

**GLEBE ADMINISTRATION BOARD  
FINANCIAL SERVICES  
RISK MANAGEMENT POLICIES**

**CAPITAL ALLOCATION**

**As at 29 August 2012**

# GAB Financial 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 Financial Services and the management of that capital. It sets out a framework to calculate the amount of capital required to support Financial 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 Financial 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 Financial Services is that portion of the total capital of the Diocesan Endowment which is allocated to Financial Services.
4. Capital primarily supports Financial 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 Financial Services.
6. The allocation of capital to Financial Services also –
  - provides a measure of the equivalent asset class investment amount that is being made in Financial Services, and
  - provides the basis on which the performance of Financial 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 Financial Services is also a key factor in determining the counterparty credit risk limits associated with the treasury investments and the lending activities of Financial 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 Financial 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. Financial 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 Financial Services is relatively stable GAB has determined to apply a fixed amount as a capital charge for operational risk, for the purposes of this Policy. The fixed amount of the capital charge is 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. Since GAB does not have many of the attributes of an advanced ADI, GAB has determined, acting on the advice of its consultants, 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 is reviewed annually by GAB with the advice of its consultants.

## Components of Capital Management

13. The components of the management of the capital of Financial Services are –
  - the calculation of the amount of capital to be allocated to Financial 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 Financial Services***

14. The method adopted to calculate the minimum amount of the capital to be allocated to Financial 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 Financial Services.
  - The determination of the Prudential Capital Ratio (“PCR”) (expressed as a percentage) applicable to Financial Services. The PCR will be determined according to what would be considered a reasonable PCR for the level of risk within Financial Services.
  - The calculation of the minimum amount of the capital to be allocated to Financial Services by multiplying the total of the RWA by the PCR determined as being applicable to Financial Services.

### ***Risk weighted assets of Financial Services***

#### *Total Risk Weighted Assets*

15. The total value of the risk weighted assets of Financial 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 Financial Services for credit risk is to be calculated by determining the risk weighted value of each of the assets of Financial 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 Financial Services to determine the risk weighted asset value of that asset is to be determined in accordance with the following table –

<b>Asset (including commitments)</b>	<b>Credit-Rating Grade</b>	<b>Risk Weight<sup>1</sup> (%)</b>
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	0
	2	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	20
	2, 3	50
6. Other loans.		100
7. 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
8. 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.

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 depreciation) 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 on the date the deposit is made, since this is equivalent to the current book value of the asset (\$5,000,000) multiplied by the relevant risk weight (20%). During the term of the deposit, the risk weighted value will increase to take account of accrued interest.

The risk weighted value of a \$5,000,000 loan to a diocesan organisation is \$5,000,000 on the date the loan is made, since this is the equivalent to the current book value of the asset (\$5,000,000) multiplied by the relevant risk weight (100%). During the term of the loan the risk weighted value will increase to take account of accrued interest.

### *Operational Risk*

21. In undertaking its Financial Services, there is a risk of loss of earnings by reason of operating errors and omissions. APS 114 specifies the principles which apply to an ADI for determining the appropriate amount of capital to be allocated for operational risk.
22. [Paragraph not used.]
23. Given that the total amount of the loans and advances and treasury investments made by Financial Services is relatively stable, GAB has determined, acting on the advice of its consultants, to apply a fixed amount of \$800,000 as the capital charge for operational risk. The appropriateness of this capital charge is reviewed by GAB each year with the advice of its consultants having regard to the relevant principles of APS 114.
24. To determine the value of the risk weighted assets attributable to operational risk, the capital charge (\$800,000), is to be multiplied by 12.5.

### *Interest Rate Risk*

25. In undertaking its Financial 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. APS 117 specifies principles for determining the appropriate amount of capital to be allocated for interest rate risk for advance ADIs. Since GAB does not have many of the attributes of an advanced ADI, GAB has determined, acting on the advice of its consultants, to apply a fixed amount of \$603,000 as the capital charge for interest rate risk for the purposes of this Policy. The appropriateness of this capital charge is 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 (\$603,000) is to be multiplied by 12.5.

## **Prudential Capital Ratio**

### *Minimum Prudential Capital Ratio*

28. If Financial 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 Financial Services must therefore be estimated. This is difficult as ADIs are not permitted to disclose their specific PCRs. However, the absolute minimum ratio is currently 8% although this is expected to increase to 10.5% under new prudential regulations. General information indicates that PCRs for ADIs currently fall within the range of approximately 11% to 14%. This has been as a basis for determining an appropriate PCR together with specific risks of Financial Services that have the greatest influence on the PCR including lending concentration (and large exposures).
30. GAB considers that a PCR of 14.0% is appropriate to determine the minimum capital required for Financial Services. The main reason for adopting a PCR at the upper end of the benchmark range relates to the large loan exposures of GAB.

### *Escalation Trigger*

31. GAB also recognises that it is appropriate to have an escalation trigger in relation to the capital allocated to Financial Services. GAB considers that a PCR of 14.5% sets an appropriate escalation trigger. GAB expects that the capital allocated to Financial Services will not be less than the escalation trigger.

### *Transition*

32. However, notwithstanding the above provisions, the nature of the assets of Financial Services as at the date of this Policy and the actual amount of capital allocated to Financial Services, means that the actual PCR of Financial Services is significantly less than 14.0%. 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 Financial Services to be restructured to reduce the total amount of the risk weighted assets of Financial Services, and allow additional capital to be allocated to Financial 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	14.0%	14.5%

### **Composition of capital**

33. For the purposes of this Policy, the capital of Financial Services consists of –
- the capital of the Diocesan Endowment allocated to Financial Services, and
  - retained earnings from Financial Services, and
  - the amount of any reserves for credit losses in Financial 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 Financial 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 Financial 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 Financial Services to ensure that –
- sufficient capital is planned to be allocated to Financial Services to meet the future forecast capital requirements, and
  - that Financial Services will always have a capital allocation at least equal to the capital requirement calculated under this Policy.

### **Reporting**

38. Reports about the following matters are to be provided to each meeting of GAB –
- the minimum capital amount required by this Policy to be allocated to Financial Services as at the end of the previous month, and
  - the actual amount of the capital allocated to Financial Services as at the end of the previous month.
39. If the capital allocated to Financial Services falls below the escalation trigger, the members of GAB are to be notified of that fact forthwith and be advised of the remedial action which has been taken, or which should be prudently taken and the timeframe for that action.

## 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 and amended on 29 August 2012.