to have appropriate experience in, training and understanding of the capital allocation requirements, and this Policy. Such staff are required to undertake appropriate training

Review of this Policy

41. GAB will review this Policy each year, and more frequently if circumstances require.

Commencement of this Policy

42. This Policy commences on 1 April 2012.

Document Approval

43. This Policy was approved by GAB on 28 March 2012.