South-West Credit Union Co-operative Limited
ICAAP Report for the financial year ended 30 June 2016

This document has been prepared in accordance with section 18 of APS 110, and is the first ICAAP Report to the Board of Directors of South West Credit Union Co-operative Limited (SWC).

- Current and three year projected capital levels for SWC are:-

	30 June 2016 Actual	31 Aug 2016 Actual	30 June 2017 Forecast	30 June 2018 Forecast	30 June 2019 Forecast
Common Equity Tier 1 Capital	18.9% (18.6% F)	18.5%	18.8% (17.8% F)	15.8% (15.6% F)	14.4%
Tier 1 capital	18.9%	18.5%	18.8% (17.8%)	15.8% (15.6%F)	14.4%
Total Capital	19.8% (19.3% F)	19.2%	19.5% (18.8% F)	16.5% (16.6% F)	15.0%

With the increased loan funding and Investment portfolios the risk weighting effect has marginally decreased by 40 basis points to August 2016 in the Capital ratio since June 2016. The forecast to June 2017 expects the loan growth in residential home lending to continue with the current trend and the investment loan funding to decrease gradually. The current levels for 2016 and 2017 are above the minimum and target rates set by SWC. Strategic plan target is at 16%.

The actual to 30 June 2016 is 50 bps above the last year forecast (F) and Capital levels indicate an improvement to previous year's forecast with a marginal drop in 2019 with increased Loan portfolio.

Projected capital level for 2017 and 2018, from applying the ICAAP are above the SWC's minimum regulatory capital requirements and target levels, which are as follows:-

	APRA PCR	SWC Minimum	SWC Trigger	SWC Target
Common Equity Tier 1 Capital	7.50%	12.50%	14.50%	15.50%
Tier 1 capital	9.00%	12.50%	14.50%	15.50%
Total Capital	11.00%	13.00%	15.00%	16.00%

Changes to ICAAP during the reporting period

The Board approved the Credit Union's ICAAP Summary Statement in March 2016. A copy of that document has previously been provided to APRA. It includes the following material changes to the Credit Union's ICAAP during the reporting period:

- Amendments in the current version of the ICAAP (which was last reviewed in February 2016) include details of the method of calculation of SWC's minimum, trigger and target capital ratios broken down into the following capital components – Common Equity Tier 1 Capital, Tier 1 Capital and Total Capital.

Stress testing and scenario analysis undertaken by SWC include:-

- *Analysis of the impact of a 200 basis points interest rate shock from July 2016 – Interest Rate Risk;*

	30 June 2016 Actual	30 June 2017 Forecast	30 June 2018 Forecast	30 June 2019 Forecast
Total Capital	19.80%	18.67%	14.67%	13.0%

With the drop in interest rate by 200 basis points over two years, the Capital has been maintained above the prudential limit of 11% and SWC's minimum of 13% to year 2018.
Please refer Appendix 1 for Net interest and net margin over 1 year under different market scenarios and show the variability ($$ amount and % of capital) under different market scenarios.

South West Credit's Earnings at risk is at 24.15% (23.61% in 2015) over next 1 year. The Net Interest Income Risk range is $1,890,820 ($1,823,558 in 2015).

- *Analysis of potential drop in property values by 10% and 20% in areas of concentration-Market Risk*

  Any drop in asset valuation will directly affect the capital adequacy ratio. A 10% drop in the current portfolio in June 2016 will lead to a 3.0% drop in CAP ratio to 16.9%. Similarly a 20% drop in extreme circumstances will lead to a 7.5% drop in CAP ratio to 12.3%.
  The effect of devaluation in property values is still sustainable and is within the prudential minimum acceptance levels.

- *Analysis of the impact of a 10% variance to loans and deposits growth targets – Strategic Risk.*

  Any drop in loans and deposits growth targets by 10% from the 2017 budget depicted a 32 bps drop in Capital ratio to 19.18% in 2017. Further years showed 16.33% for 2018 and 15.00% for 2019. These Capital ratio are above the SWC minimum acceptance levels.

- *GAP(maturity mismatch of Loans and TDs) and Net Present Value Impact Analysis*

  A principal gap chart (Appendix 2) shows the total amount of principal maturing or repricing in each time bucket. Weighted average maturity is calculated for all assets and liabilities and is a measure of riskiness of the book. Closely matched weighted average maturities of assets and liabilities would mean the book is less sensitive to changes in market

  A representation of the maturity mismatch is normally called a GAP report. In addition to the repricing mismatch, the GAP report also shows the weighted average term to maturity of both the assets and the liabilities. In general, a positive cumulative GAP normally represents a situation where the weighted average term to maturity of the assets is less than that of the liabilities and vice-versa.

  The mismatch can be influenced by the assumptions around the repricing profile of low interest bearing liabilities – the so called 'sticky' liabilities as well as assumptions around the pre-payment speed of fixed assets. Also the repricing is treated homogenously within a time bucket and therefore yields approximate results.

  The GAP report lends itself to an initial analysis of the risk in the Asset and Liability book and allows certain inferences to be drawn regarding the behaviour of net margin. A positive GAP shows that the assets reprice, on an average, earlier than the liabilities and as such in a rising interest rate market we would expect the Net Margin to increase. The opposite will hold true for a declining interest rate market.

  For South West Credit Union, weighted average maturity of assets is 0.14 years and that of liabilities is 0.54 years. (Refer to Appendix 2)

  Net Present Value is defined as the sum of all discounted future cash flows - assets generate positive cash flows and liabilities generate negative cash flows. NPV variance is a measure of risk that is calculated as change in NPV for each market scenario from the base market scenario. A large change in NPV indicates more riskiness. In the table below, NPV variance is shown as a dollar amount and % of capital.

Scenario	NPV Variance	NPV Variance (% of Capital)
Market + 2%	607,875	6.32%
Market + 1%	308,605	3.21%
Market	n/a	n/a
Market - 1%	-318,301	-3.31%
Market - 2%	-646,674	-6.72%

Worst Case Impact on capital for a 2% parallel shift in the yield curve is a 6.72% impact on NPV.(Refer to Appendix 2)

- *Analysis of concentration of loans by postcode / security – Credit Risk*

Post Code	Number of Loans	Balance	% to Total Loan Portfolio
3280	504	59,070,307	72.3%
3281	14	2,299,326	2.8%
3282	46	5,401,563	6.6%
3283	21	2,031,168	2.5%
3284	20	3,206,842	3.9%

The above table depicts the status of the current loans portfolio with more concentration in the Warrnambool post code. This represents 72% in an area of less risk of flooding or fire.

- *Value-at-Risk*

  Value at Risk is a widely used statistical risk measure. It is defined as the minimum economic loss expected to be incurred on current holdings over a given period with a certain confidence interval due to change in market conditions. It indicates the ability of a business to absorb future loss and is typically represented as a percentage of capital.

  The following table shows the Value-at-Risk for South West Credit Union over different holding periods and confidence intervals:

Period	95%	95% as proportion of Capital	99%	99% as proportion of Capital
1 day	-32,005	-0.33%	-52,714	-0.55%
10 day	-101,208	-1.05%	-166,696	-1.73%
20 day	-143,129	-1.49%	-235,743	-2.45%
1 year	-495,815	-5.15%	-816,639	-8.49%

1 day VaR is $52,714 (0.55%) at 99% confidence level, implying 99% of times portfolio loss in 1 day is likely to be less than $52,714. Similarly 1 year VaR is $816,638 (8.49%) at 99% confidence level.

- Analysis of the impact of a deterioration in arrears on loans /ability to service loans/ increase in provisions – *Credit Risk*

  The analysis depicts that with a 5% deterioration ($4.0 million) of the Loan portfolio to loans arrears leading into impairment and write offs will eventuate in dropping the Capital adequacy at 15.7%,which will be at the target level of 15%. The risk of this loss can be major but the occurrence of this scenario is considered low. This did not factor the recoverability of the fully secured impaired loans.

- *Analysis of concentrations of employment e.g. Mid Field Group – Credit and Market Risk*
    - The combined maximum loan commitment that a member or group of associated members may have with SWC is 20% of the Credit Unions consolidated capital base.
    - Current exposure to this industry (Midfield) is 16% (if all members of SWC are considered as a group) and it still within the risk appetite. Please note these are employees and hence re employable.

    Capital Risk **-**Based on the closure of the industry, the impairment of $1.6 million (fully secured loans) the maximum expected effect on Capital Adequacy ratio will be 80 basis points. SWC can absorb this change in environment.

    Valuation of properties **-**Any drop in valuation will have a direct impact on the Capital Adequacy ratio and the risk weighting of residential properties. With the expected demise with the meat industry the added impairment of assets the total maximum effect on Capital Adequacy will be around 6%. The current capital buffer of 7.5% above PCR will absorb the shock.

    Liquidity Risk **-** The current exposure to Midfield is $1.0 million and does not fall under the Large Exposures Policy but will have an effect on the Liquidity Ratio with a 1% drop.

    Reputation risk**-**This is not considered as a high risk, as SWC is not directly exposed to a specific industry. Further reputation risk is part of the Operational risk. SWC has established adequate controls and has sound BCM policy and procedures which are tested annually. In addition adequate insurances are in place to mitigate risks with staff training to ensure procedures are followed.

    (Refer to Appendix 3)

The stress testing demonstrates that the Credit Union is able to meet its minimum capital adequacy requirements in the event of adverse circumstances impacting on its key planning assumptions.

- The Credit Union does not anticipate any changes in its risk profile or capital management processes over the three year planning horizon.
- In summary, the Credit Union projects steady capital growth under its current business model, and will maintain capital above its target level.(Refer Budget 2017 and Forecast 2018)

Declaration

Pursuant to paragraph 19 of *APS 110: Capital Adequacy* and with the approval of the Credit Union's Board given on 22 April 2014, I make the following declarations on behalf of the Credit Union:

a) capital management has been undertaken by the Credit Union in accordance with its ICAAP over the reporting period

b) the Credit Union has assessed the capital targets contained in its ICAAP to be adequate given the size, business mix and complexity of its operations

c) the information included in this ICAAP Report & Declaration is accurate in all material respects

A copy of the Board resolution approving the giving of these declarations is enclosed.

Please do not hesitate to contact me if you have any questions.

Yours faithfully,

D.Brown

CEO

Board Resolution

ICAAP Report & Declaration by the CEO for the year ended 30 June 2016 was distributed to the Board for approval on the 30 September 2016.

RESOLVED to approve the CEO giving APRA the declarations contained in the ICAAP Report & Declaration.

Date of Preparation: 30 September 2016