PERTH DIOCESAN TRUSTEES
POLICY 26

Anglican Church
Diocese of Perth

INTEREST RATE HEDGING

Approved by The Perth Diocesan Trustees 23 March 2018
Next Review 23 March 2020

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POLICY AND PRINCIPLES

Policy
This Interest Rate Hedging Policy establishes the framework for managing The Perth Diocesan Trustees (The Trustees) interest rate risks related to its property investment loans. The Trustees are required to act in accordance with the covenants within its Loan Agreements and prudent commercial principles.

A sound policy is essential to ensure risks are fully recognized, managed and recorded in a manner consistent with:

- The Trustees risk management philosophy,
- Commonly accepted industry practice and corporate governance.

Management responsible for interest rate risk management are required to understand The Trustees objectives and risk appetite, as well as the limits of their authority. In this context Management is defined as the Diocesan Secretary and Chief Financial Officer (CFO).

These issues will be addressed through the continuing evolution of this policy, which is to be reviewed at intervals of no less than 24 months.

Policy Approval
The Trustees approves the Interest Rate Risk Management Policy and no part of the Policy document may be amended without The Trustees approval.

The Trustees delegates' authority for the implementation of this policy to Management. Management will comply with this policy and where any breach of policy has occurred, the Diocesan Secretary is to be advised immediately. The Trustees are to be advised of the nature and quantum of any breach at the next Trustees Meeting. Advices of breaches to the relevant party will outline what will be done to rectify the breach or will seek approval for the breach.

Sources of Risk
The Trustees are responsible for the following Trusts that own major investment property assets that are financed by significant loans.

- H1 & H7 Trust – The property described as 200 St Georges Terrace, Cloisters Arcade and 863 Hay Street, Perth; and
- Cathedral Square Foundation – The property described as 565 Hay Street and Church House, 3 Pier Street, Perth.

Hereafter, in this policy the above entities are referred to as the "Trusts".

The rate of interest on the loan for each interest period is calculated as the aggregate of the applicable margin, line fees and the applicable Bank Bill (BBSY) Rate.

Due to the floating rate nature of the interest payable upon loans and the fixed income streams from property leases, the Trusts are exposed to increases in interest rates, which would result in less net income from Trusts operations and less available surplus income for distribution to the beneficiaries of the Trusts.

The Trustees must adhere to the financial covenants embodied in the loan agreements which include an interest cover ratio. While there is currently headroom on covenant ratios, if debt levels were to increase, there would be a greater imperative to protect against negative market movements.

It is recognised the implementation of an interest rate risk management program introduces additional risks, the management of which are covered within this policy. These additional risks primarily relate to the introduction of credit and operational risks.

Risk Management Objectives
The interest rate risk management objective centers on reducing the Trusts exposure to market interest rates to assist the Trusts in meeting its strategic goals and maintaining the required distributions to the beneficiaries of the Trusts.

ORGANISATIONAL STRUCTURE AND RESPONSIBILITIES

The Management function is structured to ensure all interest rate exposures are properly supervised and executed within the policy guidelines established by The Trustees.

The Trustees are ultimately responsible for ensuring there are effective policies in place for the management of risks given the underlying objectives of the Trusts and potential impact on the Trusts financial position.

Responsibility for the management and control of the interest rate risks faced by the Trusts are categorised into two main groups:

- The Trustees, and
- The Trustees' Strategic Investment Committee.

Procedural details are outlined in Risk Management Approach Section below.

INTEREST RATE RISK

Definition
The risk that the Trusts will suffer financial loss due to adverse movements in market interest rates.

Specific Objectives

- To manage the Trusts interest rate exposure to provide greater stability and certainty with respect to cash flows.
- To ensure compliance with interest cover covenants under the Company's loan facilities.
- To minimise the impact of adverse interest rate movements using interest rate risk management tools.

Risk Management Approach
The Trustees interest rate risk management approach involves establishing and maintaining a base level of interest rate hedging using a combination of limiting and/or non-limiting cover. The interest rate exposure will be managed on a gross basis (i.e. the interest rate positions on deposits and debt are not netted for risk management purposes).

The Trusts holds deposits as part of its ongoing working capital and investment requirements only. Given the intended use of these funds, deposits will be kept at call.

Interest rate swap contracts and collars may be described as limiting hedge contracts. The contracts are limiting in the sense that the hedge contract limits participation in favourable market movements and obliges settlement at reset dates/maturity dates when the contract is out of the money. The financial outcome of collars differs from a swap, only in that the collar allows some price participation in market movements.

Non-limiting cover involves the outright purchase of interest rate caps which allows the Trusts to fully participate in favourable market movements of interest rates.

The policy is to have interest rate hedging in place in the range of 50% to 75% (calculated on loan facility limits) for each individual trust. The maximum term of any hedge product is seven years.

It is prudent to have a maturity profile of hedges to mitigate market risk at maturity of a hedge.

The following table sets out a guideline for a prudent maturity profile based on each individual Trusts loan facility limits.

Year	Guide for the Minimum Proportion to be hedged	Guide for the Maximum Proportion to be hedged
1	0%	75%
2	0%	75%
3	25%	75%
4	25%	75%
5 >7	25%	50%

Approved Instruments
Management will be restricted to using the instruments below to hedge their floating interest rate risk:

- Fixed rate facility – where the Trusts may fix the interest rate on the underlying facility rather than hedging via a separate derivative instrument,
- Interest Rate Swaps, and
- Interest Rate Caps and Collars.

Refer to **Appendix 1** for Product Descriptions.

OPERATIONAL RISK

Definition
The risk that the Trustees and/or the Trusts will suffer financial loss due to error, fraud, mismanagement, or unauthorised use of financial instruments

Specific Objective
To safeguard the financial resources of Trusts through efficient operations and to ensure that all interest rate risk management activities undertaken comply with The Trustees approved policy.

Management Approach
To meet the objective: The Trustees will establish a segregation of duties for transacting such that no one person is responsible for initiating, confirming and settling a transaction.

- The Trustees authorises the undertaking of all hedge transactions. The request for the Trustees authorisation to be completed using the template provided in **Appendix 2** as a guide.
- Thereafter the Diocesan Secretary and Chief Financial Officer jointly agree on the execution timing and specific transaction terms including being satisfied with the legal aspects of all documentation.

Performance Measurement and Reporting
An exceptions register is to be maintained to document the following:

- Failed settlements, and
- Any breach of Policy.

All exceptions are to be reported to the Diocesan Secretary and the Trustees.

Serious negligent or fraudulent action must be reported immediately to the Diocesan Secretary and The Trustees.

Confirmed or suspected fraudulent action shall also be reported to the Diocesan Secretary and the Trustees immediately.

COUNTERPARTY CREDIT RISK

Definition
Counterparty credit risk is defined as the potential financial loss associated with a customer or a financial counterparty's unwillingness, inability or failure to meet its financial obligations.

In the context of the Trusts interest rate risk management activities, the likely sources of counterparty credit risk are:

- Non-performance of obligations with respect to a contract where a financial counterparty is unwilling or unable to meet payment on demand or at maturity;
- Downgrading of a financial counterparty's credit worthiness; and,
- Funds on deposit (i.e. where access is denied to money market or trading accounts).

Specific Objective
To safeguard the Trusts financial resources through the effective implementation of credit review procedures which minimise the risk of default or other loss.

Measurement
Counterparty credit risk exposure is recognised based on the Marked-to-market (MTM) revaluations of hedged positions (i.e. particularly when the MTM is in-the-money).

Management Approach
To mitigate the potential for loss arising from a financial counterparty's unwillingness, inability or failure to meet its financial commitments against contractual obligations.

The key elements of The Trustees approach to the management of counterparty credit risks are:

- Management will determine the credit worthiness of financial counterparties based on Standard & Poor's (S&P) rating service.
- Management will only deal with counterparties that are approved by The Trustees and which hold a long term 'A' rating or better.
- In the event of a counterparty credit downgrade, any outstanding positions will be assessed and, if deemed necessary, remedial action will be taken to immediately reduce exposure to the counterparty.
- The counterparty list will be re-affirmed annually or on any credit event by the Strategic Investment Committee.
- **Appendix 3** details the approved counterparties for interest rate risk management transactions.

The Trustees exclude the Anglican Community Fund (Inc) from compliance with clauses a) to c) due to the internal relationship of the Anglican Community Fund (Inc) and The Trustees.

ACCOUNTING TREATMENT AND DISCLOSURE

Accounting practices for financial instruments are in continuous evolution. Management will monitor the changes with respect to financial instruments and accounting policies and will respond to new developments in terms of market best practice.

Management will make tax, legal and accounting judgments when reviewing and evaluating the impact of hedging decisions, based upon independent professional advice supplied from its Auditors Tax Advisors or other advisors when required.

Some hedging products will result in adjustments to earnings due to MTM revaluations. These favourable or unfavourable adjustments can be significant.

REPORTING

The CFO will report to The Trustees providing:

- Mark-to-market valuations, hedged exposure analysis and transaction listing for all interest rate hedging annually.
- A summary of each Trust's hedging position and recommendation of its current appropriateness.
- Consideration of any other loans that may need to be included in this policy.
- Details of any policy compliance breaches including any hedging limit breaches as soon as detected.
- Details of any material issues with respect to serious negligence, fraudulent action or breaches of policy as soon as detected.

Credit ratings will be monitored by the CFO on an ongoing basis and in the event of any downgrade or breach of the counterparty credit risk parameters, it will be immediately reported to the Diocesan Secretary and reported to The Trustees at the next opportunity.

REVIEW AND UPDATE OF THIS POLICY

The Trustees Strategic Investment Committee is responsible for ensuring the content of this policy is kept current.

This Policy should be reviewed as required due to a significant change of circumstances or at intervals of no less than 24 months.

APPENDIX 1 - PRODUCT DESCRIPTIONS

Fixed Rate Facility
All or part of the loan may be fixed for a period up to but not exceeding the facility expiry date, at an agreed interest rate.

Advantages

- Known interest rate cost over the life of the fixed rate facility
- Protects against interest rate rises for the life of the fixed rate facility
- Will achieve 100% hedge effectiveness
- No upfront premium is required to be paid
- No additional documentation or credit facility is required
- Can be executed over the phone

Disadvantages

- No participation in lower variable interest rates (i.e. limiting)
- The contracted terms of the component are fixed at the outset therefore any alterations to the amount drawn down or any other term, including early repayment in full or in part, may incur economic costs.

Interest Rate Swap
An interest rate swap is an over the counter (OTC) derivative instrument under which two parties agree to exchange interest rate cash flows, based on a specified notional principal amount from a fixed rate to a floating rate (or vice versa) or from one floating rate to another. There are many variants which may be structured to meet specific needs. The type most likely to be used by the Trusts is a same currency fixed for floating swap which would be used to convert a floating rate loan into a fixed rate loan. It is described below.

One party to the swap (e.g. the Trusts) commits to pay interest at a fixed rate, while the other party (e.g. Bank) commits to pay interest at a floating interest rate on a notional principal amount for a predetermined period. The two parties agree a fixed rate, which is settled against a nominated floating reference rate (e.g. BBSW) at predetermined intervals (e.g. monthly, quarterly, semi-annually) throughout the life of the swap.

The use of this instrument to fix loan facilities removes uncertainty with respect to future interest rate movements and more importantly protects against increases in floating interest rates. The terms of the swap are generally selected to exactly match the interest rate terms of the loan.

It is a limiting hedge, in that it limits positive market price participation and obliges a settlement for difference (between the fixed and floating rate) by the Trusts for out of the money (OTM) scenarios.

Advantages

- Known interest rate cost over the life of the swap.
- Protects against interest rate rises (when the user is fixed rate payer) for the life of the swap.
- Gives the Trusts the ability to hedge the underlying interest rate beyond funding term.
- If matched to underlying hedged item, will achieve 100% hedge effectiveness

- No upfront premium is required to be paid.

Disadvantages

- No participation in lower variable interest rates (i.e. limiting)
- Hedge ineffectiveness will occur only if the Trusts are over-hedged, in which case the excess will be subject to P&L impact
- There may be a cost to unwind/close the hedge at a future point if the position is OTM
- Bank credit facilities are required

Outcomes at each reset date:

At each rollover/reset date the difference between the prevailing floating reference rate and the fixed swap rate is paid to or by the Trusts;

Where the floating reference rate is higher than the swap rate, the Trusts will receive a net payment from its counterparty bank.

Where the floating reference rate is less than the swap rate, then the Trusts must make a net payment to its counterparty bank.

At each interest payment date, the underlying debt is rolled at the floating reference rate for the same period as the swap such that the net interest cost of the loan is the fixed swap rate.

Interest Rate Cap

An interest rate cap (Cap) is a derivative instrument under which the buyer receives payments at the end of each period when the prevailing interest rate exceeds the agreed option strike.

The most likely application for the Trusts will be to protect against a rise in interest rates. In this scenario the Trusts will purchase a Cap from a counterparty bank. If the interest rate exceeds the rate agreed on the cap then the Trusts will receive a payment with the net effect being that that the Trusts borrowing costs are 'capped' at the strike rate.

The Cap is usually structured to match the terms/reset dates of the loan.

This is a non-limiting hedge, in that it allows favourable market movement participation while obliging no settlement from the Trusts.

Advantages

- Maximum interest rate cost over the life of the Cap is established.
- Allows participation in lower variable interest rates (e.g. non-limiting).
- Gives the Trusts the ability to hedge the underlying interest rate beyond funding term.
- If hedging is no longer required the remaining Caps (or caplets), can be sold back to the counterparty bank.

Disadvantages

- Requires payment of an upfront or periodic premium amount.
- To be economical, the Caps are generally established at strike levels above the prevailing interest rates thus exposing the Trusts to greater upside risk on interest rates.
- Where the Cap strike rate is set closer to the at-the-money swap rate and the term to

maturity increases, the premium payable for the options also increases.

Outcomes at each reset date
If the floating reference interest rate is above the interest rate strike of the Cap then the Trusts will receive a payment from its counterparty reflecting the difference between the rates. The Trusts cost of debt is based on the Cap interest rate.

Interest Rate Collars
An interest rate collar (Collar) is an option based derivative structure which involves the simultaneous purchase and sale of a Cap and Floor. The strikes are usually selected such that the premiums net to zero.

The most likely application for the Trusts will be to protect against a rise in interest rates. In this scenario the Trusts will purchase an interest rate Cap and simultaneously sell an interest rate Floor which will offset the cost of the Cap. The structure provides the Trusts with a known protection band. The Trusts are protected against an increase in interest rates beyond the strike rate of the bought Cap and participates in falling interest rates up to the strike of the Floor i.e. the benefits of falling rates are limited to the strike of the Floor.

It is a limiting structure in the sense that participation in favourable market movements is limited to the strike of the sold floor.

Advantages

- Establishes a maximum interest cost over the life of the Collar at the Cap strike.
- Gives the Trusts the ability to hedge the underlying interest rate beyond funding term.
- Allows some participation in decreasing rates to the Floor strike.
- It can be structured to be a zero-premium payable hedging solution.

Disadvantages

- Hedging lines are required.
- Opportunity cost potential on the sold Floor. The Trusts carries the obligation to pay the difference, if positive, between the Floor strike rate and lower prevailing BBSW rate.
- It is slightly more difficult to close-out prior to maturity than an Interest Rate Swap. There may be a cost to close out depending on the relative value of the Cap and Floor.

Outcomes at each reset date
If the floating reference interest rate is above the interest rate strike of the Cap then the Trust will receive a payment from its counterparty reflecting the difference between the rates and the Trusts cost of debt will be based on the Cap rate.

If the floating reference rate is between the interest rate strikes of the Cap and Floor, then no payments will be made or received and the options will expire worthless for that period. The Trusts cost of debt will be based on the prevailing floating rate.

If the floating reference interest rate is below the interest rate strike of the Floor, then The Trusts will make a payment to its counterparty reflecting the difference between the rates and the Trusts cost of debt will be based on the Floor rate.

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APPENDIX 2 - RECOMMENDATION TO ENTER INTO AN INTEREST RATE HEDGING TRANSACTION

Borrower (Name of Trust)	
Requested Transaction (Amount and Term)	
Type of Product	
Advantages and Disadvantages of the Product	
Loan Facilities (Amount/Expiry/Financier)	
Existing Hedging (overall position and by term and amount for individual hedges)	
Resultant Position (overall position and by term and amount for individual hedges)	
Weighted Average Lease Expiry (by income)	
Loan to Valuation Ratio (existing position to covenant)	
Interest Cover Ratio (existing position to covenant)	
Counterparty Credit Risk (S &P Credit Rating Long Term)	
Is the Hedge Appropriate (How does this hedge met the Interest Rate Hedging Policy and the objectives of the Trust)	
Other Risks (any known risks that may affect the proposed hedge ie. Increase /reduction in loans, tenancy risk, loan renewal etc)	
Recommendation (summary of key points)	

APPENDIX 3 - APPROVED COUNTER PARTIES

Counterparty	**S&P Long Term Rating**
Westpac Banking Corporation	AA-
National Australia Bank Limited	AA-
Anglican Community Fund (Inc)	N/A