Southern Cross Building Society

Annual General Meeting - 15 September 2009

CHAIRMAN'S ADDRESS

Overview

The year under review was a very challenging one. Despite the very difficult economic environment, the Society demonstrated its resilience. In its 86th year of trading, the Society focused closely on retaining its strong level of liquidity whilst preserving its robust capital position.

F2009 Result

Despite the Society's balance sheet-orientated focus referred to at the Society's AGM a year ago, in the year under review the Society achieved an operating result of $3.2 million before impairment. Two key contributors to the lower operating result compared to the prior year were:

- the reduction in the size of the Society's mortgage portfolio given the liquidity focus and repayment and recovery of mortgages at the expense of growth in new lending; and
- a reduced net interest margin earned due to the Society's excess liquidity position earning interest at historically low rates given the sharp reduction in the Overnight Cash Rate by the Reserve Bank.

Impairment Experience

As was the case with a number of financial institutions, including banks, the Society's level of loans in arrears increased markedly during the period under review. Whilst Bob Smith will discuss the specifics of the Society's arrears position and impairment provisioning in his address, I would like to take this opportunity to mention some points that may provide some perspective on the quality of the Society's loan portfolio:

- Most of the increase in the loan arrears experienced arose from loans entered into before June 2007, i.e. before the Society's capital restructure and change in governance;
- It is important to distinguish between "arrears" and "impairment". Arrears includes any loan amounts in respect of which the borrower has defaulted but which in the Society's opinion, is unlikely to necessarily result in any loss to the Society . Impaired loans are those in which the estimated net realisable value of the underlying first mortgage property security may be below the carrying value of the loan.
- In the case of impaired loans, the Society makes specific provision against such loans (as at 30 June 2009 total provisions were $9 million - compared to total impaired loans at that date of $36 million). So despite the Society's first mortgage security position, the Society has provisions against almost 25% of the aggregate carrying value of the relevant loans. The Board and management of the Society think the Society's level of provisioning is realistic and perhaps conservative;
- In the year under review, Management reviewed the Society's lending criteria and lending processes - resulting in a tightening of the Society's lending policies. We do not expect a recurrence in the level of difficulties experienced in the loan portfolio during the past year.

<u>Balance Sheet</u>

In my opening remarks I mentioned the Society's strong liquidity and robust capital position. These are two critical components of balance sheet strength.

- Liquidity as at 30 June 2009 was more than double that required under the Society's trust deed (a position that continues today)
- Equity of $52 million as at 30 June 2009 provided one of the strongest capital positions in the Savings Institutions Sector.

Government Guarantee

In late August 2009 the Government announced an extension to the Crown retail deposit guarantee scheme. Although the Society's deposits remain covered by the current Crown guarantee until 12 October 2010, the Society is eligible to participate in the extension to the Crown guarantee - which applies for the period from 12 October 2010 to 31 December 2011. The Society has not yet determined whether it will opt into the extension of the Crown guarantee extension and is currently reviewing its position in this regard.

Dividend

As noted in the annual report, given the Society's bottom line financial performance in the year under review and the difficult market conditions experienced, the Board resolved to not declare any dividend for the year. As and when trading conditions return to normal, dividends may be declared to shareholders.

Industry Consolidation

As I referred to at the last AGM, the Society expects the industry in which it operates to undergo consolidation. This has also been suggested by a number of industry commentators. Despite the clear and obvious need for consolidation to enable non-bank deposit-taking institutions (such as the Society) to acquire scale to compete meaningfully in the market, very little consolidation activity has been undertaken to date. This is somewhat ironic given the strong imperative for consolidation borne out by the credit crunch. Industry participants have adopted a "wait and see" approach, probably largely concerned about the quality of others' asset portfolios. Despite this, the Board of the Society expects a change in the consolidation momentum during the next 12 months. Again, the Society is well positioned to participate in such consolidation.

Operating Environment and Outlook

The year under review was unquestionably a very tough test for the Society. Operating conditions are still tough but appear to be improving. The Society needs to remain cautious by continuing to focus on balance sheet strength and liquidity but we expect a resumption in the growth of the Society's loan portfolio.

I would like to ask Bob Smith, the Society's CEO to address you.

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CEO Address

The year can be definitely described as a game of two halves.

The First Half:

This can be characterised as a crisis of confidence by the investing public. Globally the financial markets were falling apart and our local version of this was the collapse of the finance company sector.

While our depositor reinvestment rates continued to be high due to the strong loyal customer support the Society enjoys, given the current environment investors were somewhat more cautious.

The Directors took an early decision that we should restrict lending to a minimum and adopt the age old proven position that liquidity is king in such adverse trading conditions.

The introduction of the Crown Deposit Guarantee changed the position overnight and we then ended up with an excess liquidity position, which then brings us onto the second half.

The Second Half:

The challenges for the second half of the year were,

- Competitive market for deposits
- Impairments and
- Soft lending market

Dealing with these in turn;

<u>Competitive Market for deposits</u>
Whilst the introduction of the Crown Guarantee restored depositor confidence, the Society saw the cost of funding dramatically increase. This has been driven by two factors:

1. The Banks stopped lending to each other

2. Under the new Banking Regulations the Trading Banks have to raise more of their funding from local (or retail) deposits (the same source of funds as the Society)

<u>Impairments</u>
The level of impairments is very disappointing given that we are a first mortgage lender. I can only reiterate that virtually all the impairments we have had to deal with were in respect of loans made prior to 30 June 2007.

We have taken strong action in respect of our lending portfolio. For example we have:

- completely overhauled our lending processes with far more stringent lending criteria now in place; and
- we have begun re-weighting the loan book in favour of smaller loan exposures and less risky residential loans.

Apart from the financial loss due to impairments, these pose a significant distraction to the Society's Management from focusing on growing the business.

Management and the Board have taken a very proactive and realistic approach to realising and providing for impaired assets.

Since 30 June 2009 the Society's total "net non-performing assets" (i.e. impaired loans plus arrears greater than 90 days past due, net of impairment provisions), adjusted for expected recoveries to 30 September 2009 have reduced to $25.4 million as at early September (compared to $28.7 million as at 30 June 2009).

The Society's total provisioning of $9 million as at 30 June 2009 is still considered by the Board to be appropriate.

<u>Lending</u>

It has been very difficult in the soft property market to find lending opportunities that fit our current lending criteria. We have refused to compromise on loan quality and as a consequence of this, and our loan impairment recoveries, we have seen the Mortgage Book reduce from

$338 million as at 30 June 2008 to $275 million as at 30 June 2009. A consequence of the reduction in our mortgage portfolio has been an increase in the Society's liquidity. Unfortunately this comes at a cost since the market returns on liquid assets such as cash, are very low in the current interest rate environment.

The result of the above is our operating profit before impairments has suffered, and as a result of impairments we have incurred a significant loss for the year, as the Chair has mentioned.

<u>Current Operating Environment</u>

Winter is typically a low period of activity and this year has been no exception.

However with spring around the corner we are starting to see our own version of that now hackneyed expression "Green Shoots."

For us that means we are starting to see the fruits of our hard work and patience reaping rewards with lending opportunities increasing, a slow down in arrears and impairment issues and a more predictable deposit market.

Regulatory Environment

It is clear that the Reserve Bank wishes the Non-Bank Deposit-Taking Sector to look and behave more like a Bank. Whilst we generally welcome this change and see ourselves as ultimate beneficiaries of this environment it does come at a significant cost.

I am pleased to report that the Management of Southern Cross has responded well to the increased level of compliance and we expect to meet all Reserve Bank and Treasury Requirements.

In addition I would like to reiterate that a BB (with stable outlook) long term credit rating from Standard & Poors is a good result in the current environment. Had we not had the same level of impairment, which we are now on top of, I believe this might have been a BB+ given the Society's strong capital position. However, that rating and better is a goal that we aspire to.

Operating Platform

Behind the scenes Management has significantly improved the operating platform of Southern Cross.

A few examples are:

- Much improved brand profile
- New lending processes
- A more decentralised structure with more customer service capability being implemented into the branches
- The launch of Internet and Telephone Banking
- The outsourcing of the IT infrastructure to a Civil Defence Grade Environment
- A new sales management system for lending
- Robust Treasury processes
- Ability to undertake fixed interest rate hedging to make us competitive in Residential Lending

Summary
This has been an incredibly difficult year and I would like to thank my fellow Board Members and my Management team for the support that they have provided during the year.

Despite a disappointing net result for the last year, we do have a very strong balance sheet and much improved operating platform to move forward on.

Thank You.