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REPORT ON

STATE BUILDING SOCIETY

Prepared by:
MACQUARIE BANK LIMITED

April, 1988

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[redacted]

1. INTRODUCTION

Macquarie have been asked to advise on the future direction of the Society and to report on a range of strategic options that could be considered by the Board of the Society in determining the Society's future direction.

The terms of reference (set out in Appendix 1) state that we are not required to recommend a preferred option and we have been specifically requested not to do so.

Based on the terms of reference, the discussion in this report has been divided into the following broad subjects:

- Future prospects of the industry
- Independence
- Merger with SBN or another entity
- Corporate structure
- Capital requirements and sources
- SBN/Society relationship

Prior to submitting this report, we had meetings with Society's board representatives individually and as a group to review progress and the conclusions set out in the Executive Summary. We understand from these meetings that all relevant topics and issues have been considered and that there was general agreement with the views we expressed.

2. EXECUTIVE SUMMARY

A. FUTURE OF THE INDUSTRY

We believe the trend in retail banking is towards fewer, larger participants with greater homogeneity between the participants.

- Overall retail banking business is becoming more concentrated.
- The number of building societies is shrinking.
- Overall (adjusting for conversions) building societies' traditional home loan asset base is growing at a slower rate than savings banks'. However, we have been advised that some individual societies have increased market share.
- All financial institutions are competing across a broader range of products. The commercial distinctions between trading and savings banks are disappearing.
- "Niche" operators can succeed by focusing on particular strengths, such as special services or superior management in marketing, cost control, etc. We believe few organisations will successfully implement this strategy in retail banking.
- We believe regulation of banks and societies, both in terms of activities and prudential supervision, has and will continue to become increasingly similar.

- The retail banking sector has become highly competitive, which will mean continued pressure on profits. Profit growth will be achieved through stringent cost control and developing or taking advantages of economies of scale. The recent history of competition has made it more difficult to earn superior profits from innovative products and reduced profits from innovative products and reduced the time within which competitors react to and copy new developments.

B. INDEPENDENCE

The Society may carry on business as an independent entity in the short to medium term (3 to 5 years), but in the medium to long term its only chance of remaining independent is by absorbing other retail banking businesses.

From our point of view "independence" means the board of the Society controlling its affairs without real or potential interference from a controlling shareholder. Based on that, we believe SBN currently has control of the Society, although it has been a relatively benign controlling shareholder.

We believe the central issues in considering independence are whether the Society has or can develop a competitive, sustainable business and whether it can attract non-controlling equity by offering an adequate return on investment.

- See our comments about Future of the Industry.

- Relative to several of its competitors, the Society has high overheads, low deposits per branch and a weak profit history.

- Although earnings outlook is good for 1987/88, one would expect a good result with declining interest rates and increased home lending demand. There is an issue as to whether these earnings can be maintained.

- The Society's recent internally-generated capital growth is low relative to inflation, St. George and growth in total housing finance.

- The Society's market is becoming more competitive as Banks enter a deregulated home loan market and interest rate differentials narrow. Banks have greater flexibility to switch between markets as profit opportunities arise.

- The Society has strengths which would help it become independent, such as a separate management structure and well developed product, marketing and data processing skills.

- Potential investors in the Society would probably be confined to depositors and a limited number of corporate investors, who would see additional commercial advantages. Potentially corporate investors could place independence in jeopardy since they would have their own commercial objectives in mind. It may be generally more attractive as a listed bank, but in order to service a bank's capital adequately it will need to adjust its product mix, which would entail acquiring new skills.

- To become independent, SBN would need to be replaced as fixed capital holder. From a financial point of view, we have assumed this entails the replacement of the Society's existing capital base of approximately $48 million, although from a commercial and legal point of view not all of this amount (which includes reserves) might accrue to SBN as the fixed capital shareholder. Further, if SBN chose to sell its holding the Society would not need to raise further funds to become independent. However, in either case, the Society would need to generate an adequate rate of return to make the investment attractive to the new fixed capital shareholder. Based on a potential investment of $48 million, we believe investors would seek a return of approximately $8-$10 million post-tax, assuming they held a non-strategic stake and they were not attracted by the potential of takeover speculation.

C. MERGER

In our view it is highly likely that the Society will have to merge with SBN or another entity.

The guiding principle in assessing whether a particular merger is desirable should depend on whether it maximises value for the members, depositors and borrowers of the Society. Whether it is practical will depend on what the the two classes of capital or the Minister will permit.

- See our comments on Future of the Industry and Independence.

- There are legal considerations concerning whether a proposal will serve the Society's objects and benefit members as a whole.

- A merger with the SBN offers advantages to SBN over merging with another entity:

  - complementary businesses
  - lower absorption costs (already have common infrastructure)
  - already closely linked
  - familiarity with the business
  - common marketing features

- SBN should be in a position to offer the best merger terms because it has these special advantages.

- We also believe the Society would be attractive to another controlling entity. There is also the option for the State Government to own the Society directly or through another arm.

- We believe that the Society (as an independent entity) should merge, primarily to gain market share and to decrease overheads relative to the scale of its operations. A merger with someone who has a similar style and culture and operates in the same markets is most likely to maximise rationalisation benefits. This may be difficult to accomplish without sacrificing independence since the most obvious candidate is St George. We believe a merger with regional NSW societies would be feasible, although with less benefits. Interstate mergers are unlikely to produce significant rationalisation benefits, but may help to keep the Society independent.

- There are a number of pitfalls to a merger:

  - Mergers of banking businesses with different markets, management styles and cultures have been difficult;

  - Envisaged benefits of rationalisation are often difficult to obtain in practice (e.g. systems incompatibility; delays and costs of merging; difficulties in reducing to one head office structure);

  - Mergers divert management from running the business;

  - There may be a need to reposition the merged entities' business in the market;

  - An "unfriendly" merger may debilitate the acquired business;

  - Mergers usually trigger competitive responses, which may eliminate the advantages of merger.

D. CORPORATE STRUCTURE

We see the realistic options as being building society or bank. Based on others' experience and RBA policy, if the Society were to become a bank it would probably be a savings bank.

Conversion to a bank is only worthwhile if the Society is prepared to take advantage of the business opportunities and advantages of being a bank (which will result in a move away from its home lender base).

- Banks are subject to higher prudential and capital requirements which would impose a net cost on the Society's present operations. The Society would find it difficult to meet these costs out of profits unless it changed its business structure. If the Society was prepared to become more like a full service retail bank - move substantially into more diverse commercial and consumer lending and diversify its funding base - it may be worthwhile to convert to a bank.

- Conversion to a bank will pose additional conversion costs, such as costs of acquiring new management skills, relaunching products and repositioning in the market.

- Building Societies can provide the products and service required by their traditional domestic banking customers. However, if they decide to move away from their traditional business they could be constrained by current regulations.

- RBA backing would be useful if competitive demands took the Society into non-traditional areas of business.

- Whether the Society should become a separate arm of the State is essentially a matter of government policy.

E. CAPITAL REQUIREMENTS AND SOURCES

Requirements - The Society historically has been unable to earn adquate profits to fund real capital growth internally, has been capital constrained as a result and has required external funds from its shareholders. As a bank it would have to almost double its capital in addition to meeting capital required to support real growth.

Sources - If the Society was independent, potential sources would be:

- As a society, probably limited to a small number of corporates (who may see additional commercial advantages) and depositors and small investors whom we feel are attracted for reasons other than fundamentals.

- As a bank, the same investors as a society plus the broader public and institutional market if it was listed and could demonstrate improved earnings potential.

- At present, the general market for capital is depressed and we believe new issues by financial institutions will be difficult at least in the medium term.

If the Society was not independent, investment in the Society would be less attractive to those investors listed above, especially corporates (assuming the absence of a potential takeover premium), and the Society would be more reliant for capital on the controlling entity.

F. THE SBN RELATIONSHIP

Having regard to the SBN/CBA settlement, SBN's release of savings bank products and evidence of differing interests and styles, we question whether the current relationship can persist.

Although it provides a relatively stable source of funds with a satisfactory return, the agency arrangement does not make a clear contribution to growth of the Society's business and is even less likely to do so in the future.

- The Society and SBN are in greater competition than ever before in both the home loan and savings markets.

- The Society does not rely on the agency as a significant contributor to growth in funds or assets.

- At current levels of funds of $170m approximately, the agency arrangement produces a better return on funds compared with the Society's overall return. The agency would still be profitable for the Society (after accounting for all the Society's agency related overheads) if the level of funds fell to, say $120m. If SBN does compete directly with the Society in funding, it is possible that these funds would be substantially lost and profitability would drop accordingly.

- It is possible that a substantial part of the business transacted through the agency could be retained by the Society without incurring the associated agency costs. Moreover, potential fixed cost savings from dismantling the agency could be used to offer higher rates to attract new funds, although over the long term this practice may increase overall funding costs.

3. THE FUTURE FOR THE INDUSTRY

We believe the trend in retail banking is towards fewer but larger participants with greater homogenity between the participants:

- Overall the retail banking business is becoming more concentrated and the number of building societies is shrinking (see Appendix 2A).

- Adjusting for conversions to banks, building societies' traditional asset base is growing slowly (see Appendix 2B), especially compared to savings banks'. According to Reserve Bank statistics overall building society lending and new commitments have not kept pace with savings bank lending (after adjusting for conversions from building societies to banks). We believe this trend existed before home loan interest rate deregulation. We appreciate that some building societies may be growing faster than some banks and that historically some building societies have not been as well run as banks, which would tend to depress the average performance of societies. Nevertheless, there does seem to be an overall trend towards a smaller building society presence in the Australian home loan market after adjusting for conversions.

- Over recent years the deregulation of banks has increased competitive pressures on other institutions, which has in turn lead to further deregulation. Appendix 2C summarises the history of recent building society deregulation. This has lead to increasing similarity in the activities carried on by banks and societies.

- Regulation and supervision of building societies and banks are also likely to become increasingly similar in their terms. For example, we believe that as societies expand into more and more "bank" products there will be pressure to comply with more stringent (and costly) prudential requirements.

- In general, financial institutions are competing across a broadening range of products. Building societies have expanded the types of assets in which they invest, for example, commercial lending, consumer lending and treasury operations.

- In addition, building societies now offer credit cards, insurance, personal investment advice and superannuation products. Ultimately the similarities products, funding, markets and regulation will blur the distinctions between a bank, savings bank or building society structures.

- "Niche" operators can succeed by focussing on their strengths, offering special services and by superior management in marketing, cost control, etc. We believe few organisations will successfully implement this strategy in the retail field. To compete effectively in the general retail market we believe a financial institution would need to develop a broad product range, a branch network and develop a clear, positive market image for itself and its products. These involve substantial investment in branches, products and staff and the development of management structures, which make it more difficult to focus on entrepreneurial strengths, to develop and react quickly to new profit opportunities and to maintain the flexibility needed to be an effective niche operator.

The Society has stated that it sees itself as potentially a niche operator in the household finance market. However, we believe the Society is attempting to be a full-service retail finance house within a limited geographical market and is not at this stage fulfilling a niche strategy.

- Deregulation and the entry of new banks have resulted in a very competitive environment, which will place continued pressure on profits. Profit growth in retail banking will be achieved primarily through cost control and developing or taking advantages of economies of scale. Superior profits earned from product innovation will be more difficult to achieve, first, because following a period of intense competition the potential to develop products is reduced and secondly, because new products will be rapidly copied by competitors.

4. INDEPENDENCE

The Society could survive as an independent entity in the short-medium term (3-5 years); in the medium-long term its only chance of possibly remaining independent is by absorbing other retail banking businesses.

In our view, to be "independent" the Society's board would control its affairs without real or potential interference from a controlling shareholder. We do not consider this is the case at present, although SBN has been a benign shareholder to date.

From our perspective, independence involves two issues:

(a) whether the Society has a competitive, sustainable business; and

(b) whether it can offer an adequate return to attract non-controlling investors to fund its capital base.

In the long term we believe the Society will need to grow substantially and become more cost-efficient. While we recognise that it may be possible to obtain corporate and public investors based on the Society's existing performance, we believe its performance should be improved if it wished to attract institutional investors without offering a strategic or influential holding or the potential for takeover speculation. This is based on an assumed funding requirement of $48 million, being the amount of the Society's equity, retained earnings, reserves and subordinated debt.

In addition to our comments on the Future for the Industry, our conclusions are supported by these factors:

A. STRENGTHS

We have summarized below the strengths of the Society which would assist it in being independent:

- an existing, separate management team;
- a business which is not directly reliant on SBN support to carry out its operations (although the "State" name and implicit government backing are clearly advantages of the SBN relationship);
- well developed data processing, marketing and product development skills;
- a favourable market perception;
- it is now the second largest building society in New South Wales (although it has become so more by the disappearance or conversion of competing societies than by its own growth).

B. PROFITABILITY

Compared with a number of small savings banks and other societies, the Society itself has high overheads, low deposits per branch, a weak profit history and a higher ratio of staff to assets.

The table below shows the Society's return on equity (fixed capital, reserves and retained earnings) over the last five years:

	F'cast 1988 %	1987 %	1986 %	1985 %	1984 %	1983 %
Operating P.A.T./ Fixed Capital & Reserves	15.2	1.6	4.1	9.8	9.0	3.3

Although earnings outlook is good for 1987/88, generally declining interest rates, high liquidity and increased demand for home finance have made trading conditions favourable and it is difficult to judge the Society's performance from 1987/88 results alone.

Based on the yields at which other banks are trading and our experience of the equity markets, we believe potential investors would, assuming the absence of a strategic interest or potential takeover speculation, require a post-tax yield on investment of between 15% and 19%. Clearly this is significantly greater than the yield at which, say, Advance Bank is trading, however we believe Advance's yield largely reflects underlying takeover speculation in its shares, which is inconsistent with it remaining an independent entity. The return required from a building society investment compared to a bank is likely to be at the higher end of the range because we believe the building society structure is less attractive than a bank. Other factors, such as whether there is a listing, the identity of the major shareholders, the overall capitalisation of the entity and spread of shareholders will also have an impact.

The tables below show that the Society's overheads are relatively high compared to St. George, but not compared to major banks. They also show that deposits per branch are low in comparision with competitors.

Overhead/Average Assets	1987 %	1986 %	1985 %	1984 %	1983 %
SBS	3.3	3.3	3.4	3.1	N/A
St. George	2.5	2.4	2.6	2.6	2.6
Advance	3.0	3.2	2.5	2.4	2.4
ANZ	3.2	3.4	3.4	3.2	3.7
Westpac	3.4	3.5	4.0	4.3	4.3
Deposits per Branch	**$M**	**$M**	**$M**	**$M**	**$M**
SBS	10.4	9.7	8.0	7.3	N/A
St. George	16.6	15.2	13.2	12.2	12.9
Advance	15.7	12.5	11.7	10.1	8.8
ANZ	20.2	18.8	14.3	11.9	8.6
Westpac	21.7	16.4	14.5	11.8	9.6

We understand the Society has invested more in data processing support than, for example, St George, which would clearly contribute to greater overheads. However, we also consider that the Society's general overheads are high relative to St. George.

C. INTEREST RATES

The Society's market is becoming more competitive as Banks enter the deregulated home loan market and interest rate differentials narrow.

For example, Appendix 3A shows the interest rates charged by the Society, relative to competitors, on new home loans. Although it is more difficult to compare deposit rates, we believe the Society can attract funds at a rate comparable to that paid by small banks.

Macquarie believes that public depositors see the Society as secure and would continue to do so, even if its association with SBN or the State ceased. We therefore concluded that ability to attract funds at competitive rates is unlikely to be a problem if the Society was independent, provided the overall solvency of building societies or the Society itself was not an issue. In the money markets, societies are normally net investors in liquids and risks against societies are usually very short term. Hence to the extent societies need to fund from the market they can do so in the short term on a basis that is competitive with banks.

The corollary of this is that if the Society became a savings bank, it would be unlikely to experience savings in costs of funds sourced from its traditional retail deposit market. However, we believe that a lower cost of funds would be available as a bank because the Society would have a wider variety of funds sources available (including the domestic and offshore wholesale markets). As a bank, the Society would be able to take advantage of the cheapest source of funds available in a wider market, having regard to the total costs of attracting those funds.

Although it is difficult to quantify the potential savings, we believe they are reflected in the retail deposit rates banks are prepared to pay. If banks offer lower rates, it will either be because they can attract deposits at those rates, or the rates reflect the maximum amount they are willing to pay for funds having regard to the costs of raising deposits and other potential sources or they are less reliant on increasing their overall funding to maintain profits.

D. <u>INVESTMENT CAPITAL</u>

To become and remain independent, the Society would need to attract new capital sufficient to meet capital adequacy requirements and provide for growth. This is examined in more detail in Section 7. To the extent it relates to independence, our conclusions are:

- Potential investors in the Society would probably be confined to depositors and a limited number of corporate investors, who would look for additional commercial advantages (which may ultimately put independence in jeopardy). It has been stated that the Society could raise between $15 million and $20 million from its depositors, which does not seem unreasonable. The Society may be generally more attractive as a listed bank, but in order to service a bank's capital adequately after allowing for the cost of a bank's prudential requirements it will need to adjust its product mix, which would entail acquiring new skills and involve other costs.

- The Society's recent capital growth from operations is low relative to CPI, St George and growth in total housing finance. This is summarised in Appendix 3B. As an independent entity it will have a continuing need for external capital unless long term internal capital generation is improved.

5. MERGER WITH THE STATE BANK OR ANOTHER ENTITY

In our view it is highly likely that the Society will have to merge with SBN or another entity.

This view follows from our conclusions that the Society can only maintain independence by growing and that the status quo of the SBN relationship cannot be maintained. We believe organic growth is very difficult and expensive to achieve in the retail banking market and that growth by merger is the most practical route. We also believe SBN will either seek to merge with the Society, sell its interest to a controlling shareholder who will seek a merger/takeover or sell its investment to new shareholders who will seek to expand the Society's business by merger.

We believe the Society would be very attractive to potential merger partners, particularly larger institutions seeking to expand their retail banking business.

The guiding principle in assessing whether a particular merger is desirable should depend on whether it maximises value for the members, depositors and borrowers of the Society.

Whether it a merger has a practical chance of success will depend on what the two classes of capital and the Minister will permit.

A. LEGAL CONSIDERATIONS

Although we have not sought a legal opinion, in considering a merger of the Society with SBN or with another entity we believe the following legal considerations must be born in mind.

Any proposal to merge with the State Bank or another entity would have to be referred to the Takeover Review Committee for ministerial approval unless special authority was received from the State Government to bypass this procedure. Should the proposal be referred to the Takeover Review Committee then that party would most probably require that a special resolution had been passed by a majority of the members of the Society and that the proposal be registered by the Registrar of Societies. Under the State Building Society's rules a special resolution must be passed by a majority of not less than 2/3 of the Members entitled to vote and voting, provided that majority includes 2/3 of the holders of fixed capital shares present at the meeting and voting.

Secondly, it is important to consider in any proposal to merge the Society with an entity which is not a building society the following:

(a) the rights of the fixed capital and withdrawable capital shareholders;

(b) the duties and responsibilities of the directors of the society to the holders of all classes of shares.

Based upon information available in relation to recent bank/building society conversions it would appear that, in general, the withdrawable shareholders do not have any present entitlement to the reserves of a society while it is an ongoing concern. They merely have a potential right to the surplus (if any) on a winding up. It is therefore a very limited contingent right. When a society is to be merged or transformed into a company, the directors of the society have a duty to act in the interests of members as a whole and must strike a balance between ensuring that the reserves continue to be available for the underlying

objects for which they were created, that is, to provide capital to fulfil the society's primary purpose as a cooperative home lender, and compensating the members for loss of any potential right to a surplus on a winding up.

It should also be borne in mind that withdrawable shareholders do have the right to vote on any merger proposal and so, at a practical level, their interests need to be considered. Furthermore on winding up, the rights of all classes of capital to any surplus are contingent upon the passing of a special resolution (pursuant to the Society's Rules) and compliance with the relevant legislation.

B. STATE BANK

A merger with the SBN offers particular advantages to SBN which would not necessarily be available to another party:

- complementary businesses
- lower absorption costs (they already have common infrastructure)
- already closely linked
- SBN is familiar with the business
- they share common marketing features

From the Society's perspective, SBN should be in a position to offer the best terms because it has these special advantages.

SBN and the Society have businesses which complement each other. They are both participants in the retail deposit market and in the home loan market. SBN has launched savings bank products. The Society is moving into commercial property loans, insurance and financial advice.

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The Society and SBN have duplicated branches in over 100 locations - presumably a substantial number of these could be eliminated upon a merger. Equally economies could be achieved by eliminating central costs, such as head office and data processing expenses.

However there would appear to be differences between the two entities, in terms of culture, the objectives of top management and the style of business done by the two organisations.

Reports have indicated that the recent mergers among the big four Australian banks were difficult. We also believe that in those cases, the envisaged benefits of rationalisation were hard to obtain or considerably delayed. Differences in culture and style would tend to exacerbate these kinds of difficulties.

. Other possible pitfalls associated with mergers are:

(a) At an internal level, the need to reduce two central management structures into one, the difficulty in merging different systems, cultures and skills and the amount of management time diverted to making the merger work.

(b) At an external level, that a merger may trigger competive responses (such as a further mergers by competitors or the launch of new products or techniques which undermine the benefits of the merger); that it diverts management from running the business competitively and that it requires an expensive and difficult repositioning of the merged entity in the marketplace (in effect, the creation of a new brand name).

(c) In the case of an "unfriendly" merger, the pitfalls are likely to become more prominent. The struggle to obtain success may not only result in an increased outlay, but also destroy some of the value obtained by the surviving entity by the alienation of the target's management, workers and customers; the debilitation of the target's business while its future is clouded and the creation of increased opportunities for competitors while the management of both entities are diverted from running their businesses.

The terms of reference require us to consider a number of relationship possibilities with SBN as a controlling shareholder (such as subsidiary, department, division or savings bank arm). We believe that in those circumstances a complete merger is the most rational structure. If the Society were to be merely a building society subsidary of SBN, or a department or division, perhaps with separate management, many of the problems which arise from the current structure would not be eliminated and we think it unlikely that the attractions of merger, from SBN's point of view, would be fully realized. Becoming a savings bank subsidary of SBN would appear to be unnecessary in functional terms and to go against the recent trend. Both Westpac and the Commonwealth Bank have recently merged their savings bank and trading bank activities.

D. <u>OTHER ENTITIES</u>

We believe the qualities the Society, as an independent entity, should look for in a merger partner are:

- similar businesses with compatible styles, systems and cultures;

- the ability to improve productivity and competitiveness;

- whether the merger will enhance profitability and growth prospects;

- benefits to parties in the cooperative structure, such as members, depositors and borrowers.

The potential merger targets for the Society to absorb (while remaining independent) are likely to become fewer if the industry trends continue. In our view it is in the Society's interests, as an independent entity, to seek a target which enable the Society quickly to increase its mass, reduce overheads and gain more productivity from its operations.

The greatest rationalisation benefits would result from merging with a competitor in the Society's current markets. We believe this is likely to be very difficult without sacrificing independence, based on the size and strength of the Society's direct competitors, particularly St George which potentially offers the best rationalisation benefits. The easier course would be to merge with building societies or banks in other markets, either in New South Wales or interstate.

Clearly if the target is not similar in structure or style (e.g. bank vs building society) or there is little overlap between the markets served by both parties (e.g. NSW vs interstate operations), the merger is less likely to will produce rationalisation benefits. However, even in the absence of clear, immediate rationalisation benefits, merger to create mass may enhance the Society's ability to remain independent and lead to some greater efficiencies over time.

6. CHOICE OF CORPORATE STRUCTURE

6.1 AVAILABLE CORPORATE STRUCTURES

The practical alternative structures are:

- Bank (trading or savings)
- Building Society

If the Society were to become a bank, based on past experience and RBA policy, it would most probably become a savings bank. We have assumed in this section, that the choice of becoming a bank is limited to becoming a savings bank.

Other structures which have been considered and discarded include:

- State-owned financial corporation created by special legislation
- Credit union
- Finance company
- Merchant bank
- Other forms of cooperative or friendly society

The choice of a State owned financial institution is clearly a matter for government policy, both as regards the Society and SBN. As a commercial choice for the Society, we have rejected the concept of a separate State owned savings bank or building society as it would result in there being two independent State owned financial institutions competing directly against each other. This is already occurring since SBN launched savings banks products and entered the home loan market. This situation is neither practical nor sustainable in the long run and would tend to undermine both entities. This assessment is supported by recent merger of the State Bank and Savings Bank of South Australia.

6.2 BUILDING SOCIETY OR BANK

Conversion to a bank is only worthwhile if the Society is prepared to take advantage of the business opportunities and advantages of being a bank (which will result in a move away from its home lender base). There are limits on how far the Society could diversify as a savings bank.

We have approached this choice of building society or bank from the following points of view:

A. Impact on profits in terms of:
   (i) Additional costs arising from conversion to bank status
   (ii) Product mix and funding benefits of being a bank
B. Product restrictions
C. Taxation
D. Lender of last resort

A. IMPACT ON PROFITS

Conversion to a bank would impose significant additional costs on the Society, in particular:

- costs of additional capital;
- costs of prudential requirements.
- costs of conversion, in particular, marketing and acquiring new skills and systems.

We have concluded that it is unlikely that these costs would be compensated by the advantages of being a bank, unless the Society substantially altered its business. Clearly it could not alter its business immediately and accordingly the benefits of conversion would only be realized over the medium to long term. The kinds of alteration in business we would consider necessary include a move away from a core business of home lending to focus on higher margin activity such as commercial lending, leasing and fee-based income. To some extent the Society is doing this already.

The Terms of Reference specifically ask us to consider the corporate structure of the Society as a specialist home lender. Conversion to a bank would not appear to offer a clear advantage if the Society's activities were restricted to retail deposit taking and home lending.

We approached the task by estimating whether the additional capital, prudential requirements and other costs of being a bank result in a net cost or benefit having regard to the commercial opportunities and advantages of a banking licence.

Some simple examples of the methodology we used are set out in Appendices 4A, 4B and 4C. Appendix 4A shows an example of the additional costs which the Society would incur in complying with the prudential requirements and in servicing any additional capital required. In Appendix 4B we have reviewed whether these costs can be offset by improvements in profitability arising from a changed product mix and lower funding costs.

Appendix 4C summarizes the proforma adjustments we have made to profit and loss based on conversion to a bank and diversification into more profitable assets using Challenge Bank as a model. We used Challenge because it is an example of diversification in practice and significantly more information is available on its activities than other small banks. We do not suggest that the Society should necessarily emulate Challenge Bank in determining its future direction. However, based on our example, if the Society did adopt a balance sheet structure similar to

Challenge Bank, we believe the costs of conversion could be covered over the long term.

We tested these examples against changes in variables and likely sensitivities.

B. PRODUCT RESTRICTIONS

Building societies can provide the products their customers are likely to require over the medium term. However if the current growth in profit and volume of non-traditional products continues, building societies may find their activities constrained by existing rules and regulation. In support of these conclusions Appendix 4D sets out typical bank and building society product ranges.

The following constraints apply on the product mix offered by building societies and banks:

Building Societies

1. 50% of assets must be secured over residential property, (not necessarily owner occupied).
2. 60% of the money advanced on loans in any year must be secured over owner occupied residential property.

Savings Banks

94% of depositors' balances must be invested in:

1. Loans for housing and other purposes on security of land
2. Reserve assets
3. Deposits and loans to other banks
4. Government and semi-government securities

The remaining 6% is unrestricted.

Trading Banks

Unrestricted.

Appendix 4E compares the Society's changing product mix and the yields from those products.

The Society is currently constrained by the 60% rule since new commercial and investment loans amount for 40% of all new lending. Since commercial loans currently offer a better margin, this potentially represents lost profit opportunities.

C. TAXATION

The likely tax impacts for the Society are summarized below:

Tax treatment	
Trading or savings bank	Taxed as a company under the Income Tax Assessment Act (the "ITAA") Dividends nondeductible and rebatable. Franking system applies.
Building society	Taxed as a company under ITAA. Dividends to fixed capital deductible under sections 118 and 120. Dividends on withdrawable shares deductible under section 51. No dividend rebate.
State owned entity	Not taxable under ITAA if a "public authority" carrying out activities of a "public nature". SBN currently "taxed" by NSW at 50% of accounting income.

It is difficult to tell whether being taxed on the basis of accounting income (like SBN) is advantageous or not. However these points should be noted:

- Historically, tax-based depreciation and investment allowances have been more generous than accounting depreciation. The tendency for politicians to use the tax system to create financial incentives must be an advantage of an ITAA basis of tax accounting.

- Macquarie understands another State bank has recently elected to change to the ITAA basis.

- An ITAA basis would take into account the special treatment of foreign or exempt-sourced income.

<u>Investor Preferences</u>

1. Logically, small investors paying tax at the maximum rate will be indifferent between franked and unfranked dividends, provided that that the lack of franking credits is reflected in the company's underlying tax rate and companies adjust dividend payout to reflect whether franking credits are available or not.

   However, in practice small shareholders will probably prefer franked dividends. The "tax-free" dividends will seem more attractive and companies which do not pay sufficient tax to frank their dividends are unlikely to adjust their dividend payout to compensate fully for the tax payable since their major corporate or tax-exempt shareholders (see below) will place less value on receiving a franked dividend.

2. Corporate investors will generally prefer to receive rebatable, unfranked dividends, unless they are under pressure to distribute franked dividends themselves.

3. Tax-exempt funds will prefer unfranked dividends which reflect a low underlying corporate.

4. The State Government would prefer a State Corporation, as it would pay State tax rather than Federal tax.

D. <u>LENDER OF LAST RESORT</u>

The absence of lender of last resort facilities is unlikely to impede the Society's effectiveness in carrying on business in its traditional markets.

However, that view would change if the Society wished to fund in the wholesale markets, expand its international business or if the financial position of an important building society, or building societies generally, deteriorated substantially.

For all practical purposes, the Society has "lender of last resort" facilities through the SBN and the State Government. The issue of absence of a lender of last resort therefore is only relevant if the Society chose not to convert to a Bank and its association with the State Governement was terminated.

Other building societies (without the RBA backing or implicit lender of last resort backing of SBN and the government) compete successfully with the Society. The absence of RBA or government backing is clearly not detrimental to them.

Market research has shown that retail savers regard banks as safer than building societies and associate the Society with safety and the State. Based on that, one would have thought the RBA or State government backing was important. However, there is little difference between interest rates offered by the Society compared to other societies. The differences appear to be better explained by fluctuating funding requirements rather than market perceptions of risk.

The money market generally regards building societies as sound, for all practical purposes like banks. We anticipate this could change if the general economy or outlook for building societies deteriorated significantly. Moreover the risks taken against building societies by the market are very short term (usually simply an overnight risk) and building societies and do not rely on the market for significant amounts of funds.

7. CAPITAL REQUIREMENTS AND SOURCES

7.1 REQUIREMENTS

The Society historically has been unable to fund real capital growth internally and has required external funds. As a bank it would almost have to double its capital in addition to meeting the capital required to support real growth.

Appendix 3B illustrates the growth rates for the Society's capital, compared to the growth in housing finance, inflation and St. George's capital.

The Society's capital needs have become more acute in the past year as home lending has expanded significantly. This year SBN made a $5 million subordinated loan to the Society which has improved its capital position. However, with total new housing lending currently growing at 27% per annum, the Society is likely to continue to be capital constrained in the short term.

7.2 SOURCES

Potential sources are:

- As a society, probably limited to a small number of corporates (who may see additional commercial advantages) and depositors and small investors whom we feel are attracted for reasons other than fundamentals.

- As a bank, the same investors as a society plus broader public and institutional market if it was listed and could demonstrate improved earnings potential.

A. GENERAL

At present there could be difficulties for the Society, either as a building society or a bank in raising capital from the market for the following reasons:

(a) New capital raisings are obviously less likely to succeed in the current environment. Financial services companies have been particularly down graded.

(b) The Society has an erratic profit record which would not be attractive to institutional/professional investors.

(c) Any new capital raising would require the consent of the present holders of fixed capital i.e. the State Bank.

Our conclusions as to the appeal of investment in the Society to various types of investors are set out below.

B. INSTITUTIONS

Institutions are less likely to seek capital in the Society than a bank for the general reasons given above and as a result of the Society's structure and the difficulties it presents:

(a) less flexibility in an operating sense than a bank;

(b) the Society's cooperative status (including the rights of withdrawable capital) and the regulation and approvals required for, for example, takeovers and capital restructuring;

(c) the high political profile of building societies at a State level;

(d) we are unsure whether, as a cooperative, the Society could obtain a listing since many of Society's Rules and the legislative restrictions are inconsistent with the policies and requirements of the Stock Exchange;

(e) banks are perceived to offer more security.

C. CORPORATES

Macquarie believes capital subscriptions in the Society could be attractive to a limited number of corporates, particularly other building societies or banks (who would in general be only interested in 100% ownership or a merger) but also corporates which would benefit from access to the Society's deposit and lending business - such as housing developers. Corporates are unlikely to be interested in taking a minority equity position based solely on investment fundamentals.

The fact that corporates will view investment in the light of their own commercial and strategic objectives may potentially jeopardize independence.

The points concerning the Society's cooperative structure (mentioned above under "Institutions") may also be a negative factor for corporate investors. However since the investors are likely to be more interested in the potential to obtain control or a premium on sale reflecting strategic value, the Banks (Shareholding) Act could prove to be a greater drawback than Building Society legislation.

The Society should also bear in mind that the identity of its major shareholders will have an effect on market image, corporate culture, staff morale and on the willingness of people to do business with the Society.

D. <u>PERSONAL INVESTORS</u>

Personal investors, in particular the Society's depositer base, could well support an issue by the Society. Although there would be a number of drawbacks (such as absence of a listing) to personal investors subscribing for fixed capital in the Society, the experience of St. George shows that significant amounts can be raised. It has been stated that between $15 and $20 million could be raised from the public and we do not believe that is an unreasonable suggestion. The experience of Advance Bank and Challenge Bank also shows depositor support for capital issues on conversion. The underwriting and flotation of Metway Bank indicates confidence in the capital raising ability of new savings banks in the present climate.

8. STATE BANK/STATE BUILDING SOCIETY RELATIONSHIP

Having regard to the SBN/CBA settlement, SBN's release of savings bank products and evidence of conflicting interests and styles, we question whether the current relationship can persist. If this conclusion is accepted then in the light of our other conclusions we believe the logical alternatives for SBN are either to seek a merger with the Society or dispose of its investment.

8.1 ADVANTAGES/DISADVANTAGES OF THE RELATIONSHIP

While we have considered the broad advantages and disadvantages of the relationship to the Society, we recognize that many are by nature intangible and difficult to measure.

The SBN relationship provides the following broad advantages to the Society:

- Through use of the name "State" the Society is perceived as possessing an implicit government guarantee and lender of last resort.

- The Society is frequently confused or at least associated with SBN and this helps to re-inforce the Society as a safe and secure institution.

- The relationship provides the Society with a greatly expanded delivery system and contributes 12% of the Society's withdrawable funds.

The major disadvantages of the relationship to the Society are:

- SBN now has the potential to be one of SBS's major competitors in the retail market and yet it is also in a position of significant influence and potential control over the Society through its fixed capital, the Society's board composition, the agency agreement and ultimate State ownership. This may hinder the Society's ability to formulate a fully independent and competitive growth strategy.

- Increased competition will make the relationship less profitable for the Society.

- There are cultural differences between the two organisations in terms of top management objectives and business style.

- The Society lacks a clear identity and this would impede its ability to develop its business.

8.2 COST/BENEFITS OF THE AGENCY ARRANGMENT

Although it provides a relatively stable source of funds with a satisfactory return, the agency arrangement does not make a clear contribution to growth of the Society's business and is even less likely to do so in the future. The fundamental commercial basis of the arrangement has been removed now that the Society and the Bank may compete directly against one another in the savings bank market. In our view, the profitability of the Society would not be adversely affected if the agency was terminated. These conclusions are based on the following:

A. GROWTH IN FUNDS

The Society does not rely on the arrangement as a significant contributor of funds. As the table below shows, SBN funds as a percentage of total funds have declined from 20% in '83/'84 to 13% in December '87.

Although the level of SBN funds has risen sharply in the last 6-9 months, it is unlikely that this growth will be maintained. The State Bank has recently launched its own range of savings products and is therefore in greater competition with Society than ever before.

Analysis of Funding	83/84 $000	84/85 $000	85/86 $000	86/87 $000	87/88 7MTHS $000
SBN Funds	129,663	124,111	129,243	125,926	170,383
Growth		(4)%	4%	(3%)	35%
% of total	20%	16%	14%	12%	13%
Society Funds	534,210	644,739	821,680	916,524	1,138,570
Growth		21%	27%	12%	24%
% of total	80%	84%	86%	88%	87%
Total	663,873	768,850	950,923	1,042,450	1,308,253
Growth		16%	24%	10%	26%

B. GROWTH IN ASSETS

Since SBN entered the home loan market the agency arrangement has ceased to be a source of asset growth for the Society.

The level of new loan approvals has declined dramatically since 1984/85 and this situation is unlikely to reverse in the future.

	84/85	85/86	86/87	87/88 6MTH
	$000	$000	$000	$000
Loan Approvals	60,655	34,860	3,880	710

C. PROFITABILITY

Based on a historic level of agency funds of between $120 - $130 million, the agency arrangement would appear to be profitable to the Society, although the return has been declining.

In the last six months the level of agency funds has risen to $170 million and at this level we believe the agency would generate a return on funds in excess of that generated by the Society on its own funds.

We have analysed the profitability of the agency by calculating a marginal return on funds generated through SBN and taking into account those costs, (including commissions and transaction fees, data processing, agency and marketing support costs), which are attributable to the agency as estimated by the Society. We estimate that even if the level of agency funds dropped to approximately $120 million, the return could be comparable to the Society's existing overall return.

However, if current circumstances prevail, it is unlikely that the recent increases in agency funds will be sustained in the long term as:

- SBN has the client contact, has recently launched its own range of savings products and is competing more vigorously with the Society in savings deposits.

- SBN branch managers obtain no credit or incentive to sell and market the Society's products.

- Presumably the fixed costs of the agency will largely remain if funds are lost.

D. ALTERNATIVE ARRANGEMENTS

We compared the profits obtained under the agency with the results which would be obtained by cancelling the agency agreement and retaining or replacing agency funds through existing Society facilities.

It is possible that a significant proportion of funds generated by SBN would remain with the Society because:

- Approximately 27% of the current SBN portfolio is term deposits which, after the deposit is made, are handled through Society's head office.

- Term depositors are interest rate sensitive and would presumably stay with the Society if its rate was competitive.

- Approximately 30% of the existing portfolio is held in SBN branches where there is a Society branch in the same locality.

However:

- SBN's new savings bank products and marketing effort may result in a significant leakage of funds back to SBN.

- Many Society customers who bank through SBN may in fact have their principal accounts with SBN.

We have identified net overhead savings in dismantling the agency, after taking into account additional costs of replacing SBN services and facilities. We believe that after taking into account these savings, the profits currently made by the Society from the agency could be largely maintained, even allowing for additional marginal costs of raising quickly new term deposits if none of the agency funds were retained. However, attracting a significant amount of funds by offering higher rates over a short period may result in a long-term increase in cost of funds.

9. APPENDICES

APPENDIX:

APPENDIX 1
TERMS OF REFERENCE

Against a background of continuing deregulation of the financial markets in Australia and the conversion of some building societies into banks, the directors of the Society require a review and report on a range of strategic options that could be considered by the Board in determining the Society's future direction.

The report is not required to conclude with a preferred option but to fully explore and develop the advantages and disadvantages of each option of consideration by directors. Each option should be examined in light of the possible requirements of the Takeover Review Committee established under provisions of the Permanent Building Society Act, 1967. The following matters which are not intended to be exclusive, should be addressed:

1. What forms of corporate structure will best enable the Society to fulfil its fundamental mission as a specialist home lender? In particular,

1.1 Should the Society remain registered and/or incorporated under appropriate building society legislation of New South Wales and/or Australia? If not, what would be more appropriate?

1.2 Should the Society convert to a Bank? If so what type of bank would be most suitable? What would be the advantages to the Society in this approach as opposed to (1.1)?

2. As a bank or a building society, should that body seek to operate nationally:

    (a) by acquisition and/or merger?
    (b) by development of interstate branch structure?

3. Is the Society's close relationship, (name, livery, agency agreement, board representation etc) in its current form, with the State Bank of New South Wales, an advantage or disadvantage for the Society?

4. How can any disadvantages identified in (3) be eliminated and/or converted to being advantages and how can identified advantages be used to greater mutual benefit?

5. The capital requirements of the various corporate structures should be identified. What options are available to comply with these capital requirements? Some possible examples are:

   (a) issues to existing members only (i.e. holders of withdrawable and fixed capital)
   (b) issues to public generally
   (c) placements to corporate sector selectively
   (d) issues to SBN only as holder of present fixed capital
   (e) issues to Government or Government Authority
   (f) combination of two or more of the foregoing

   Canvass the implications and ramifications of each.

6. The following relationship possibilities, which are not necessarily exclusive, should be examined from the Society's and members' standpoints:

   (a) the Society being totally independent from the State Bank.
   (b) the Society becoming a wholly owned subsidiary of the State Bank but operating as a separate legal entity, in the form of:

      (i) a building society, or
      (ii) a savings bank, or
      (iii) other financial intermediary.

(c) the Society becoming a Division/Department of the State Bank.

(d) conversion of the Society to become the State Savings Bank under unique legislation or the Banking Act with New South Wales Government guarantee but independent of the State (Trading) Bank of New South Wales.

(e) the Society transferring its assets and liabilities to the State Bank, another building society, another bank or other body.

7. It is expected that you will cover the future prospects of:

   (a) Government financial institutions;
   (b) building societies; and
   (c) banks (both savings and trading banks as separate or joint businesses)

   having regard to the deregulation of the financial sector, mooted further deregulation or re-regulation and the possibility of privatisation.

8. The report on the various relationship possibilities should cover the implications of:

   (i) Income Tax Assessment Act on the distribution of Income to likely shareholders or sponsors, and
   (ii) the existing contractual arrangements with State Bank under the Agency Agreements between the Society and State Bank.

APPENDIX 2A (i)

BUILDING SOCIETY NUMBERS

TOP TEN IN 1983

1983 RANK	SOCIETY	STATE	1987 RANK	COMMENT
1	St. George	NSW	1	Still No. 1.
2	N.S.W.	NSW	-	Converted to Advance in 1985.
3	Statewide	VIC	2	Merged with RESI in 1985.
4	United	NSW	-	Merged with NMRB in 1987.
5	Perth	WA	-	Merged with Hotham and converted to Challenge Bank 1987.
6	Town & Country	WA	4	-
7	Metropolitan	QLD	-	Will convert to Metway Bank in 1988.
8	SBS	NSW	3	Have moved from No. 8 to No. 3.
9	RESI	VIC	-	Merged with Statewide as above.
10	SGIO	QLD	5	Became part of Suncorp group.
10		TOTAL	5	

APPENDIX 2A(ii)

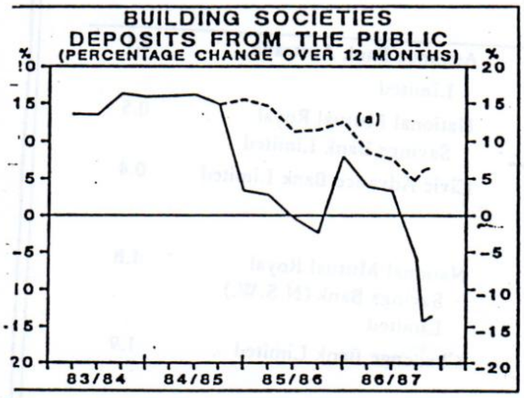
BUILDING SOCIETIES — CONVERSIONS TO SAVINGS BANKS

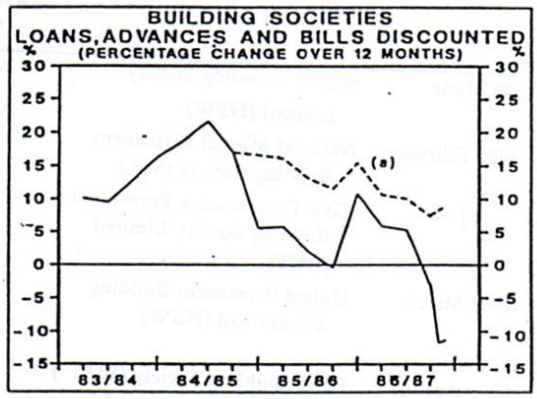
Date	Building Society Name	Share of total assets (a) (%)	New Savings Bank Name	Assets(b) ($b)
1985 June	N.S.W. Building Society Limited (NSW)	10.4	Advance Bank Australia Limited	2.1
1986 February	National Mutual Permanent Building Society (Vic.)	2.2	National Mutual Royal Savings Bank Limited	0.5
June	Civic Co-operative Permanent Building Society Limited (ACT)	1.9	Civic Advance Bank Limited	0.4
1987 March	United Permanent Building Society Ltd (NSW)	8.5	National Mutual Royal Savings Bank (N.S.W.) Limited	1.8
April	Perth Building Society (WA)) Hotham Permanent Building) Society (Vic.))	9.9	Challenge Bank Limited	1.9
1988 April	Metropolitan Building Society Limited (QLD)	6.0	Metway Bank Limited	1.1

(a) Share of total assets of building societies at end month prior to conversion.
(b) At commencement of operations.

Source: R.B.A. Bulletin

APPENDIX 2B(i)

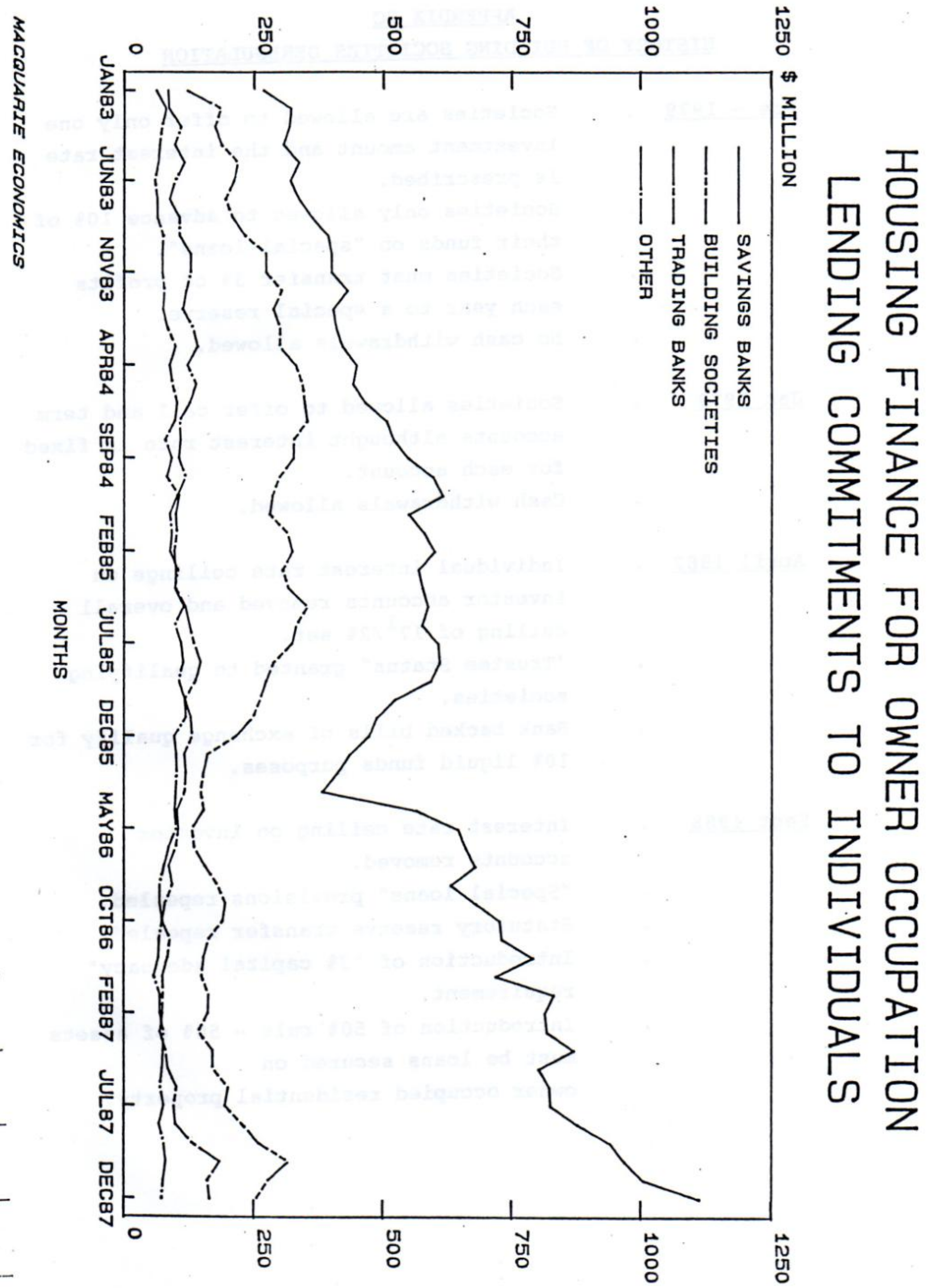




a) The dotted line shows growth of building societies adjusted for those societies which became banks.

ource: R.B.A. Bulletin

APPENDIX 2B(ii)

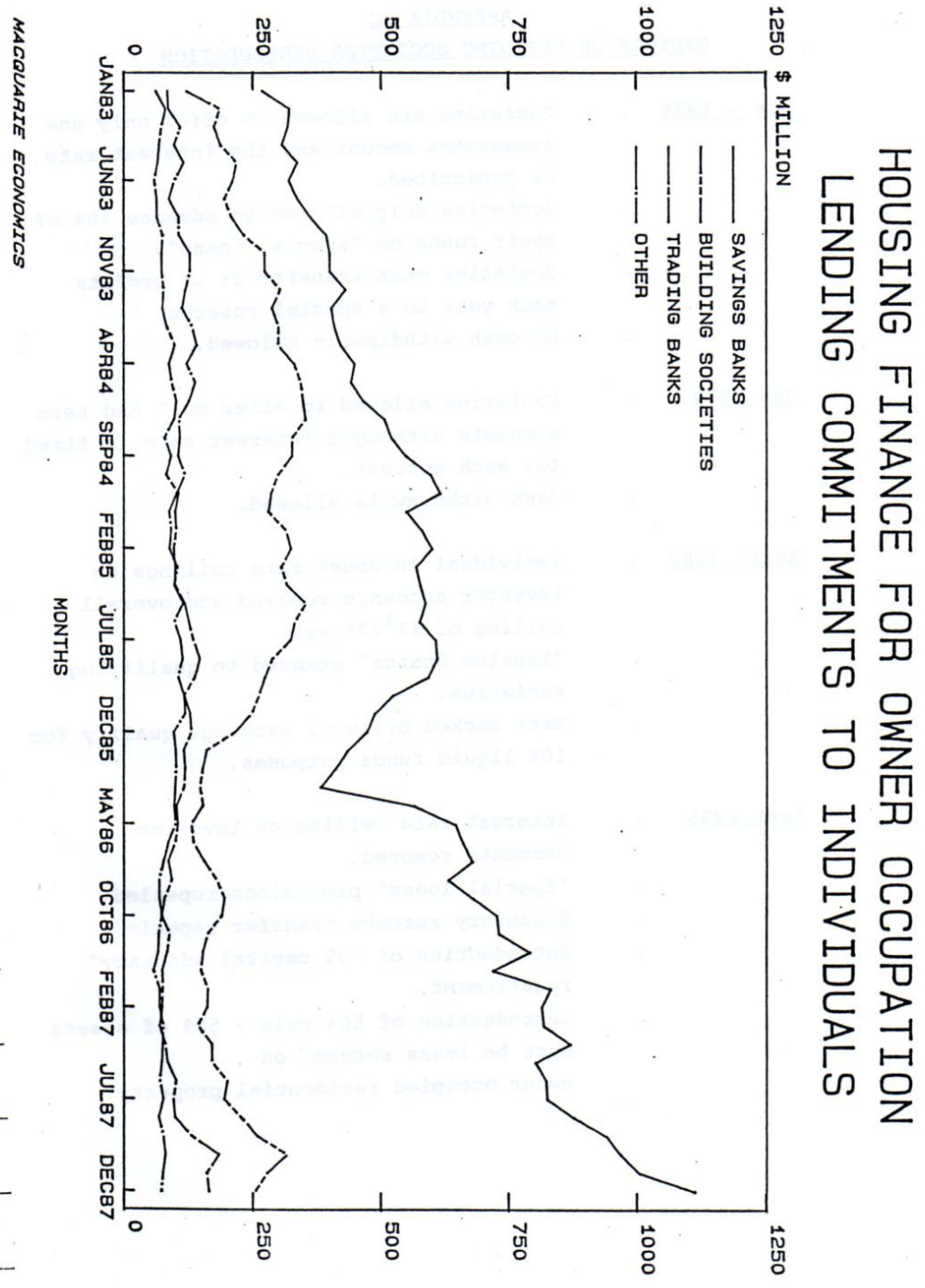


APPENDIX 2C

HISTORY OF BUILDING SOCIETIES DEREGULATION

Pre - 1979	. Societies are allowed to offer only one investment amount and the interest rate is prescribed. . Societies only allowed to advance 10% of their funds on "special loans". . Societies must transfer 3% of profits each year to a special reserve. . No cash withdrawals allowed.
Jan 1979	. Societies allowed to offer call and term accounts althought interest rate is fixed for each account. . Cash withdrawals allowed.
April 1982	. Individual interest rate ceilings on investor accounts removed and overall ceiling of $17\frac{1}{2}\%$ set. . "Trustee Status" granted to qualifying societies. . Bank backed bills of exchange qualify for 10% liquid funds purposes.
Sept 1988	. Interest rate ceiling on investor accounts removed. . "Special loans" provisions repealed. . Statutory reserve transfer repealed. . Introduction of "3% capital adequacy" requirement. . Introduction of 50% rule - 50% of assets must be loans secured on owner occupied residential property.

APPENDIX 2B(ii)



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- Societies must transfer 3% of profits each year to a special reserve.
- No cash withdrawals allowed.

Jan 1979

- Societies allowed to offer call and term accounts althought interest rate is fixed for each account.
- Cash withdrawals allowed.

April 1982

- Individual interest rate ceilings on investor accounts removed and overall ceiling of 17 1/2% set.
- "Trustee Status" granted to qualifying societies.
- Bank backed bills of exchange qualify for 10% liquid funds purposes.

Sept 1988

- Interest rate ceiling on investor accounts removed.
- "Special loans" provisions repealed.
- Statutory reserve transfer repealed.
- Introduction of "3% capital adequacy" requirement.
- Introduction of 50% rule - 50% of assets must be loans secured on owner occupied residential property.

. Introduction of 60% rule - 60% of funds advanced must be loans secured on residential property.

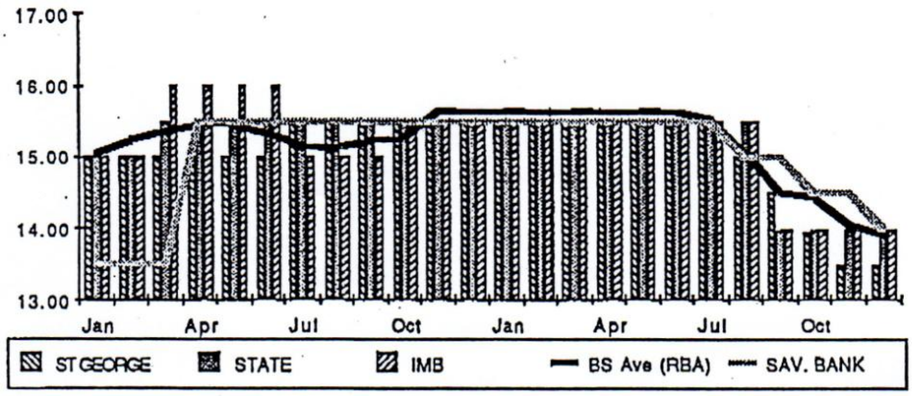
<u>July 1987</u>

. Takeover Review legislation introduced.

. Building socieities allowed to issue payment orders.

APPENDIX 3A

NSW SOCIETIES
Interest Rates (1986-1987)



APPENDIX 3B
BUILDING SOCIETY CAPITAL GROWTH

	$M 1983	$M 1984	$M 1985	$M 1986	$M 1987
Society's capital	28.63	31.38	34.14	38.50	39.12
% growth	N/A	9.61	8.80	12.77 (1)	1.61
Growth in CPI %	11.5	7.9	5.8	8.4	9.3
Growth in building society lending %	14.0	17.4	19.7	10.0	6.5
St. George capital	79.71	91.71	111.33	123.20	137.75
% growth	N/A	15.06	21.39 (2)	10.66	11.81

(1) 9.6% relating to revaluations
(2) 7.8% relating to revaluations and includes Pacific Building Society

Over that period, the Society's average annual capital growth rate has been 8.2%, compared to inflation of 8.6%, building society lending of 13.5% and St. George capital growth of 14.7%. Although other factors such as a asset revaluations, acquisitions and disposals do have an effect on capital growth, in recent years the Society has not generated sufficient profits to support real capital growth.

APPENDIX 4A

ADDITIONAL COSTS OF BEING A BANK

We have identified four key areas of additional costs:

1. Prudential costs
2. Capital adequacy
3. Direct conversion costs
4. Interest rate ceiling

1. Prudential Requirements

The relevant prudential requirements are set out below:

	Building Societies	Savings Banks	Trading Banks
Capital Adequacy	3%	5.5-6.5%	6-6.5%
SRD	-	-	7%
Liquidity	10%	-	-
Prime Asset Ratio	-	13%	12%

In a practical sense, these requirements mean that the Society would need to generate more profits to service approximately twice its existing capital while, at the same time, being required to invest a greater proportion of its assets in low yielding securities.

The following table shows an example of profit and loss impact of switching to trading bank and savings bank financial ratios:

. Society Depositors Funds - Dec '87: $1319m

	Savings Bank
. P.A.R. assets required:	12%
. Society historic compliance with P.A.R:	5%
. Yield discrepancy between P.A.R. assets and other liquids:	0.75%
. Cost of additional investment in P.A. required: (12%-5%) x 0.75% x $1319m	$0.69m
	=====

2. Capital Adequacy

In order to switch to a savings bank, the Society would have to raise approximately $39 million additional capital:

CURRENT	31 DEC '87 $M	AS A BANK	31 DEC '87 $M
Share capital	3	Share Capital	47
Reserves	40	Reserves	40
Sub Loan	5	Sub Loan	-
A. TOTAL CAPITAL	48	A. TOTAL CAPITAL	87
B. TOTAL ASSETS	1408	B. TOTAL ASSETS	1447
A. as % of B.	3.4%	A. as % of B.	6%
	====		====

In order to re-finance a total capital base of $87 million the Society would need to generate maintainable returns of between $13 and $17 million:

Pricing Criteria		Required Earnings To Support $87m
1. Capital pricing model. Required return on investment:		
ANZ - 18.36		
NAB - 18.22		
Westpac - 18.39		
Weighted average = 18.3%		$15.9m
2. P/E ratios (prospective)		
Major Australian trading banks	6.9	$12.6m
(cf. Weighted average of Advance & Challenge	9.8	$8.9m)
3. New issue P/E (prospective)		
Advance	4.0	$21.8m
Challenge	4.9	$17.8m
Metway (March '88)	5.8	$15.0m

In Macquarie's view, institutional investors are unlikely to contribute the required capital based on the Society's earnings history.

Although the Society forecasts profits of $7 million for 1987/88, it does not have a comparable earnings history. While there are some factors which are peculiar to the Society which may have depressed profits recently, we understand that other building societies are also expecting comparable increases in earnings owing to particularly favourable trading conditions this year.

It should be noted that St. George's capital raising was on p/e of 11.5 (against average p/e for listed Australian Banks at the time of 7) and succeeded in raising $50 million out of $150 million sought. The proposed raising sought was very large relative to St. George's then existing shareholders' equity of $138 million. Clearly issues to small investors can be sold on lower yields than indicated above.

3. <u>Direct Conversion Costs</u>

Switching to a bank would entail considerable direct costs which are difficult to quantify without establishing the extent to which business strategies and marketing would be altered. However, the costs of a simple conversion to a bank of the Advance Bank type are likely to be relatively modest over the medium term. These costs include:

(a) Marketing costs in developing a new image and corporate identity. These costs have been estimated by Society staff at $0.6 million, and would include:

    a. Corporate Logo
    b. Stationery
    c. Signage
    d. Advertising

(b) Acquiring new capabilities and skills in data processing, administration, personnel and marketing to cope with a bank's reporting and accounting requirements and expanded product range.

Macquarie believes that the bulk of this expenditure would be discretionary in Society's case, but extra expenditure would probably be incurred to take advantage of the new business available as a bank. Although it is difficult to determine the scope of additional investment, the reported investment decisions of other new banks are noted below:

<u>Advance</u>

1985/86	-	38% increase in book value of plant and equipment (inc. new computer system)
	-	establish Investment Advisory Division
	-	establish credit supervision and debtor management systems
	-	comprehensive staff retraining programme
1986/87	-	23% increase in book value of plant and equipment
	-	introduced specialist business accounts and insurance products
	-	increased staff retraining
	-	establish Corporate Banking Division (including new credit division)

<u>Challenge Bank</u>

1986/87	-	established Financial Planning Services and Commercial Lending Division

<u>NMRB</u>

1985/86	-	comprehensive new retail products launched
	-	purchase of T.C. Powell through Capel Court
	-	restructure NMP Building Society business
	-	business cheque accounts

1986/87 - new retail products launched
- new funds management products
- restructure information services and data processing.

Source: Annual Reports

4. Interest Rate Ceiling

At present, there is a statutory ceiling on the interest rate which savings banks can charge on all home loans made prior to 1 April, 1986.

Should the State Building Society convert to a savings bank, they may be required to comply with this provision in relation to their pre April '86 home loans. The interest rate ceiling for savings banks is 13.5% and the State Building Society's current home loan rate is also 13.5%. Therefore at present the interest rate ceiling would not present a cost of conversion although this could obviously change in the future. Indeed it is possible that a new savings bank would not be required to comply with the old ceiling.

APPENDIX 4B
PRODUCT MIX AND FUNDING BENEFITS

A conversion to a bank potentially offers cheaper sources of funds and the opportunity to increase returns on assets by switching out of home finance to commercial transactions, personal loans and other forms of banking business. A bank will also obtain an additional return on the new capital invested to comply with capital adequacy requirements.

1. Product Mix Effect

The following table shows a calculation of the incremental yield which the Society could obtain on its loan portfolio if it adopted the product mix of one of the newly listed banks.

CURRENT LOAN PORFOLIO

	Yield	Dec '87 SBS Mix	Sept '87 Challenge Mix
Retail mortgage/housing	15.2%	84%	61%
Commercial property	16.9%	16%	26%
Consumer Loan)	18.5%	-	12%
HP/leasing)		-	1%
	15.5%	100	100

ADJUSTED SOCIETY LOAN PORTFOLIO

	New Society Mix	$M	Yield
Retail mortgage	61%	558)	15.2%
Commercial property	26%	237)	16.9%
Consumer loans	12%	110)	
HP/leasing	1%	9)	18.5%
ADJUSTED WEIGHTED AVERAGE YIELD		915	16%
EXISTING WEIGHTED AVERAGE YIELD			15.5
INCREMENTAL YIELD FROM NEW PORTFOLIO			.5%

2. Cost of Funds

It is debatable whether independent savings banks such as Advance have achieved a substantial reduction in cost of funds. Advance is still heavily reliant on retail deposit funds. It appears to be competing head-on with building societies and the interest rates it offers (disregarding the weighting which should be given to deposits in various accounts) are comparable to those offered by building societies.

On transaction accounts the differences between institutions are minimal and centre more around charges and fees than interest rates.

On savings accounts there appears to be a small differential between building societies and small banks of 0.25% approximately. Major banks are 1.5% to 2.0% below building societies.

Currently major bank term deposits rates are 0.75% - 1.0% below building societies. There is very little difference between term deposits rates for building societies and small banks.

The management of the Society has commented to us that they believe the differentials in rates offered in the retail deposit market are explained by competitive pressures or desires to increase market share, rather than size or status. While we accept that view, banks in general appear unwilling to price retail deposits as aggressively as building societies. We believe this is because banks still rely on transaction accounts, they seek a higher margin and they have wide sources of funds and profits available which make retail deposit taking less attractive having regard to the costs involved. Industry experience suggests some banks still believe the cost of raising retail deposits adds roughly 7% to their cost of funds.

For the sake of our example in Appendix 4C, we have assumed the Society could, as a bank, save 0.25% off its savings and investment deposit base.

3. <u>Other Considerations</u>

Similar organisations have not dramatically changed their business since conversion to a banks:

(a) BALANCE SHEET COMPOSITION

	Advance		Challenge	
Assets	Old	New	Old	New
Home Loans)				41
Commercial Property Loans)	62	57	66	17
Consumer Loans	-	12	7	9
	62	69	73	67
Liquids	33	22	22	20
Other	5	9	5	13
	100	100	100	100
Liabilities				
Shareholders Funds	5	7	3	5
Deposits	93	87	85	78
Loans and Bills	-	5	10	16
Other	2	1	2	1
	100	100	100	100

This may be explained by:

- the short time-frame since conversion;
- difficulty in changing existing asset portfolios, skills and management style.

(b) Regulatory authorities have been willing to help building societies compete by loosening the restrictions on products permitted (See Appendix 2C)

APPENDIX 4C

CONVERSION TO BANK - PROFORMA ADJUSTMENTS

We have prepared a list of pro-forma adjustments to the Society's budgeted profit and loss for 1987/88 based upon the balance sheet as at 31/12/87.

BALANCE SHEET AS AT 31/12/87	$M
Total Assets	1,408
Total Deposits	1,319
Total Loans	915
	=====
PRE-TAX PROFIT (Budgeted for Y/E 31/5/88)	14.0

(After tax return on $48m = 14.88%)

ASSET ADJUSTMENTS:

(a) Incremental yield from a Bank Product Mix

Total loans x incremental yield: 4.58

915 x .5%

(b) P.A.R. Cost

Additional investment in PA's required x yield forgone

(7% x 1,319) x .75% (.69)

LIABILITY ADJUSTMENTS:

(a) Reduction in Cost of Funds

	$M		MIX		C.O.F. REDUCTION		
Savings and Trans:	1319	x	24%	x	0	= 0	
Savings and Invest:	1319	x	48%	x	.25%	= 1.58	
Term Deposits:	1319	x	24%	x	0	= 0	1.58

(b) Incremental Income from Increased Capital Base

(Capital Required x Loan Rate) - O/H)

$39m x 13.5% = 5.27

Less overhead @ 3% 1.17 4.10

REVISED PRE TAX PROFIT 23.57

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(After tax return on $87m = 13.82%)