Review of IMB Ltd's Capital Structure

May 2012

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Overview

IMB Ltd ("IMB") is a mutual Authorised Deposit-taking Institution ("ADI") regulated by both the Australian Prudential Regulation Authority ("APRA") and the Australian Securities and Investments Commission ("ASIC"). IMB is a public company limited by guarantee and shares. The members of IMB comprise guarantee members and guarantee members who hold shares (shareholder members).

IMB has 39.9 million ordinary shares on issue. The features of the ordinary shares are:

- one vote per shareholder member (provided that a minimum of 100 shares are held). There are approximately 4,200 shareholder members who are a subset of approximately 180,000 guarantee members. The voting power of shareholder members is a small proportion of total votes as guarantee members also have one vote per member (provided they hold a minimum of $250 on deposit);
- in the event of a winding up of IMB, shareholder members are entitled to the return of capital subscribed and a proportion of the surplus capital and reserves calculated in accordance with a set formula; and
- the Board may declare a dividend on ordinary shares but there is no obligation to do so.

The ordinary shares do not sit comfortably with the mutual structure and present challenges for IMB's Board in balancing the expectations of guarantee members and shareholder members. These challenges are:

- some ordinary shareholders see themselves as proprietors rather than members of a mutual;
- the cost of servicing the ordinary shares has become very significant (although this is a result of Board decisions as IMB's Constitution does not provide for any obligation to pay dividends); and
- the right of shareholder members to a significant share of surplus assets on any winding up of IMB (which has been an obstacle to mergers with other mutual ADIs).

Nevertheless, the ordinary shares have advantages in that they:

- are Tier 1 capital; and
- allow IMB to utilise accumulated franking credits.

More recently, the impending implementation of the Basel III capital requirements and the need to increase capital, particularly Tier 1 capital, in difficult market conditions have added to the challenges that IMB faces.

The IMB Board committed to undertake a review of the longer term capital structure options available to IMB to establish which option would best meet the requirements of APRA and would provide the best outcome for all IMB members. IMB has appointed Grant Samuel Corporate Finance Pty Limited ("Grant Samuel") and

Watson Mangioni Lawyers Pty Limited ("Watson Mangioni") to assist it in undertaking this review.

This paper sets out a summary of the capital structure options considered by Grant Samuel and Watson Mangioni and contains a recommendation to IMB.

Recommendation

IMB has few capital structures available to it. Each has been considered in the context of how it might enable IMB to grow in an increasingly competitive industry. Increased competition and regulatory requirements are leading to consolidation in the banking sector and this is expected to continue in the medium term.

It is understood that, to achieve longer term growth and viability, IMB aims to:

- **reduce the cost of regulatory capital;**
- **address the loss of capital through the outflow of dividends; and**
- **be an active participant in the mutual ADI sector consolidation that is expected to occur in the coming years.**

Based on the available capital structure options and IMB's aims, Grant Samuel and Watson Mangioni recommend that the mutual structure be supported by seeking to cancel the ordinary shares through buybacks of the ordinary shares on issue.

1. Cancel the Issued Ordinary Shares

The ordinary shares have become an expensive form of capital for IMB as a result of decisions to increase dividends, resulting in reduced capacity to reinvest in its business and grow Tier 1 capital. In addition, together with the application of the wind up rule, the ordinary shares are a deterrent to IMB executing mergers with other mutual ADIs. Unless both issues are addressed, IMB is unlikely to participate significantly in the expected consolidation in the mutual ADI sector. This will increasingly put IMB at a disadvantage to its competitors in terms of scale and efficiency and is likely to result in IMB being a less relevant participant in the mutual ADI sector over time.

To achieve longer term growth, IMB will need to reduce the cost of regulatory capital and the loss of capital through the outflow of dividends and be an active participant in the consolidation of the mutual ADI sector.

Accordingly, IMB needs to deal with the ordinary shares. Several options have been considered, including a share buyback, conversion of the ordinary shares to another form of security and transfer of the ordinary shares to a trust.

The preferred option is a buyback of **all** of the ordinary shares on issue.

ADVANTAGES	DISADVANTAGES
• Simplifies IMB's structure and removes the confusion created by the share/mutual structure • Removes the conflict that exists between the expectations of shareholder and guarantee members • Eliminates the outflow of capital from any dividends paid on the shares in the future • May be attractive to shareholders as part of the consideration for the share buyback is likely to be treated as a fully franked dividend and any capital gain should be minimised • Improves IMB's attractiveness as a potential merger partner for other mutual ADIs • Does not impact IMB's ability to demutualise in the future	• IMB will not be able to buy back all of its shares in a single transaction due to capital constraints • An immediate reduction in Tier 1 capital • The amount saved in dividends will be offset (at least in part) by the cost of replacement Tier 1 capital • The support of ordinary shareholders to any proposal will be required and this may not be achievable on terms that are in the best interests of all IMB members

However, a single buyback of 100% of the ordinary shares could not be achieved without IMB breaching its regulatory capital adequacy requirements. Accordingly, it is proposed that IMB undertake a series of annual share buybacks over the medium to long term. IMB would be able to utilise the "10/12 rule" (in the same manner as other companies). This type of share buyback does not require member approval.

IMB is unlikely to be able to buy back all of the ordinary shares on issue through a series of 10/12 rule buybacks. IMB would need to "mop up" any remaining ordinary shares at some future time through a share cancellation process.

It is recognised that the proposed buybacks will reduce IMB's Tier 1 capital in the short to medium term. However, the reduction in issued capital will also reduce the outflow of retained earnings from any future dividends paid which is likely to, over time, result in a strengthening of IMB's capital base.

A mutual structure enables IMB to deliver its strategic goals. To support its mutual structure, IMB needs to deal with the ordinary shares. The recommended way to do this is to cancel the shares progressively through a series of annual share buybacks.

2. Demutualisation and ASX Listing

2.1 Demutualisation

Demutualisation would involve IMB converting from a company limited by guarantee and shares to a company limited by shares.

Demutualisation is a long and complex process and could take up to 24 months to implement. As each IMB member class (guarantee, depositor and shareholder) would need to approve the demutualisation, the proposal (including the basis for allocation of shares) would need to be attractive to each member class.

ADVANTAGES	DISADVANTAGES
• Simplifies IMB's structure and removes the confusion created by the share/mutual structure • Removes the conflict that exists between the expectations of shareholder and guarantee members • Creates capacity to raise capital to fund future growth and meet regulatory capital requirements • The shares issued to all members as a result of demutualisation would qualify as Tier 1 capital • Gives ability to raise equity capital (particularly as a buffer to withstand "shocks") • Gives ability to offer securities as consideration for acquisitions • Gives all members access to the underlying value of IMB • Right to vote based on number of shares held (one vote per share)	• Removes the key differentiator between IMB and listed banks/building societies • May create conflicts between customers and owners – will IMB continue to offer attractively priced products and other member benefits • Reduces the likelihood that IMB can merge with mutual ADIs • Increased vulnerability to takeover

While demutualisation would provide access to additional capital, IMB does not have an immediate need for capital (other than to bolster IMB's Tier 1 capital for regulatory purposes). A demutualised IMB:

- is unlikely to merge with other mutual ADIs as the majority of mutual ADIs are committed to the mutual structure and to independence and will not want to merge with a company limited by shares. Such mergers are generally only possible as "agreed" transactions. There is limited history of agreed mergers between companies limited by shares and mutuals. While regulatory requirements may increase the need to consolidate, it is likely that consolidations will occur within the mutual sector (rather than between mutuals and companies limited by shares);
- could acquire or merge with other listed building societies (MyState/The Rock, Wide Bay). However, their geographic location is not complementary as they are based in Tasmania and/or regional coastal Queensland;
- if listed, would be the second largest listed building society (based on net assets). However, IMB would be much smaller than the listed regional banks and would be likely to become a takeover target for a regional bank (e.g. Bendigo & Adelaide Bank or Bank of Queensland) looking to expand in New South Wales. IMB would be an attractive target due to its size, branch distribution and relatively strong financial position.

IMB's mutual structure provides a key differentiator in a competitive financial services market. There is no compelling reason for IMB to change its structure at this point in time – it is performing well and is regarded as having good management and effective corporate governance.

Demutualisation would represent a fundamental shift in the basis on which IMB operates. IMB would become a profit driven entity (although it is already run on a commercial basis). There would be an expectation that returns to shareholders in the form of dividends would be generated.

2.2 Listing

IMB can demutualise without listing on the Australian Securities Exchange ("ASX"), although member approval for a demutualisation without an intention to list is considered unlikely. IMB cannot list on the ASX without first demutualising.

ADVANTAGES	DISADVANTAGES
• Gives a higher public profile with customers and suppliers • May allow equity capital to be raised more easily • Would potentially increase the liquidity of IMB shares • ASX regulatory requirements should lead to better systems and controls, improved management information and greater operating efficiency	• There is often an incentive to place increased focus on short term results rather than long term strategy • There are costs involved in maintaining a listing • The higher degree of disclosure and corporate governance required by an ASX listed company would involve additional management time and investment in information and compliance systems

IMB has also considered listing the existing ordinary shares on other Australian exchanges, including the National Stock Exchange of Australia ("NSX") and the Asia Pacific Exchange Limited ("APX").

ADVANTAGES	DISADVANTAGES
• Listing the existing ordinary shares on the NSX may allow the "one member one vote" rule to be maintained (i.e. may not require IMB to demutualise) • Would potentially increase the liquidity of IMB shares	• Trading of IMB's shares through a broker removes the opportunity to interact with new shareholders, particularly to explain the structure of IMB • IMB would no longer have control over access to the share register, which enables determination of voting eligibility • APX utilises the services of only a small number of brokers which may not provide the trading options required by some shareholders • Shareholders would continue to be guarantee members and any process through an exchange or through a broker would need to accommodate this requirement • The cost to members to trade through a broker would be likely to be higher than the cost of trading through IMB's current market

Many of the benefits of listing on an approved stock exchange without demutualising (such as liquidity) are arguably already available through the trading of the ordinary shares on IMB's current share trading system.

If IMB was to demutualise, it would list on the ASX and this would be required to obtain approval from members to demutualise.

In the absence of a demutualisation of IMB, it is preferable for IMB to retain its independent share trading system. An IMB operated exempt market flags to potential investors that IMB shares are "different" to shares listed on the ASX.

3. Utilise Accumulated Franking Credits

IMB generates franking credits as it pays tax on profits. Franking credits can attach to the dividends paid by IMB to shareholders. There is no ability to utilise accumulated franking credits other than through the franking of dividends. In particular, IMB cannot sell surplus franking credits.

IMB is in the same position as other mutual ADIs that are not able to distribute accumulated franking credits and the franking credit balance continues to grow every year. There has been some lobbying of government to allow the "release" of the accumulated franking credits held by mutuals that do not have the ability to distribute them to members under the existing tax legislation.

Franking credits do not belong to any particular class of members or shareholders. IMB members as a whole would benefit most from IMB joining other mutual ADIs in lobbying the government to allow the "release" of accumulated franking credits for the benefit of all members.

4. Reactivate Dividend Reinvestment Plan

IMB operated a DRP from the payment of the first dividend in April 1990 until it was discontinued in 2004. Shareholder participation in the DRP scheme peaked at approximately 70% during 1991 and 1992 with a participation of 48% for the 2004 final dividend. The IMB Board discontinued the DRP after taking into account the following factors:

- the DRP allowed IMB to retain capital that would have otherwise been paid out;
- the increasing number of shares resulted in increased cash dividends; and
- the increasing share base impacted IMB's ability to remain below a 50% payout ratio required to comply with Regulatory Guide 147 ("RG 147"). RG 147 sets out the criteria that ASIC considers when determining whether an entity has a mutual structure in circumstances where the entity proposes to change its Constitution or issue shares in a way that might alter its existing mutual structure.

ADVANTAGES	DISADVANTAGES
• Dividends are reinvested back into the business increasing Tier 1 capital • The new capital is issued at a small discount to the current market price providing a more cost effective source of capital	• Continually increases the outflow of retained earnings each year, which has the potential to increase the payout ratio above 50% unless dividends are fixed or reduced

The factors taken into account by the Board in discontinuing the DRP in June 2004 remain valid. There is no reason to reactivate the DRP at this point in time.

5. Merge with Other Mutual ADIs

5.1 Merger

IMB has identified merging with other mutual ADIs as a key strategy for growth. Mergers of mutual entities are generally undertaken without any cash cost and, if well executed, can deliver growth and scale efficiencies in a relatively short timeframe.

ADVANTAGES	DISADVANTAGES
• Increased profitability and balance sheet size and reduced cost to income ratio • Scale and efficiency synergies • No cash payment/no premium • Access to additional capital • Expanded footprint/distribution capability • Cultural fit and compatible ethos • Acquisition of specialist skills and systems	• Takes management time away from operation of business • There are risks associated with the integration of two organisations

IMB has attempted to merge with a number of mutual ADIs over the last 10 years. None of these attempts has been successful. Concerns expressed included:

- concerns about IMB's structure;
- reduction of capital from the payment of dividends; and
- fears that the wind-up rule would penalise incoming members.

While IMB has developed a method to quarantine the reserves of potential merger parties and a merger roadmap to assist with future merger proposals, the wind-up rule in IMB's Constitution remains a significant impediment to growth by merger as it provides a return of surplus assets on a wind-up to the shareholders in excess of what they would receive in their capacity as members. Amending the wind-up rule so that all members share equally in the surplus of IMB in the event of IMB winding up would remove one of the main obstacles to mergers with other mutual ADIs.

5.2 Amend Wind-Up Rule

IMB put a resolution to members seeking to amend the wind-up rule in June 2007. The shareholder member vote did not achieve the requisite majority and accordingly, the proposed amendments to the Constitution were not implemented.

ADVANTAGES	DISADVANTAGES
• Simplifies IMB's Constitution • Improves IMB's ability to merge with other mutual ADIs	• Shareholder members may perceive this as a change in their "rights" notwithstanding it only applies in the unlikely event of winding-up

Merger with other mutual ADIs is an important strategy and the IMB Board remains open to merger opportunities. Amendment of the wind-up rule would significantly diminish the concerns of other mutual ADIs about the ordinary shares and could be implemented reasonably quickly. However, shareholder opposition to this amendment would need to be overcome.

6. Rebrand as a Mutual Bank

Following the global financial crisis, the safety and security attributed to the major banks (and to a lesser extent the regional banks) was a significant factor driving the investment decisions of retail and wholesale depositors. It became critical for IMB to educate its members that it is regulated in the same way as a bank and has to meet the same prudential requirements as a bank.

Further, research undertaken by IMB indicates that the descriptor "bank" is much more widely recognised and understood than the term "building society", particularly in younger markets and urban areas where IMB has a focus on growing members and financial relationships.

In the December 2010 announcement of banking reforms designed to increase competition and its focus on creating a "fifth pillar" of credit unions/building societies, the Federal Government indicated that it would explore ways to make it easier for credit unions/building societies to describe themselves as "banks". Since that time, a number of IMB's mutual peers have converted, or applied to convert, to a "mutual bank" (e.g. Mecu – *bankmecu*, Queensland Teachers Credit Union – *QT Mutual Bank Limited*, Teacher's Credit Union – *Teachers Mutual Bank Limited* and Heritage Building Society – *Heritage Bank Limited*).

ADVANTAGES	DISADVANTAGES
• Perceived safety, security and strength • Better understood across broad demographics, particularly by youth • Mutual status should counter anti-bank sentiment • Fill the "regional bank" void left by Westpac's acquisition of St George in New South Wales	• Perceived consumer issues with "banks" • Potential member concern (or anticipation) that becoming a mutual bank is a precursor to demutualisation • Potential member concern that IMB's pricing and fees may change to the detriment of members

IMB should maintain a watching brief to understand the longer term benefits from rebranding as a mutual bank. However, while rebranding as a mutual bank may assist in improving perceptions about the strength of IMB and promote greater competition, it does not resolve IMB's capital structure issues.

7. Issue Preference Shares

IMB initially considered raising capital by issuing preference shares in 2000. At this time, preference shares were treated as Tier 1 capital. While the issue of preference shares was investigated over a number years, increases in the expected coupon on the preference shares and IMB's stable capital position (at the time) resulted in a decision not to proceed with the proposed issue.

Changes to the Prudential Standards as a result of Basel III will mean that only perpetual preference shares will be eligible for inclusion as Tier 1 capital (to be called

"Additional Tier 1 Instruments"). Hybrid instruments currently considered innovative Tier 1 capital will no longer be eligible as Tier 1 capital and features such as "step-ups" or other incentives to redeem will not be allowed. Additional Tier 1 Instruments will be required to be written-off or converted into listed common equity on the occurrence of a trigger event.

Basel III requires Tier 1 capital to be at least 6% of risk weighted assets and common equity Tier 1 to be at least 4.5% of risk weighted assets (i.e. 1.5% of Tier 1 capital may be made up of Additional Tier 1 Instruments). APRA is proposing to replace the current limits on capital set out in APS111 with the Basel III limits and minimum requirements.

ADVANTAGES	DISADVANTAGES
• Fixed dividend payment generally linked to BBSW • Ability to utilise franking credits • Subject to terms, likely to be treated as Tier 1 capital (but limited to additional Tier 1 instruments) • Could be issued with terms that do not enable preference shareholders to share in any surplus on a winding up	• Cost of issuing preference shares • Ongoing regulatory uncertainty regarding the prudential treatment of preference shares (i.e. the preference shares would need to be perpetual and therefore almost the same as ordinary shares) • Increased cost of the preference shares as a result of ongoing market volatility • In conjunction with the dividends paid on ordinary shares, the dividends on preference shares may cause IMB to breach RG147 requirements

Certain types of preference shares are a source of Tier 1 capital for IMB. However, IMB's current capital position, the impact of Basel III requirements and ongoing regulatory and financial market uncertainty mean that other sources of capital are more efficient.

Important Notice

The material in this paper is a summary of capital structure options considered by Grant Samuel and Watson Mangioni and sets out their recommendation to IMB.

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