PLAN TO RETAIN THE STATE BANK IN VICTORIAN OWNERSHIP

This document outlines the key elements of a plan to retain the State Bank of Victoria in operation in its own right.

The plan deals with the problem of Tricontinental debts and allows the people of Victoria to retain ownership of the Bank.

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EXECUTIVE SUMMARY

1. The sale of the State Bank of Victoria to any buyer is not financially necessary.

2. The current proposed sale to the Commonwealth Bank is not a good deal financially for Victoria. It understates the long run value of the bank to Victoria by as much as $2,700 million. Other adverse effects of the sale would include:

   - reduction in the level of banking competition;
   - removal of a major State asset and an important means to assist Victorian home buyers; and
   - the undermining of the financial industry infrastructure now located in Melbourne.

3. The State Bank of Victoria can be retained, and continue to operate in its own right as a publicly owned bank.

   A plan to achieve this aim and resolve the Tricontinental problem has been developed and essentially involves:

   - complete separation of Tricontinental from the Bank;
   - no extra State borrowings will be needed to supply capital for the Bank;
   - future Bank earnings will offset Tricontinental losses and provide future revenue for essential public services (or opportunities for tax reductions) for Victoria.

   The plan is not inconsistent with some future direct equity participation by Victorians if desired.

4. The Victorian Government should urgently reconsider its current plan to sell the Bank, particularly in light of the major adverse impact on future State finances that would follow if the sale proceeds.

PLAN TO RETAIN THE STATE BANK IN VICTORIAN OWNERSHIP

Need the State Bank of Victoria be Sold ?

The sale of the SBV is not necessary.

At the price offered, the sale does not appear to be a good deal for Victorians.

In fact, the State Bank is in the long run worth more to the peopleof Victoria than could be obtained now from a sale to any of the major banks.

What is wrong with the sale proposal?

A sale of the Bank would:

- Reduce the level of competition in banking in Victoria
- End the Bank's important and long standing function of assisting Victorians at all levels of income with home ownership through the vicissitudes of economic cycles
- Remove from Melbourne the head office of the fifth largest bank in Australia, thus threatening the critical mass of financial industry infrastructure in Victoria
- Give up a perpetual stream of income available to the Government of Victoria in the form of State Bank profits thus imposing on the people of Victoria either higher rates of taxation or lower levels of provision of essential public services
- Preclude the option to sell or partly privatise the Bank on terms more favourable to the people of Victoria than those in the current offer.
- Involve selling in a most unfavourable market and under most unfavourable conditions one of the State's largest assets built up by generations of effort over almost 150 years

Why then was the sale proposed?

At the time it provided an immediate and needed solution to avert a potential crisis of confidence in the Bank. That crisis has passed and other options can and should now be considered.

The proposed sale fitted in neatly with the Federal Labor Government's agenda to gain party support for privatisation. That support has now been achieved, so the chance to carefully consider other options now exists.

The proposed sale gave the people of Victoria the illusion that, in some sense, the Federal Government was taking the consequences of the Tricontinental loan losses off their hands. In fact the Victorian Government retains responsibility for Tricontinental and the Federal Government is taking a "clean" State Bank.

The proposed sale would provide a lump sum to the Victorian Government to be used for debt reduction. It is open to serious doubt that this is the largest lump sum that should have been obtained; the Commonwealth Government has proposed to underpay the Victorian Government and people by several hundreds of millions of dollars on the lump sum value of the taxation component of the sale.

Even though the proceeds will fall far short of the value to the people of Victoria of the State Bank as a going concern, the aggregate lump sum proceeds of the sale provide the short run political appeal of "cash in hand".

Is the proposed sale a good deal for Victoria ?

Part of the rationalisation for the "fire sale" of the SBV was a view that the State could not afford to own the SBV given the losses incurred by the State via Tricontinental. This involves two fallacies:

1. The losses can be avoided.
2. An equity injection involves a cash injection.

The reality is:

1. The losses have already been incurred - no asset sale or any action is going to change that. In fact, the terms of the fire sale explicitly involve the State maintaining responsibility for the bad loans and selling a "clean" asset. Losses only require asset sales if, as a result, cash is required.

2. Restoring the SBV's equity base to acceptable levels does not require an injection of cash. When Tricontinental's losses were discovered, the SBV's obligation to Tricontinental's depositors meant that SBV equity was denuded because of increased loan loss provisions. However, once the State government assumed responsibility to meet those loan obligations, the SBV equity was restored. (This is shown graphically in Attachment 3).

The sale involves the Victorian Government receiving a capital payment now in exchange for an asset (a "clean" SBV) which will generate a stream of future earnings. Only if the capital payment received exceeds the present value of those future earnings (and other intangibles) to the seller, should a voluntary sale be made.

As far as we are aware, this calculation has not been performed - the sale appeared to be based on the premise that a sale had to be made and would be made to the highest bidder in a very hasty, highly constrained auction. It is important to note that the amount prospective buyers are willing to bid may well be below (or above) the State's valuation of the asset. Consider, by way of analogy, a geological formation regarded as a "national treasure" which contains valuable mineral deposits. The State's valuation of this asset will undoubtedly be quite different from that of a mining company interested only in demolishing it.

In the current context, the fact that Westpac Banking Corporation and the Commonwealth Bank each offered around $1,600 million does not mean that this is all the State Bank is worth to Victorians. The $243 million "top up" payment by the Federal Government indicates this - but the top-up looks to be far too small.

Elements in Valuation of the State Bank

The valuation of the minimum price which should be accepted by the Victorian Government should include the following elements:

a) loss of expected future income from Bank operations - available to the people of Victoria as either dividends from the Bank, payments in lieu of tax, or retained earnings by the Bank

b) any loss of payroll, stamp duty, FID taxes, etc. arising from transfer of staff and transactions out of the State

c) losses of business to the State economy arising from any greater propensity of the Bank's new owners to use non-Victorian suppliers

d) a decline in State employment arising from a rationalisation of Bank branches

e) some judgement about the value to be placed on public desire for retention of assets within public ownership

f) the value of any services provided on a non-commercial basis by the SBV for the people or Government of Victoria.

g) reduced competition in Victorian banking

h) a decline in the significance of Melbourne as a financial centre

Were the Victorian Government not to sell the SBV it would forego receipt of a capital sum which was to be applied to reducing the State's debt and thus reducing future debt servicing charges. Instead, those debt servicing charges would remain but would be offset by the revenue received into the State budget from the profits on SBV operations. Comparing these alternatives is not simple, since various assumptions must be made. However, the following illustrative calculations may help.

Suppose that not selling the SBV and foregoing the $2 billion capital receipt means that this amount of State debt remains on issue in perpetuity. Assume, further, that the real interest rate paid by the State on its debt is 6% p.a. The implication, then, is that budget outlays in the form of interest payments are $120 million p.a. higher in perpetuity than would otherwise be the case. However, the State budget would receive a stream of income in perpetuity from SBV profits which would otherwise have been lost. If the net profits/assets figure was as 1.0%, the receipts next year would be of the order of $240 million p.a. This is about twice the interest saving and this difference would grow in line with growth in the real assets of the Bank.

Two points warrant emphasis:

1. The decision to sell or not sell the SBV has no implications for the charge upon future budgets of the State Government's obligations under its guarantee to meet Tricontinental loan shortfalls. This cost to future budgets remains. The key issue is whether the public debt interest saved (from retiring debt with the sale proceeds) is significantly less than the expected future income foregone (from not receiving the profits of the SBV).

2. While selling the SBV and "booking" the proceeds of the asset sale as "income" may reduce the recorded State budget deficit, this is little more than creative accounting. Decisions to sell assets and retire debt should not be made on the basis of accounting presentation - but on whether the asset sale makes good economic sense. By way of analogy, repaying a $100,000 mortgage by selling a $200,000 house for $100,000 reduces debt but is clearly stupid. Selling the SBV would only make sense if the amount received were to exceed what it is worth to the seller - the people of Victoria.

What is the State Bank worth to Victoria?

Depending on the future outcome of the way in which the Bank is operated and the monetary valuation of the elements listed above that should be included, the Bank could have a present net worth of as much as $5,000 million.

In making this assessment it is worth focusing on item (a) in the list of elements in a valuation, the expected future stream of income from operations of the Bank. If the lump sum sale proceeds clearly are less than the value of the future income generated by the Bank, the proposed deal is a bad one and should not proceed.

For a full cost benefit analysis, the sale proceeds would also have to exceed the full value, not only of future Bank income, but of an amount which includes the other items, (b) to (h), that will be lost if the sale proceeds.

If need be, our analysis, which is based on publicly available information about the Bank, can be confirmed by reference to the Board and Management of the Bank.

One way to examine the question is to use the Victorian Government's own real discount rate of 4 per cent per annum that it requires public authorities to use in making decisions.

Using the Government's rate of 4 per cent, a constant stream of real income of $200 million a year in perpetuity, which is less than might be expected from the Bank's operations, would have a value now of $5,000 million.

Another approach is to ask the following question: "What rate of discount is implied by the current sale price?" Using a formula known as the Dividend Growth Model we obtain a real discount rate of 13.5 per cent per annum.

This is a very high real discount rate. At the current rate of inflation this is equivalent to a nominal discount rate of over 20 per cent per annum.

Discount rates at these high levels indicate that the Victorian Government has placed an extraordinarily low value on the income that would be generated by the Bank in the longer term future and is clearly inconsistent with the Government's own guideline rate for long term decision making.

Amount To Be Received from The Commonwealth Government

The Commonwealth Government is to pay the Victorian Government a lump sum reimbursement of $243 million for the stream of taxation revenue on State Bank profits which in future will go to the Commonwealth rather than to Victoria.

Was this fair compensation?

One basis of calculation would be to accept the $1,600 million payment from the Commonwealth Bank as a fair assessment of the lump sum value to the buyer of the after-tax component of profits generated by the State Bank Assets. The Westpac Bank bid of $1,655 million suggest that this was a minimum value. On the basis of an average tax rate of 30% the taxation component would be worth approximately 43 per cent of $1,600 million, that is $686 million.

Instead of $686 the Victorian Government accepted only $243 million, thus incurring a loss of $443 million for this part of the sale.

However, the assessment of the loss on the transaction should have been made on the basis of the value to Victorians of projected future earnings of the State Bank, not on the basis of the value of the past tax stream paid by the Bank, or on the inadequate basis of the value of the State Bank to a purchaser.

In the Cash Flow and Asset/Liability Projections for the Bank attached to the Plan Document, in real 1990 dollars the Bank profits are put at $251 million in 1991 rising to $294 million in 1999. The taxation component (at 30%) is $75 million rising to $88 million in the year 2000. In reality, the stream will continue in perpetuity. Using a 4% real discount rate, a sum of $75 million in perpetuity would have a present value of $1,875 million. If the profits were to rise at a modest rate of 2% per annum in real terms, a conservative estimate of the future growth in Bank earnings, the lump sum compensation from the Commonwealth should have been $3,750 million.

On these bases of calculation, Victoria was short changed by the Commonwealth by at least $1,632 million; $1,100 for every Victorian household.

Can the State Bank be saved?

A plan which would maintain the SBV in Victorian ownership is outlined below.

Elements of the Plan

The essential elements of the plan are:

1. Complete organisational separation of Tricontinental from the Bank. Tricontinental becomes a separate entity, the responsibility of the Victorian Treasury. This has to happen anyway under the plan to sell the SBV, as no buyer wants Tricontinental.

2. The present loan of $2,353 million from the State Bank to Tricontinental is guaranteed by the Victorian Government. This means that the $23,391 million total asset portfolio of the State Bank is more secure than that of most other banks and the State Bank is solvent and profitable.

3. Once clear of the problems of Tricontinental, the State Bank can be expected to earn a real net profit before tax of around 1.05 per cent on its total asset portfolio. In real 1990 dollars, this stream of income for the people of Victoria would be of the order of $250 million in 1991 growing to more than $300 million by the year 2000.

4. The Victorian Treasury does not need to make any extra borrowing to provide capital for the Bank. The State Bank would retain a share of its annual profits to maintain a capital asset ratio of more than 9 per cent, a significant margin above Reserve Bank requirements of 8 per cent.

5. The annual flow of payments from the Bank to the people of Victoria by way of dividends and payments in lieu of taxation would augment State revenues sufficiently to allow Treasury to pay the Bank a reasonable rate of interest on the Tricontinental borrowing and to pay back the loan over the next nine years as Tricontinental is wound up.

Positive Consequences for Victorians

The positive consequences for Victorians of retaining ownership of the Bank are substantial. They include:

- Maintaining the level of competition in banking in Victoria

- Continuing the State Bank's important and long standing function of assisting Victorians at all levels of income with home ownership through the vicissitudes of economic cycles

- Keeping in Melbourne the head office of the fifth largest bank in Australia, thus maintaining the critical mass of financial industry infrastructure in Victoria

- Preserving for people of Victoria the stream of State Bank profits in perpetuity; after 1999 they enjoy either lower rates of taxation or higher levels of provision of essential public services

- Providing a more favourable outcome for the Victorian budget than using the proceeds from the sale to retire debt

- Retaining the option to sell or partly privatise the State Bank on terms more favourable to the people of Victoria than those in the current offer.

The Future Activities of the State Bank of Victoria

Victorian taxpayers could rightly be concerned about the possibility that maintaining the SBV under State ownership could lead to further losses and calls on the State Budget. Any plan to retain the bank must therefore ensure that SBV activities are "low risk" ones which will not lead to that outcome. Is this possible?

The current problems arise from two general factors.

1. The first, and by far the most significant one, was the inadequately supervised activities of a subsidiary (Tricontinental), for which the Bank (and the State) was obliged to act as a guarantor. This is readily overcome in the following way.

   To the extent that activities involving potential exposure are undertaken by a Bank subsidiary, there would need to be a clear statement that the SBV's support for the organisation does not extend beyond its subscribed capital. The SBV would also be precluded from guaranteeing liabilities of the subsidiary. This will have two important effects. First, those activities involving potential exposures will tend to be undertaken within the Bank, where supervision (both within the Bank and by external auditors and regulators such as the Reserve Bank) will be at an appropriate level. Second, it will prevent any unwarranted expansion of the Bank's activities, and extension of government guarantees, into areas which are inappropriate.

2. The second contributing cause to current problems has been the rapid growth of corporate lending activities by the Bank and its subsidiaries - which have led to significant loss. While there is nothing inappropriate about the SBV engaging in such activities, their poorly supervised, rapid expansion created a significant, undesired exposure.

   It is appropriate for the SBV to have some involvement in corporate lending, but the bank's history - and the market advantage - lies in its dominant position in the Victorian retail market. The emphasis of the Bank should be upon retaining its market advantage in this sector, where prudent policies can ensure adequate returns. Low risk expansion of commercial and corporate business should be pursued. The diversification of the Bank's portfolio from such expansion is desirable, but diversification should not be into high risk areas - unless that is a desired policy of the Bank's owner, i.e. the Government of Victoria. Such an approach may see the Bank lose market share in "boom times" - but that should not be seen as a bad result.

The Corporate Objectives of the Bank would include the following.

1. To provide banking and financial services for the people of Victoria. These include:

    a) the provision of a safe, guaranteed, haven for funds

    b) the provision of finance for personal and business borrowers engaging in non-speculative ventures with adequate security

    c) other activities such as funds management and market making as approved by the Board of Directors

2. To provide, subject to adequate remuneration, a vehicle for the implementation of those State Government policies which are best directed through a financial institution

3. To adopt policies which will provide an adequate return on Government capital funds employed, while ensuring that the risk of loss of those funds is minimised

4. To promote the development of the Victorian economy, both through its lending policies and by ensuring adequate competition in the Victorian financial sector

5. To develop the skills and well-being of all members of staff

6. To operate in an efficient and cost effective manner

7. The Bank's objectives do not include maximising market share or rapid growth

Conclusion

Demonstrating that the Bank need not be sold is not, of course, the same as showing that it should not be sold. That requires a careful cost-benefit analysis which compares all benefits and costs to Victorians of the post-sale outcome (resulting from the type of sale chosen) with those of retaining a State-owned bank.

We do not purport here to undertake such an analysis, since our concern is that the current sale was based on a wrong assumption that a sale was necessary. Since, as we have argued, that sale is not necessary it is important for the welfare of Victorians that a more studied analysis be undertaken of whether a sale, and if so what type of sale, would be desirable. It may be, for example, that an issue of equity to bank depositors (as has occurred with the conversion of several building societies to banks) could be more in line with Victoria's interests.

Attachment 1

Cash Flows and Asset/Liability Levels 1991-2000

The attached spreadsheet calculations illustrate what can be expected. Calculations are shown in real terms and in an inflationary environment of 5 per cent .The major assumptions are:

1. Assets grow at 2% p.a. in real terms.

2. The "clean" SBV earns a real net return on assets before tax of 1.05% p.a. (see attachment "Return on Assets").

3. SBV profits are allocated as follows:

   - 39% to the Victorian Government in lieu of tax

   - an amount is retained as an addition to equity capital to comply with Beserve Bank of Australia guide-lines

   - the residual is paid as a dividend to the Victorian Government.

4. The SBV raises extra non-equity capital resources at a rate which satisfies Beserve Bank of Australia guide-lines.

5. Risk weighted assets remain in the same proportion to total assets as currently.

6. Victorian Government Budget receipts from SBV in the form of payment in lieu of tax and dividends augment revenue sufficiently to allow Treasury to pay the Bank a reasonable rate of interest on the Tricontinental borrowing and to pay back the loan over the next nine years as Tricontinental is wound up.

7. The real interest rate paid by the Government owned Tricontinental to the SBV is 4% p.a.

8. The performing loans in the Tricontinental loan book repay $750 million over the next three years as they become due. This is consistent with the Victorian budget papers which show a net deficiency in Tricontinental of $1,600 million.

Plan to retain Victorian ownership of the State Bank Victoria

growth rate:	0.02
inflation rate:	0.05
equity/assets:	0.07
real r.o.e.:	0.15

Model assumptions

[1] ROA (nominal) = roe(real)*(1+infln)*(equity/assets) + infln *(equity/assets)
[2] Capital plus reserves = 4.1% of risk weighted assets
[3] Allocation to reserves aimed to achieve [2], remainder to Govt
[4] Other capital grows at product of inflation and real growth rates
[5] Weighted assets = 0.81112 total assets
[6] Real interest rate on Trico debt = 4%
[7] Payments to Govt used to repay Trico debt
[8] Profit = ROA (nominal)*Assets
[9] $750m of Trico loans repaid by customers over next three years

October 1990

Cash Flows and Asset/Liability levels

:Inflation rate 0.05
:Real Growth rate = 0.02
year to 30 june

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Assets	25052	26830	28735	30776	32961	35301	37807	40492	43366
net profit	318	340	365	390	418	448	480	514	550
Return On Assets	0.0127	0.0127	0.0127	0.0127	0.0127	0.0127	0.0127	0.0127	0.0127
Payments to Vic. Govt. and reserves									
tax @ 39% of profit	124	133	142	152	163	175	187	200	215
Dividend	135	144	155	166	177	190	203	218	1778
total to budget	259	277	297	318	340	365	390	418	1992
to bank reserves	59	63	68	73	78	83	89	96	
Bank Capital									
capital&reserves	833	892	956	1023	1096	1174	1257	1347	1442
other capital	1071	1147	1228	1316	1409	1509	1616	1731	1854
total capital	1904	2039	2184	2339	2505	2683	2874	3078	3296
wtd assets	20320	21763	23308	24963	26735	28633	30666	32844	35175
cap/wtd assets	0.094	0.094	0.094	0.094	0.094	0.094	0.094	0.094	0.094
TRICO									
Loans from SBV	2055	1735	1368	1197	989	740	443	93	-316
Customer repayments	250	250	250						
Interest@ 4% real	189	160	126	110	91	68	41	9	-29

Cash Flows and Asset/Liability levels

:Inflation rate 0
:Real Growth rate = 0.02
year to 30 june

	1991	1992	1993	1994	1995	1996	1997	1998	1999
Assets	23859	24336	24823	25319	25826	26342	26869	27406	27954
net profit	251	256	261	266	271	277	282	288	294
Return On Assets	0.0105	0.0105	0.0105	0.0105	0.0105	0.0105	0.0105	0.0105	0.0105
Payments to Vic. Govt. and reserves									
tax @ 39% of profit	98	100	102	104	106	108	110	112	114
Dividend	137	140	142	145	148	151	154	157	1109
total to budget	235	239	244	249	254	259	264	270	1223
to bank reserves	16	16	17	17	17	18	18	18	
Bank Capital									
capital&reserves	793	809	826	842	859	876	894	911	930
other capital	1020	1040	1061	1082	1104	1126	1149	1172	1195
total capital	1813	1850	1887	1924	1963	2002	2042	2083	2125
wtd assets	19352	19739	20134	20537	20948	21367	21794	22230	22674
cap/wtd assets	0.094	0.094	0.094	0.094	0.094	0.094	0.094	0.094	0.094
TRICO									
Loans from SBV	1945	1538	1110	911	698	472	232	−23	−294
Customer repayments	250	250	250						
Interest@ 4% real	78	62	44	36	28	19	9	−1	−12

Attachment 2

Return on Assets

To determine an appropriate return on assets we require several pieces of information. One is evidence on typical returns which have been achieved. This is given in the Table below which combines together post-tax rates of return on assets and estimates of the ratio of tax paid to assets of major trading banks over the years 1984-1988.

	After Tax Return on Total Assets (%) (a)	Tax Paid as % of Total Assets (b)	Nominal Pre-tax Rate of Return (c)
1984	0.9	0.59	1.49
1985	0.85	0.57	1.42
1986	0.68	0.48	1.16
1987	0.60	0.67	1.27
1988	0.75	0.74	1.49

(a) Source: KPMG Peat Marwick Hungerford 1989 Financial Institutions Performance Survey (p.4).

(b) Source: R Milbourne and M Cumberworth "Australian Banking Performance in an era of De-regulation: An Untold Story?" 19th Conference of Economists Sydney 1990.

(c) Sum of previous two columns.

The other piece of information is the link between these rates of return and the rate of inflation. Since the historical figures are nominal rates of return and will vary with inflation, we need to understand how they will vary in order to simulate for different inflation rates. To do that we assume the real rate of return on equity is constant and use the following;

Nominal rates of return

Return on Assets = Net Profits/Assets

= Net Profits/Equity * Equity/Assets

= Return on Equity * Equity/Assets

Nominal and Real rates of return

Nominal return on Equity = Real return on equity + Rate of inflation + Real return rate * Rate of inflation

$$= (r + p + r*p)$$

Where r = real rate of return on equity and p = rate of inflation.

Thus,

Nominal return on Assets = Nominal return on Equity * Equity/Assets

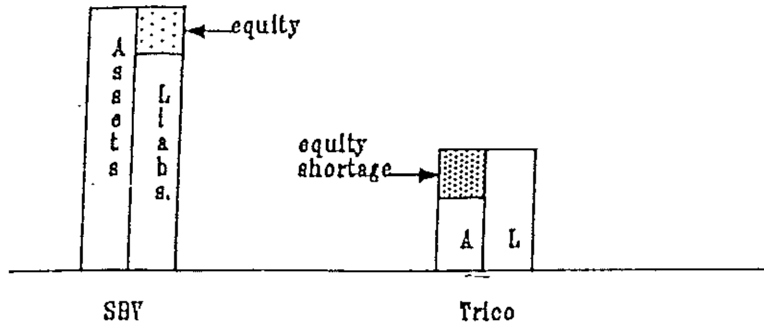
$$R = (r + p + r*p) \; * \; E/A$$

Where R = nominal rate of return on assets, E/A = the equity/ assets ratio.

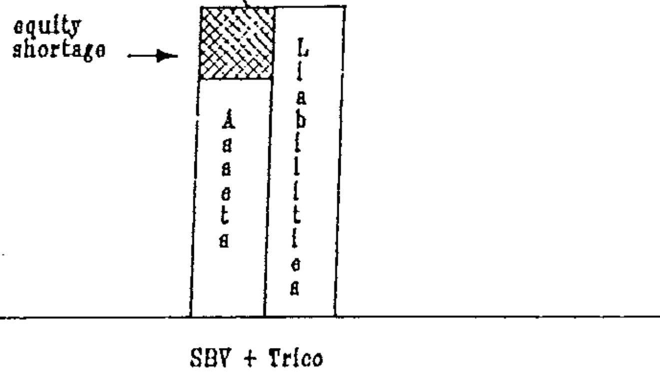
We chose a value of 1.05 per cent for a real rate of return on assets. Thus an equity/ assets ratio of 5 per cent corresponds to a 21 per cent real return on equity and with an inflation rate of 5 per cent, gives figures for a nominal rate of return on assets of 1.27 per cent as shown in the cash flows assets and liabilities table for the years 1991 to 2000.

ATTACHMENT **3** SBV and TRICO – Assets and Liabilities

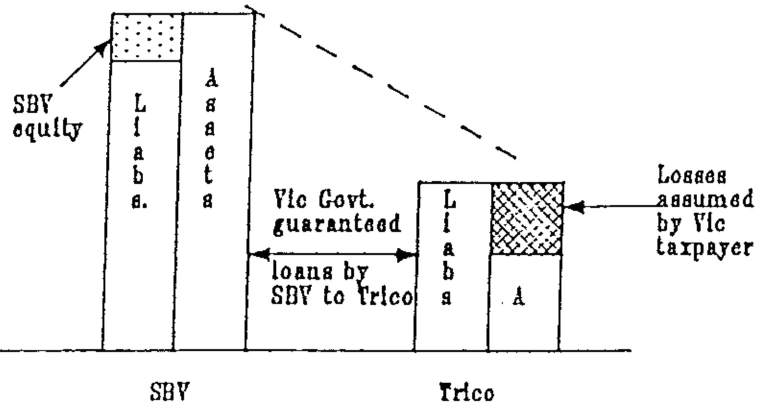
Stage 1: Trico losses first recognized



Stage 2: Trico folded into SBV



Stage 3: Trico taken out of SBV. Loans by SBV to Trico guaranteed by Vic. Govt.



Stage 4: ?

SOLD or **KEPT** | **KEPT REGARDLESS**

SOLD
Benefit: use receipt to reduce state debt and future interest obligation.
Cost: lose SBV future profit, still must service Trico obligation from budget revenue.

KEPT
Benefit: use future SBV profit to service Trico obligation and reduce state taxes.
Cost: do not reduce state debt, service debt interest from budget revenue

KEPT REGARDLESS
Cost: Vic. taxpayers bear the cost of past losses from Trico operations.