KPMG

cutting through complexity

Mutuals Industry Review 2014

Mutuals sector challenged for growth

Financial Institutions Performance Survey

November 2014

kpmg.com.au

Contents

1 Introduction

Australia's credit unions, building societies and mutual banks (together 'the mutuals') faced another challenging year in 2014 with a 1.5 percent decrease in operating profit after tax while achieving growth in assets of 3.0 percent. The industry remains well capitalised and continues to invest to grow in the coming years.

Snapshot of key financial findings:

- Impairment provisions remain low at 0.08 percent of average gross receivables (0.09 percent in 2013).
- Capital levels increased with an average capital adequacy ratio of 18.2 percent (17.9 percent in 2013).
- Total members increased by 4,361 (0.12 percent).
- Total branches reduced by 30 (3.1 percent).

The sector however has not enjoyed the growth achieved by the major banks over the past year:

- Net interest income grew by 2.7 percent – major banks 6.3 percent increase.
- Non-interest income fell by 1.4 percent – major banks 9.4 percent increase.
- Profit after tax fell by 1.5 percent – major banks 10.5 percent increase.
- Total assets grew by 3.0 percent – major banks 8.4 percent increase.
- Deposits grew by 4.0 percent – major banks 7.9 percent increase.

Please watch our video (control+click) for a summary of the report.

Within the sector mutual banks have fared better displaying a diverging pattern of higher growth with total assets growing by 4.1 percent.

The value of the brand 'mutual bank' is now emerging with 2 years of data and 10 institutions operating as mutual banks.

The cost to income ratio of mutuals, historically higher than that of the major banks has increased over the last 5 years from 68.8 percent to 78.7 percent. Personnel costs accounted for 45.9 percent of total operating costs. The cost to income ratio was lower for larger mutuals, indicating an opportunity for smaller mutuals to improve efficiency through collaboration.

Mutuals continue to look for merger opportunities with three mergers during the year resulting in the top 10 mutuals holding 62 percent market share, a 1 percent increase from 2013. Concentration of assets in residential housing loans has increased to 92 percent.

The key developments for the year were:

- Mutuals did not participate in the loan growth achieved by the major banks on the back of rising house prices.
- Mutuals did not obtain the benefits of lower wholesale funding costs with retail deposit funding at 96.6 percent, compared to 74.7 percent for the majors.
- Maturing fixed rate loans repriced at lower rates as interest rates remained low.

- The cost to income ratios remained high as the sector continues to invest in new technology and capabilities.

In many ways the mutuals faced the perfect storm of increased competition for home loans, limited access to cheap funding from wholesale markets, continued low interest rates and the need to continue to invest in new technologies and capabilities keeping the cost to income ratio stubbornly high.

From a financial system perspective, increased concentration of Australia's financial services businesses away from the mutuals is not in the best interests of maintaining a strong and diverse Australian banking industry.

This year's results demonstrate the time for industry transformation has arrived. Maintenance of the status quo is not an option as it will only result in a further widening of the gap. As a customer owned business, a mutual is uniquely differentiated from shareholder based institutions. This differentiation allows a mutual the opportunity to take a long term perspective on customer value creation by providing a wide range of products to a broader constituency during their life stages.

The relevance of branches continues to be questioned. A general consensus is that more investment in technology, i.e. online and mobile banking, is necessary as consumers are switching from face-to-face banking to online and mobile banking. However, large overhead costs and limited capability to invest in technology presents the sector both with a challenge and an opportunity, creating a sense of urgency to collaborate through strategic alliances and partnering.

Increasing industry concentration is a key issue being examined by the Financial System Inquiry.

KPMG made three recommendations to the FSI:

- Explore the scope for concessional risk weighting for low risk lending provided by mutuals.
- Allow mutuals to licence as banks.
- Recognise perpetual debt instruments as capital without the requirement to be converted to equity.

The results of the survey further support KPMG's recommendations to the FSI.

The future for mutuals is becoming increasingly clear with three key drivers:

- Mutual bank status is of real benefit with growth rates ahead of the industry.
- Collaboration is the most effective way to invest in new technologies and capabilities without punitive cost challenges (particularly for smaller mutuals).
- Diversification away from home loans to capitalise on lending opportunities in other parts of the Financial Sector – particularly small business.

Mutuals have a real choice to make as a sector. Continue to operate as individual small businesses or achieve scale benefits by operating collaboratively and by facing the market with a unified value proposition.

Mutuals act very independently of each other. To achieve sustainable market share growth and improved long term profitability we see some key opportunities for the sector to consider including:

- The establishment of shared service centres to provide back office functions such as account opening, servicing and maintenance
- Rationalisation of the existing branch network through branch sharing
- Adopting a consistent market facing position with comparable products and services
- Upgrading skills and capabilities
- Shared investment in new technologies and innovations.

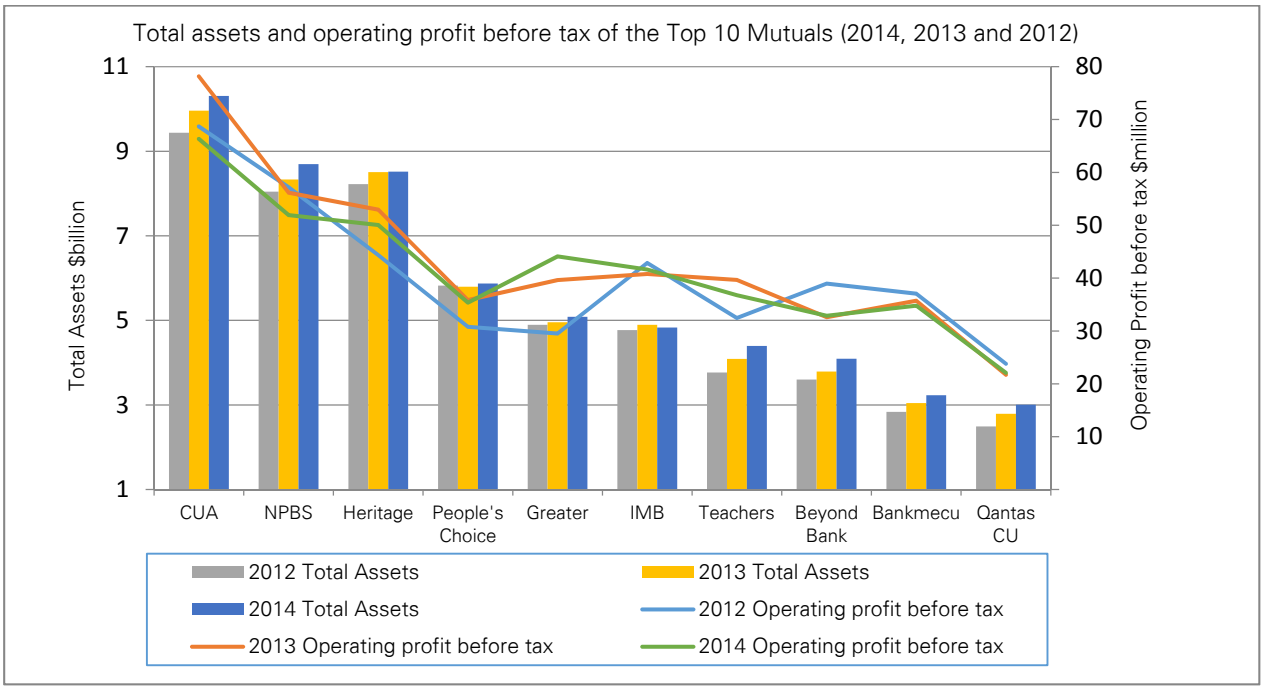
On the upside from a countercyclical perspective the sector has not participated to the same extent as its competitors in lending into the current house price inflation. If conditions tighten in the short to medium term and unemployment increases the mutuals may fare better. In this environment the real value proposition of a mutual can be more tangible in the marketplace. As a customer owned institution a mutual can take a long term view to work through customer challenges as they arise.

The survey included a qualitative questionnaire covering the risks, challenges and opportunities facing the industry. The results of the questionnaire are included throughout the body of the report.

KPMG would like to take this opportunity to thank each organisation that participated in the survey. Without your support this survey would not be possible.

For the purposes of preparing our charts and analysis KPMG has disclosed the results of the Top 10 mutuals ('the top 10') together with the results of the remaining mutuals (i.e. non top 10 mutuals).

The chart below shows the total assets of the top 10 as well as their operating profit before tax.



> The mutual sector is at a critical point… The sector's 5 percent market share has deteriorated… Despite this, our sector has the opportunity, and the responsibility to ourselves and our members, to grow in relevance to become the genuine alternative…
>
> *People's Choice, Annual Report*

2 Mutual banks

Awareness of the new P&N Bank brand amongst the general public continues to grow with more people considering P&N Bank as a genuine banking alternative to the major banks.

P&N Bank, Annual Report

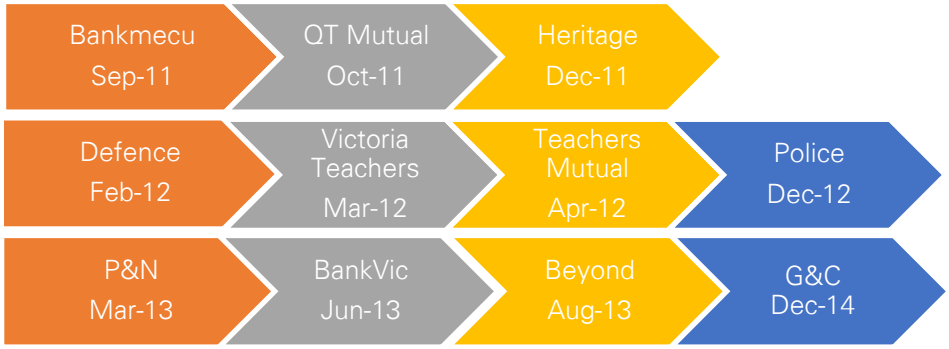
Mutual banks grew by 4.1 percent in 2014, compared with 5.4 percent increase recorded in the previous year. Their growth exceeded the rest of the mutuals industry which saw 2.5 percent growth in 2014 and 2.9 percent in 2013.

The Competitive and Sustainable Banking System package – announced in December 2010 – provides the opportunity for mutuals with Tier 1 capital of at least $50 million to present themselves as a bank. 2014 marked the first full year of mutual status for three mutual banks and the second year for the remaining six.

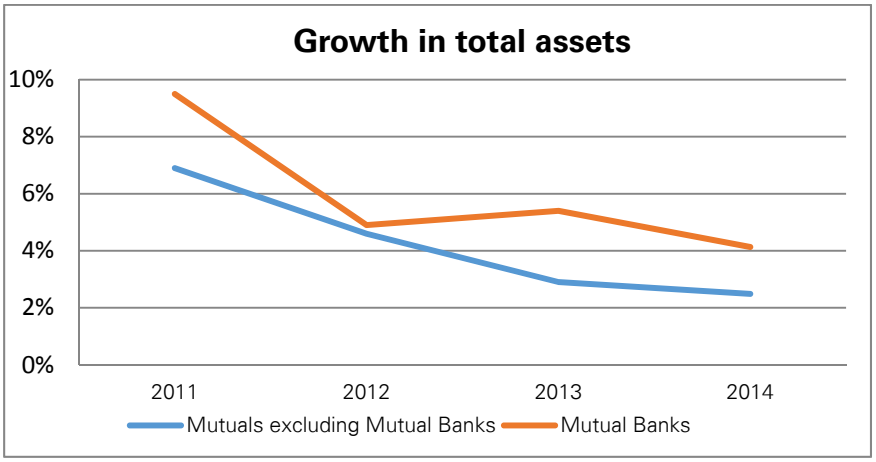
On 1 August 2013 Community CPS Australia Ltd changed its status to Beyond bank.

This survey includes all 10 mutual banks ('the mutual banks'), which represent 32.3 percent of total assets of the sector. SGE Credit Union announced the conversion to G&C Mutual Bank, effective 1 December 2014, in its 2014 annual report.

Transition to mutual banks



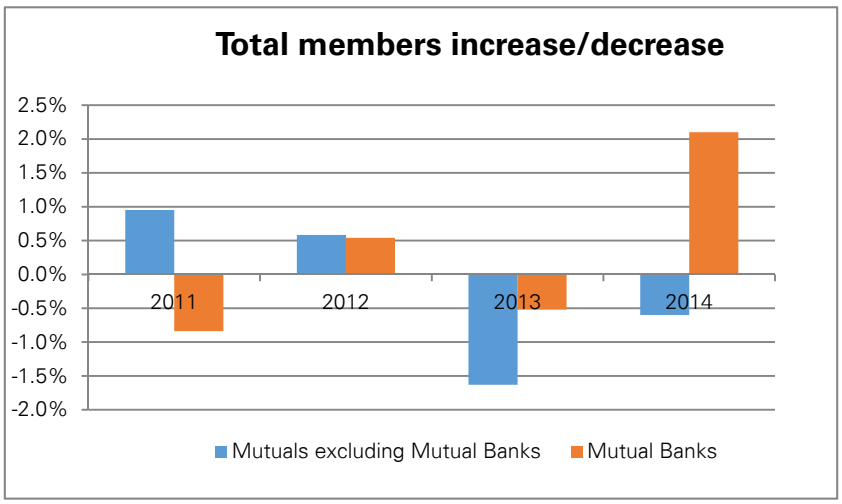
Below are the results of the mutual banks as compared against the results of the remaining sector.



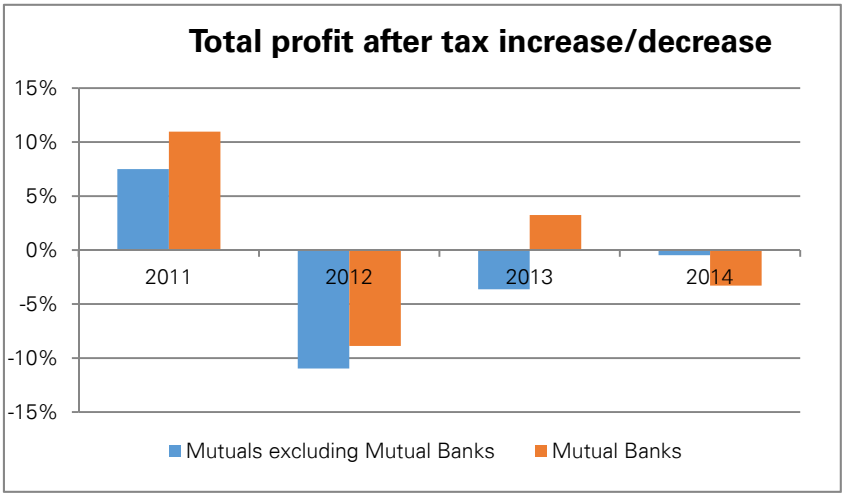
The upcoming launch of G&C Mutual Bank will see us join the ranks of the thriving 'Mutual Bank' sector, which now comprises 11 of Australia's largest and most successful member-owned financial institutions.

SGE Credit Union, Annual Report

The diverging pattern of growth between mutual banks and non-bank mutuals is likely to be associated with higher brand awareness of the mutual banks and their ability to use the terms 'bank' and 'banking'.



Mutual banks have increased members by 2.1 percent whilst other mutuals' memberships slipped in each of the last two years. Beyond Bank and Teachers Mutual Bank acquired the largest number of new members, with 6 percent (through merger of Alliance One Credit Union) and 4 percent increase respectively.



In contrast to the prior year, 2014 profit after tax of the mutual banks has decreased by 3.3 percent (2013: increase of 3.2 percent). This decline was predominantly due to the transformation of mutual banks with re-branding, investment in people, technology and new products. Other mutuals' profit growth excluding mutual banks continues with the declining trend in terms of profits after tax, with a decrease of 0.5 percent (2013: decrease of 3.6 percent).

3 Consolidation

The proposed merger will result in a very strong and secure banking institution, will offer staff better opportunities for development, and the expected economies of scale…

Select Credit Union, Annual Report

The number of mutuals has decreased to 103 at 30 June 2014 (2013: 106), and one of the mergers involved one of the top 10.

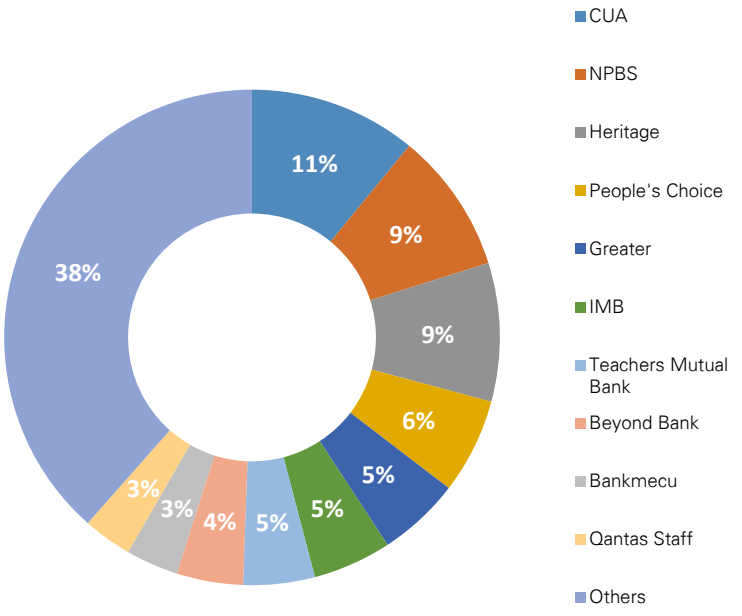
The recent merger activity is summarised in the table below.

Merging entity one	Merging entity two	Status completed
Alliance One Credit Union	Beyond Bank Australia	August 2013
Tartan Credit Union Ltd	Select Credit Union Limited	October 2013
Swan Hill Credit Union Limited	Bankmecu	June 2014

The mutuals continue to look for merger opportunities. Post June 2014 Encompass Credit Union has announced a proposal to merge with Select Credit Union subject to regulatory and member approval. Eighty-two percent of mutuals believe there will be less than 80 mutuals in five years.

The 2014 market share shows that the sector is becoming more concentrated with the top 10 entities holding 62 percent of the market (2013: 61 percent).

2014 Mutuals market share by total assets



4 Merger activity – taxable gain or tax neutral event?

With continuing merger activity, the ATO has recently confirmed its tax neutral approach to credit union mergers and has extended this to tax attributes not previously considered.

KPMG

With the appetite for collaboration continuing through increased mergers, the ATO released a view on the income tax treatment of mergers which more closely aligns with the commercial and prudential treatment.

KPMG has recently been involved in obtaining a private binding ruling, which confirms the tax neutral treatment of credit union mergers and extends the view to certain other tax attributes not previously covered by the ATO's published views.

Firstly, taking a step back, mergers are governed by the Financial Sector (Business Transfer and Group Restructure) Act 1999 ("FSBTA"). Under this Act, the statement of compliance that is required to be issued in respect of a merger specifically states that the transfer of assets and liabilities under the FSBTA is taken to have the same taxation implications for both the merging and continuing credit union, as if the assets and liabilities are 'transferred in a normal sale'. This is contrary to the treatment prescribed for all other purposes under the FSBTA, which provides for a neutral succession at law.

Whilst the ATO has historically taken the pragmatic view instead of a strict legal interpretation of the 'normal sale' provision, there has to date been very little in the way of formal guidance. The recent private ruling that KPMG has assisted with obtaining not only confirms the ATO view but also extends the view to tax attributes not previously contemplated (such as the transfer of losses and franking credits). In summary, ensuring that the tax attributes of the merging credit union survive in the succeeding credit union.

Whilst a private ruling is binding on the Commissioner, it is only binding for the particular applicant in the context of the specific facts and circumstances and cannot be relied upon by other taxpayers.

For credit unions that have undertaken a merger in the past 5 years, or are considering merger activity in the near future, we recommend obtaining a private ruling from the ATO to obtain certainty around the tax neutral treatment of the merger. KPMG Australia has experience in this area and can assist in obtaining a successful outcome in the most efficient manner.

Please contact Natalie Raju on 02 9335 7929 or email nraju1@kpmg.com.au for further information.

5 Data Analytics- are you the disrupter or being disrupted in your industry?

Data analytics helps with compliance with APRA's new Risk Management standard, CPS 220, which requires institutions to maintain effective systems for risk monitoring and reporting.

KPMG

Many mutuals find investment risk management systems, analytics and interactive reporting systems a challenge.

Some of the key problems are:

1) Scale – lack of economies of scale.
2) Capability – attracting a strong calibre of talent with analytics, risk management and IT skills.
3) Intellectual Knowledge – cutting edge targeting and risk management practices advance each year.
4) Data Quality – a common issue in data analytics is assessing data quality and ensuring that the data is 'fit-for-purpose'.
5) Insight – moving from data to insight to action is a key challenge for any organisation, forward-looking predictive analytics is key to this, and is in its infancy.

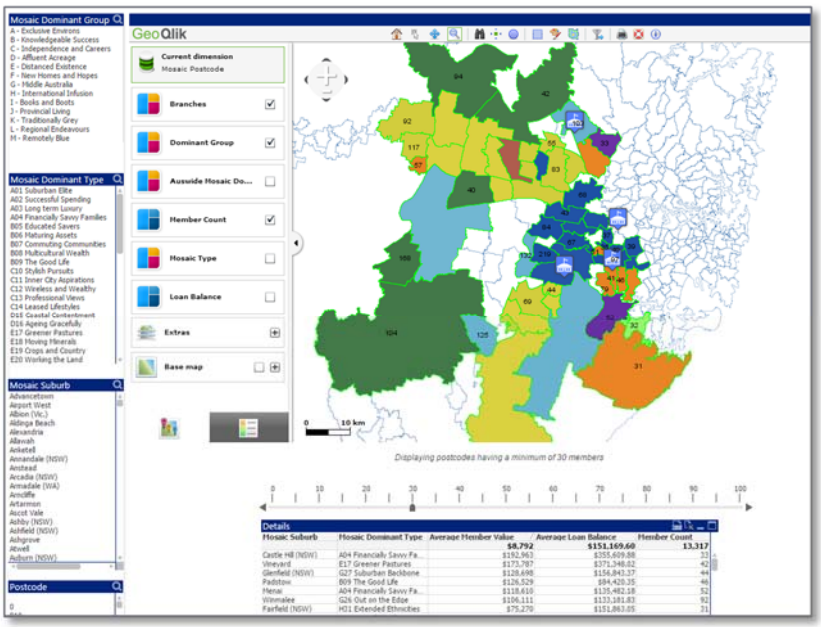
In order to address these challenges, KPMG has developed a suite of interactive solutions that allow data analysis and exploration, and the uncovering of actionable insights that help growth, and manage cost and risk.

This approach has a number of advantages. Identifying prospecting and cross-sell opportunities through demographic and economic-based insights helps with growth. It assists with cost efficiency with the ability to tap into cutting-edge analytics without large amounts of up-front capital investment. It assists with loss mitigation, by enabling institutions to reduce the probability and extent of credit losses by using the wealth of internal and external data to make better credit and pricing decisions.

The suite of solutions presents an interactive view of member data, and includes various forms of member segmentation, with each segment selected and profiled. Types of segmentation lenses include Mosaic micro-segmentation, member value, loan behaviour and credit and debit spend behaviour deciles. Through these various segmentation lenses, members spending patterns across credit and debit channels can be profiled. For example, payments to other financial institutions can be readily explored for insights around cross-product targeting.

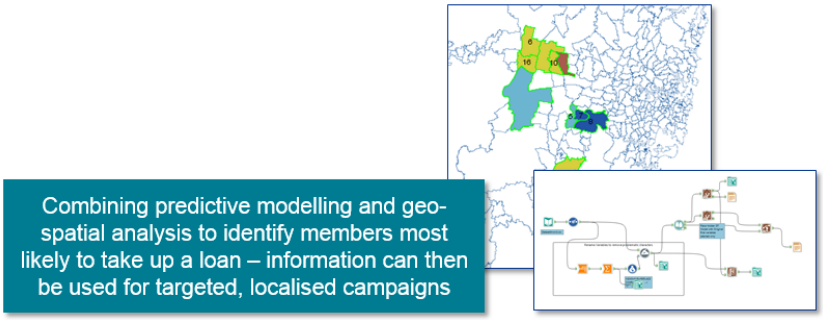
Source: KPMG Australia analysis, 2014

A greater understanding of member demographics can be garnered through geospatial analysis and interactive mapping. This includes an understanding of the member's Mosaic segmentation profile, as well as insights around the relationships between member populations, Mosaic types and branch location.



Source: KPMG Australia analysis, 2014

Predictive models are also used in conjunction with the dashboard for a number of applications, such as uncovering the characteristics behind high value customers and determining where to find more of them, delinquency prediction based on historical arrears behaviour, and likelihood to take up particular products. The modelling output is particularly powerful when combined with the interactive maps.



Source: KPMG Australia analysis, 2014

In terms of risk, a detailed risk analytics dashboard has been built that visualises the entire portfolio and allows historical trends to be analysed. It also offers the ability to slice and dice through various dimensions of portfolio composition. It also provides analysis around dynamic LVR ratios, and allows the user to stress test the portfolio under different scenarios.

Source: KPMG Australia analysis, 2014

In summary, through focussing on business intelligence and data analytics, you can combine multiple, disparate data sources into a single member view, interrogate this dataset for insights through an interactive reporting front-end, create new metrics and innovative data visualisations that help track business performance, build new segmentation views and forward-looking predictive models, and garner and communicate these actionable insights to a wide variety of stakeholders to help the institution grow, and manage risk and cost.

If you are not focusing on better understanding your members and managing risks, your competitors are - are you the disrupter or being disrupted?

Please contact Stephen Hastings (shastings@kpmg.com.au) for further information.

6 Assets and assets quality

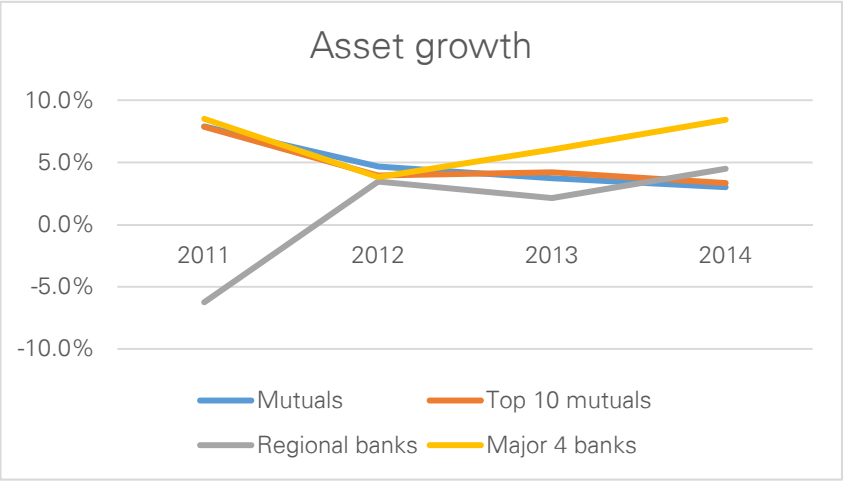
Growth is important because it provides the Bank with scale, which brings efficiencies as well as opportunities for staff and customers.

Bankmecu, Annual Report

Growth in total assets has slowed to 3.0 percent (3.7 percent in FY13) whilst major banks growth rate has jumped to 8.4 percent (5.8 percent in FY13) on the back of continuing housing price growth.

The Australian housing market experienced strong growth, especially in major capital cities, both in price and value of loans.

While the major banks and regional[3)] banks have taken advantage of this uptrend – see table below – the mutuals overall have not with a downward trend in growth rates of total assets (3.0 percent overall and 3.3 percent for top 10).



The sector considers growth as one of its biggest challenges in the year ahead. Acquiring new members, particularly, of the younger generation is a key strategic focus in growing market share. Member numbers have increased by 4,361 (0.12 percent) during the year.

Source: FIPS Mutuals 2014 Survey Questionnaire

KPMG's survey Digital Perspectives – Insights through to outcomes of its younger professional group identified that 65 percent of respondents want financial coaching to help make smarter investment decisions.

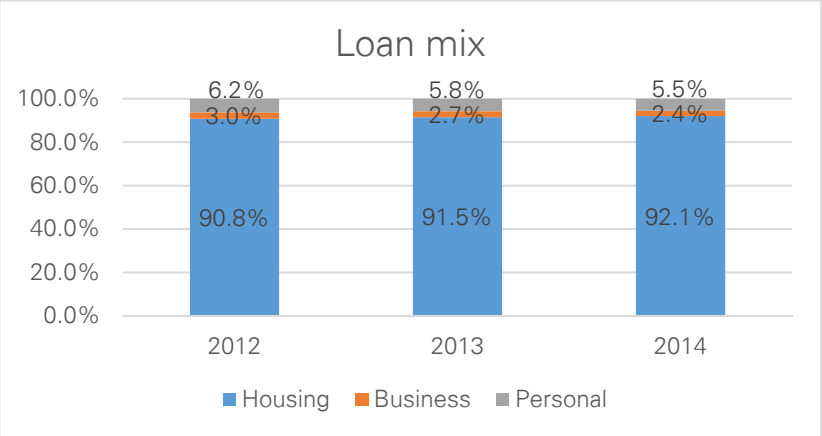
KPMG

The mutuals loan portfolio became more concentrated on residential mortgages during the year. Business loans and personal loans showed a continuing decline. To achieve growth, diversification of service and product offering continues to be a key challenge. Wealth management, financial planning, and insurance are emerging areas to diversify revenue streams. Key highlights of portfolio diversification of service and product offering include:

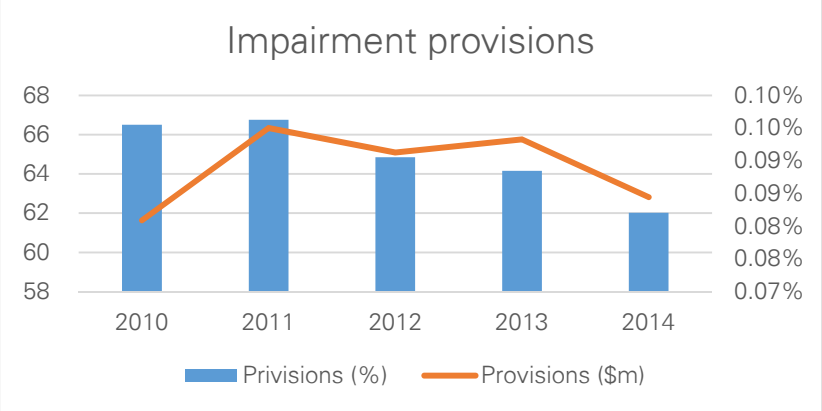
- CUA's transition of CUA Health as a 'for profit' fund and a sale of Financial Planning to Bridges Financial Services*.

  (**Bridges remains CUA's partner for referring customers for financial planning.)*

- Police Bank's acquisition of a financial planning practice in Newcastle.
- People's Choice Credit Union's alliance with BT as a wealth management partner.
- Greater Building Society and IMB introduced to small businesses the option of linking their accounts to third party online accounting software for managing business finance.
- P&N Bank made significant changes to credit and process policy for broker services.
- Community First Credit Union introduced a low-interest, 10-year solar loan.



The sector's low impairment provisions, both in dollar terms and percentage of gross loans, remains at historically low levels of 0.08 percent (0.09 percent in 2013). In future years if interest rates and house price inflation return to more normal levels provisions are expected to return to historical levels.

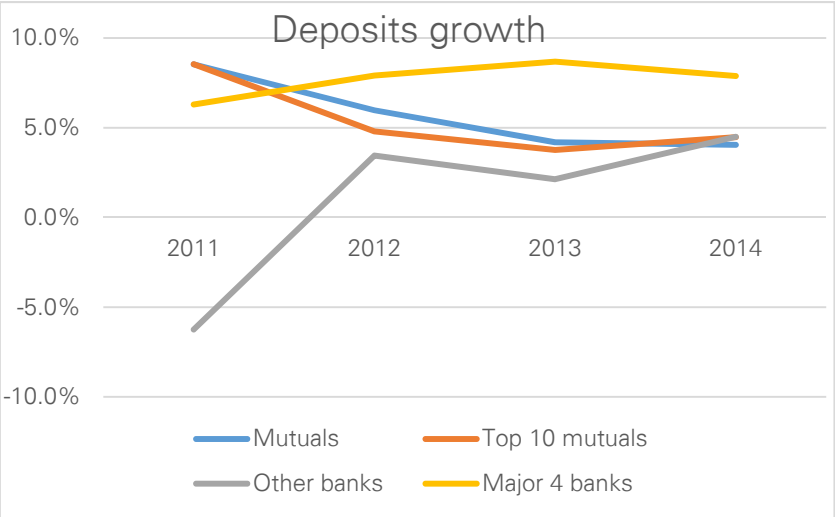


7 Deposits

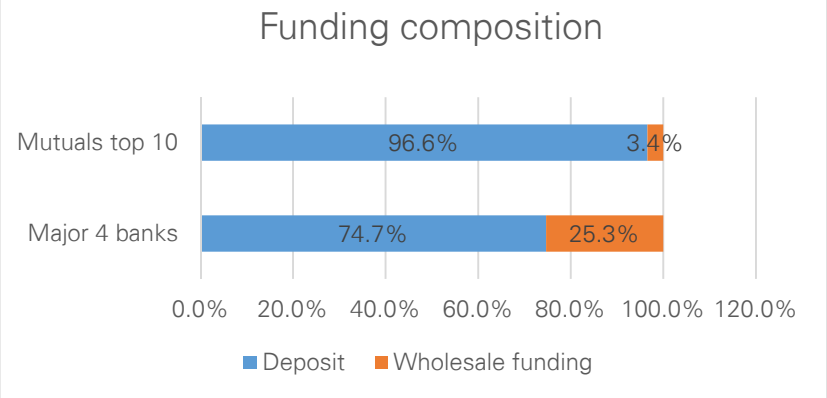
The decline in total assets is due to a decision to not pay overly high interest rates for large dollar value term deposits. We are paying fair market rates on our deposits, and our credit union is in a stronger financial position as a result of this decision.

Capricornian, Annual Report

Retail deposits are the primary source of funding for the mutuals as they have limited access to other types of funding such as institutional deposits and wholesale funding. Deposits across the mutuals grew by 4.0 percent (2013: 4.2 percent).



Larger mutuals such as the top 10 are in a better position to access wholesale funding. However their concentration of funding on retail deposits (over gross loans) of 96.6 percent, compared with the majors 74.7 percent, demonstrates the sector's significant reliance on retail deposits. Diversification of funding through collaboration within the sector is necessary in order for the mutuals to access cost effective wholesale funding.



8 Capital

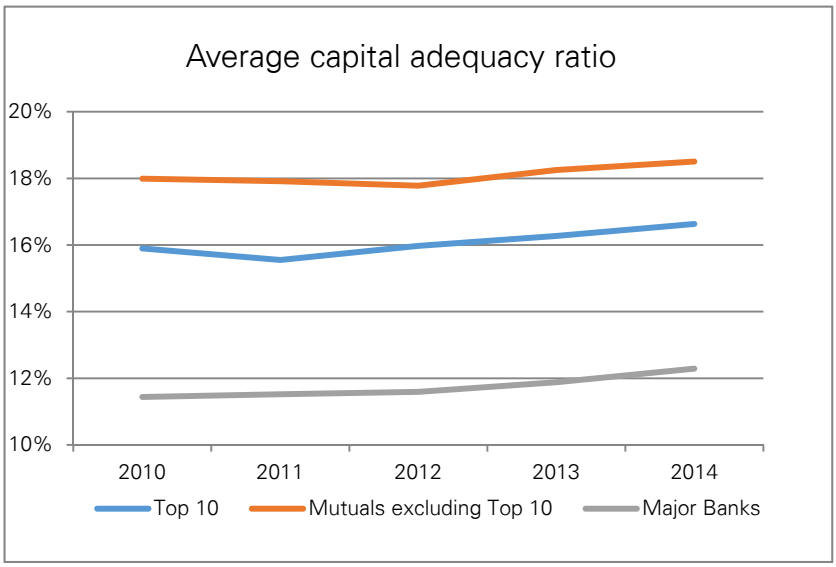
The profit Newcastle Permanent generates is entirely retained in the business to provide additional capital and enhance product quality and value for the benefit of the members.

Newcastle Permanent Building Society, Annual Report

Average capital adequacy ratio has increased to 18.2 percent from 17.9 percent.

The mutuals have continued to maintain strong capital adequacy ratios during 2014, with an average of 18.2 percent (17.9 percent in 2013). The Top 10 have maintained a lower average ratio of 16.6 percent (16.3 percent in 2013).

The reasons for continued high capital ratios remain consistent with prior years, being continued profitability, conservative risk appetite, and minimal capital management transactions. We expect effective capital management funding plans, growth and profitability to contribute to ongoing prudential strength.

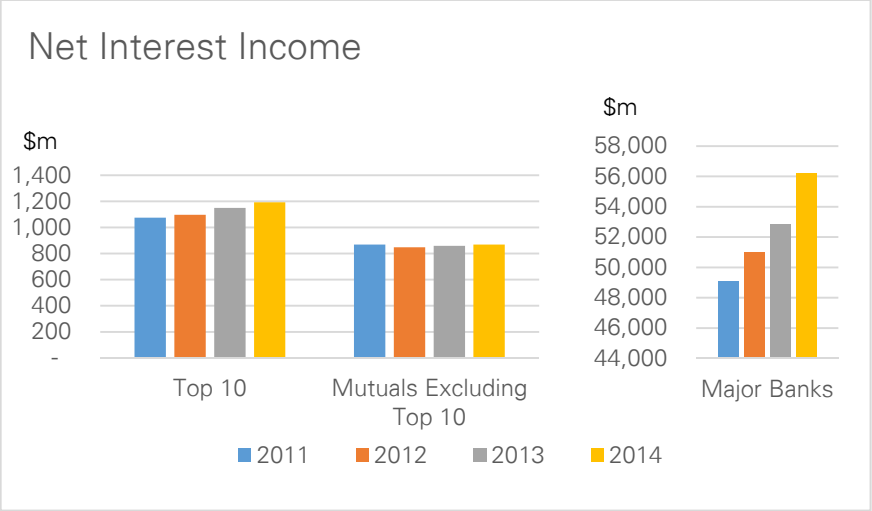


9 Net interest income

Throughout 2013/2014, the broader financial sector has continued to face challenges as tight margins and a difficult funding environment persist, driven by a more conservative consumer.

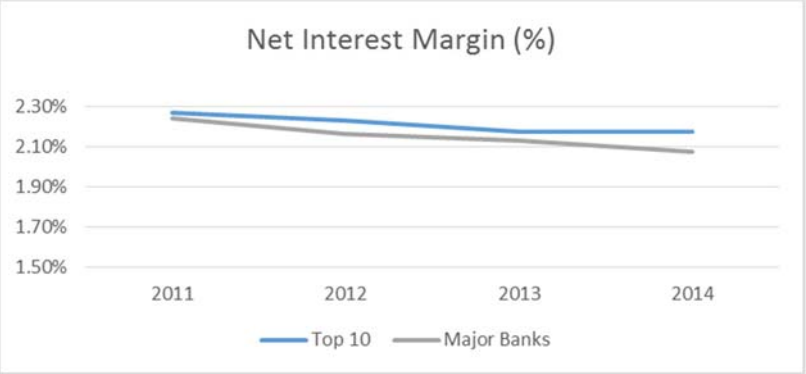
Beyond Bank, Annual Report

The top 10 mutuals recorded net interest income of $1.19 billion in 2014 (2013: $1.15 billion). The rest of the industry excluding the top 10 had $869 million (2013: $859 million).



The changing financial market and historically low interest rates have led to greater pricing competition in the financial sector, which in turn has caused continued downward pressure on residential lending margins. Slow growth in net interest income is also associated with a decreasing level of deposits and limited access to wholesale funding, leading to lower spreads between their lending and funding rates. Ageing member bases and low member growth are other contributing factors to constraining growth in net interest income.

The net interest income of the mutuals is significantly dwarfed by the major banks performance. During FY14, top 10 Mutuals have shown an increase of 3.65 percent to $1,193 million in their combined net interest income. Performance of the other mutuals (excluding top 10) remains low showing growth of 1.06 percent. In comparison, the major banks have shown a healthy increase in total net interest income of 6.3 percent.



The top 10 mutuals NIM remains higher than the major banks due to their larger capital base.

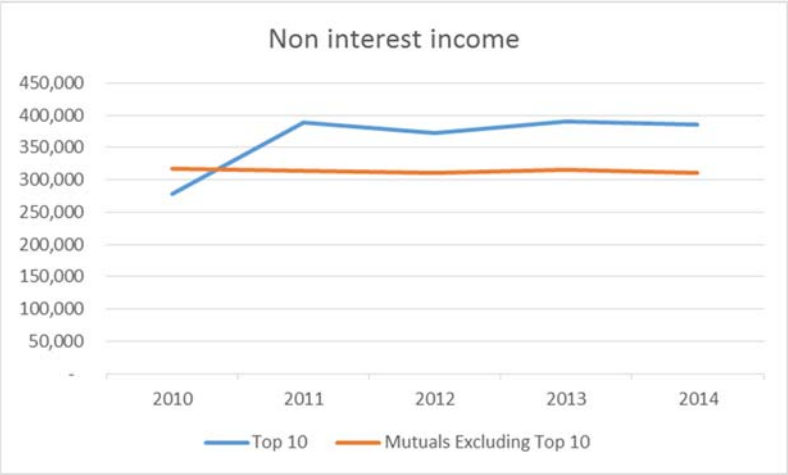
10 Non-interest income

Attracting new members in the younger demographic continues to be a focus. Gains have been made in this area with 66 percent of the new members to Summerland in 2013/14 being aged 49 or younger.

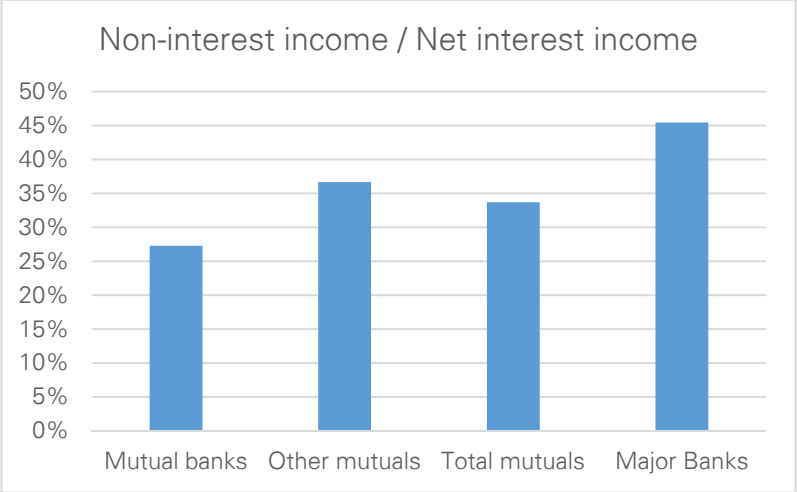
Summerland, Annual Report

Total value of non-interest income generated during the year was $385 million, which represents 34 percent of the total net interest income.

The top 10 mutuals recorded non-interest income of $385 million (2013: $390 million) while the rest of the industry excluding the top 10 mutuals recorded a value of $310 million (2013: $315 million). No growth was observed in non-interest income in the top 10 and other mutuals.



Mutual banks have lower non-interest income relative to net interest income, i.e. more revenue is generated from interest income, due to the mutual banks growing their loan books faster than the other mutuals. Mutual banks' non-interest income has increased by 2.2 percent whilst the other mutuals have decreased by 2.6 percent. Mutual banks non-interest income represents 26 percent of total non-interest income for the industry.



11 Costs

The new look branch offers more advisory and personalised services for our members, iPads and free WiFi. Defence Bank remains committed to investing and developing new technology.

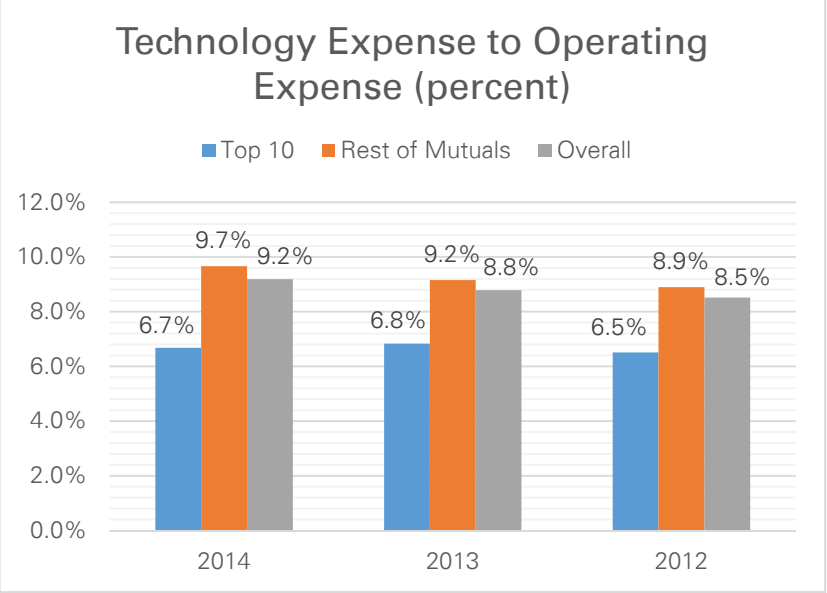
Defence Bank, Annual Report

Mutuals continue to be disadvantaged by lack of economies of scale with average cost to income ratio unchanged at 79 percent.

On average, there has been little change in the cost to income ratios for the financial industry. However, mutuals continue to be disadvantaged by lack of economies of scale. Major banks have consistently maintained a significantly lower cost to income ratio (average 45.9 percent) compared to mutuals (average 78.7 percent). Economies of scale allow the larger competitors to offer competitive prices while reducing their costs.

With the rapid move to digital banking, mutuals are investing in their technology base along with all competitors in the financial services industry. Larger organisations are able to access economies of scale to reduce technology costs. Mutuals incur significant costs to transform their technological capabilities. Collaboration will allow the sector to work together to access and advance their information technology at a more efficient rate. The key to improving efficiency and positioning is through collaboration across the sector.

The top 10 mutuals relative weight of technology expense to total operating expense has remained steady around 6.7 percent on average compared with 9.2 percent for the rest of the sector. This could be explained by the benefits of economies of scale larger mutuals have when investing higher dollar amounts compared to smaller mutuals.



Currently, the most significant cost for mutuals is personnel costs. Overall, personnel expenses make up 47.3 percent of the total operating expenses for the top 10 mutuals, and 44 percent for the rest of the sector. Personnel expense relative to total operating expense has

increased from 46.2 percent to 47.3 percent for top 10 mutuals and from 43.2 percent to 44.0 percent for the remaining mutuals.

Customers are increasingly switching from face-to-face banking to online and mobile facilities and accommodating this transition has required reviewing the current level of overhead costs. A number of mutuals have taken up this initiative such as Encompass Credit Union's branch sharing arrangement with My Credit Union and Community First Credit Union's strategic alliance with not-for-profit health fund, Peoplecare.

Source: Encompass Credit Union

Fiscal 2014 was a year in which we reflected on who we are, why we exist and what value we add. These are difficult but compelling questions which go to the heart of our sustainability. We intend to continue our rich heritage of supporting Members through all stages of their life.

Gateway Credit Union, Annual Report

According to the survey, opportunities to improve performance lie in…

'Increased efficiency' – 33 percent

'More collaboration' – 20 percent

'Alliance partners' – 10 percent

Source: FIPS Mutuals 2014 Survey Questionnaire

12 Taxation considerations – GST opportunities

While operating costs continue to increase, it is important to evaluate and review your GST policies, processes and procedures to ensure that GST incurred on costs is recovered to the full extent.

KPMG

GST continues to be an area in which there are plenty of opportunities to increase recovery.

Mutuals incur GST on various overhead costs and acquisitions from their suppliers which, as a general rule, cannot be recovered in full. However, based on our experience, many mutuals are not recovering the GST to the extent of their entitlement.

Areas that should be at the forefront of your evaluation of the effectiveness of your GST profile include:

- apportionment
- Reduced Input Tax Credits ("RITCs"), and
- opportunities to review current GST recovery and the potential use technology to review data and automate procedures.

Apportionment

Mutuals undertake a mix of activities, some of which give rise to an entitlement to recover GST and others which restrict GST recovery.

Accordingly, financial supply providers need to make a fair and reasonable estimation of their entitlement to recover GST on costs on an apportionment basis that is appropriate and accurate.

By undertaking a review of your apportionment methodologies, you may be able to realise additional benefits by accurately capturing and maximising GST recovery on costs.

RITCs

RITCs are available on certain costs specified within the GST Regulations. Accordingly, it is important to regularly review your entitlement to RITCs based on the nature of your acquisitions and any relevant changes to the GST Regulations and their interpretation.

Using Technology

The ATO has increased its activity in the finance and investment industry, particularly in its scrutiny of apportionment methodologies and RITCs claimed.

Based on our observations, we note that mutuals, as financial supply providers, generally have apportionment methodologies that are manual in nature and often do not capture all relevant variables. Consequently, the resulting apportionment may not be accurate in calculating an entity's entitlement to recover GST.

For that reason, it has been increasingly important to review apportionment methodologies and consider the use of technologies to ensure that these methodologies are fair, reasonable and accurate.

Please contact Alison Marshall on 02 9335 7386 or email armarshall@kpmg.com.au for further information.

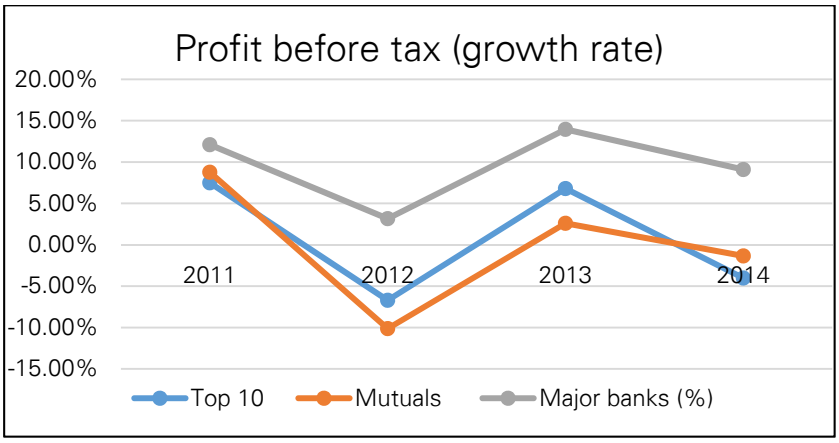
13 Profits

Not only do we maintain a close eye on the financial metrics, we also take into account our relationships and performance with our people (staff and members), our environment, and the communities in which we operate.

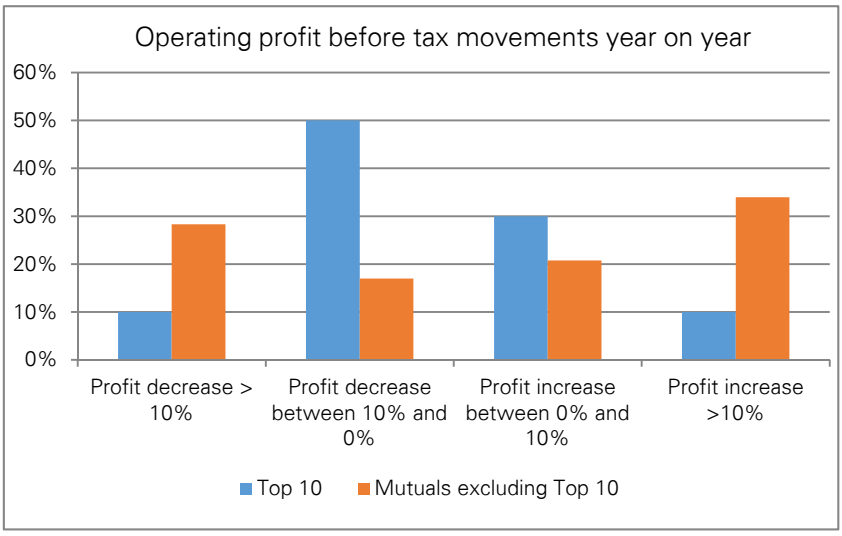
Community Mutual Group, Annual Report

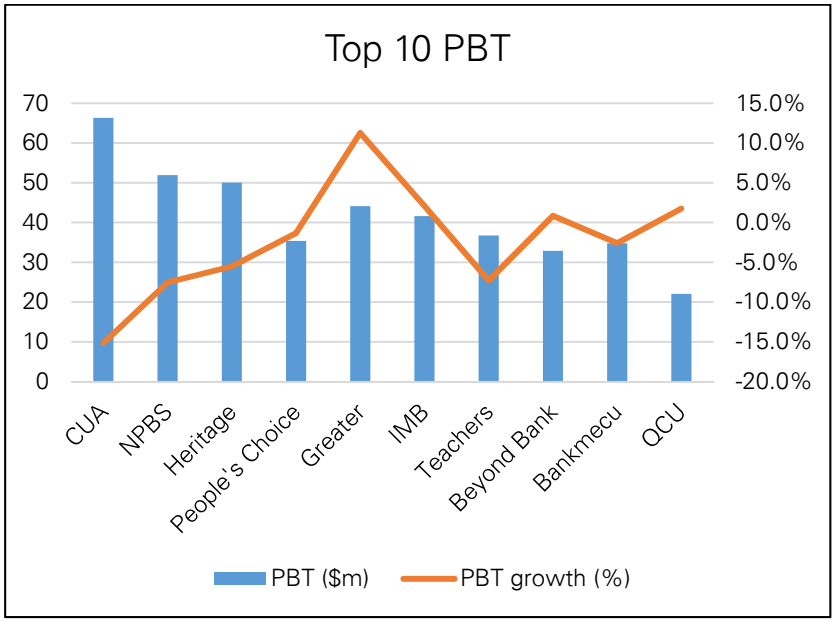
Operating profit after tax are down by 1.5 percent to $464 million. Top 10 mutuals profits of $416 million represent 64 percent of the total sector.

The mutuals have booked an overall profit before tax of $645 million in FY14, a 1.3 percent decrease from the prior year. This compares to the major banks 9.1 percent growth in profits. The top 10 mutuals, which represent 64 percent of the total PBT, recorded a negative growth of 4.0 percent. Major drivers that reduced profits were higher personnel costs and implementation of technology and training. Limited profit growth was also a result of competitive market conditions, i.e. tighter margins, difficult funding environment, and low brand awareness.



The top 10 mutuals represent 64 percent of sector profit and this concentration is expected to strengthen with further consolidation.





Contribution to communities is a key differentiator of the mutuals. To give back to the community, mutuals make significant donations to charities as well as being involved in community events.

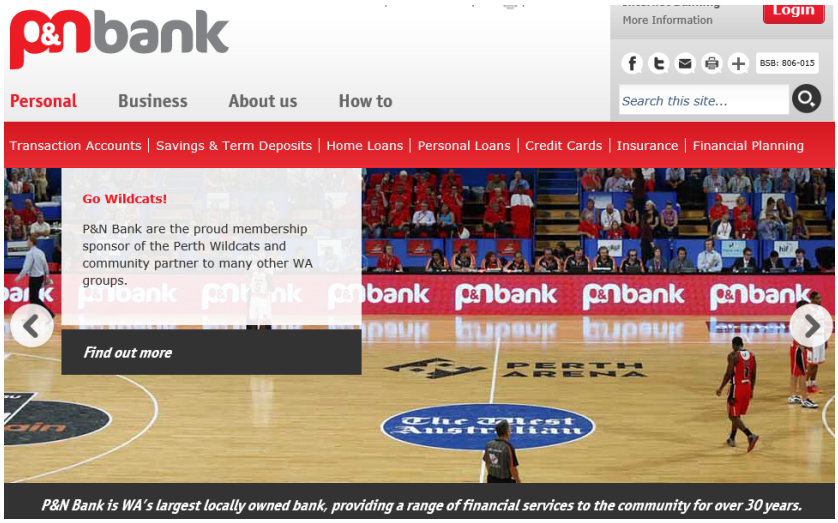
The Credit Union Christmas Pageant held in Adelaide attracts more than 300,000 people each year with competitions, floats and activities. The pageant is sponsored by People's Choice, Beyond Bank, Credit Union SA, Police Credit Union.

Source: Credit Union Christmas Pageant

Newcastle Permanent Building Society invites the community to "come sing with princesses, fly with dragons and build your imagination with Lego"[5]. *Newcastle Permanent's Cinema Under the Stars* screens at 16 different locations in NSW from Mudgee to Coffs Harbour.

Source: Newcastle Permanent Building Society

P&N Bank have taken a different approach as the membership sponsor of WA NBL team, Perth Wildcats.



Source: P&N Bank

Anti-Money Laundering and Counter-Terrorism Financing Changes

Amendments to the AML/CTF Rules came into effect from 1 June 2014 requiring Reporting Entities (RE's) to undertake a number of additional actions.

These include: more detailed knowledge of the beneficial owners of an account and also, that unlike previously where there was a 25 percent threshold, the test of beneficial ownership is also focussed on control, thus an account may be in the name of a person but controlled by another, unnamed person and the RE must take reasonable steps to establish the beneficial owner. Changes to Politically Exposed Persons (PEPs) now extends to domestic PEPs and immediate family members of a PEP.

There are other changes regards trusts, recording keeping and a number of other areas. AUSTRAC has allowed for RE's to put in place a Transition Plan if they have not put these changes into effect for 1 June, however such a plan must be documented and approved by the RE's CEO prior to 1 November 2014, with all RE's requiring to be compliant by 1 January 2016. RE's should pay particular attention to High Risk customers as these need more immediate action

Please contact David Luijerink (dluijerink@kpmg.com.au) for further information.

14 Technology

This investment in transforming our business for the digital age is non-negotiable – we must make these changes to stay relevant to our customers

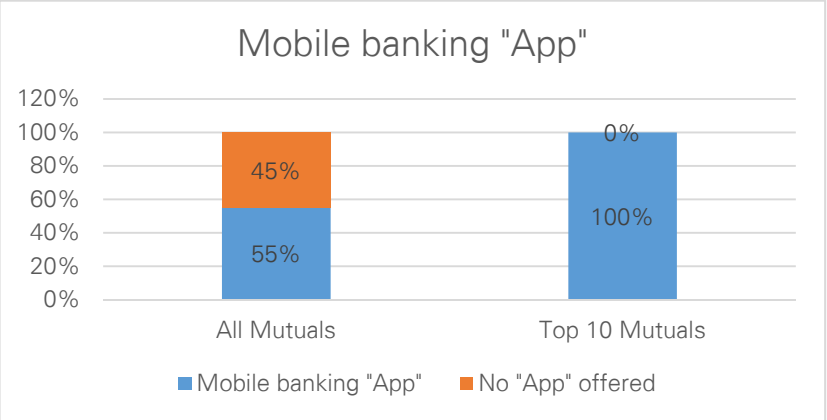
Heritage Bank, Annual Report

Technology is one of the main vehicles driving transformation, relevance and competitiveness. Customers want accessible and up-to-date banking facilities on par with the services offered by competitors, and with the increasing proliferation of mobile devices and a new demographic of younger customers, this trend is likely to continue.

Mobile banking

2014 saw large investments in mobile technology and growth which is expected to continue in 2015 with 92 percent of participants planning to invest more than the previous year and 52 percent stating mobile technology is a top 5 project.

All top 10 mutuals offered a mobile banking application in 2014, in line with their desire to offer their members the latest banking services, while 41 percent of all mutuals have at least a mobile-friendly interface for the mobile browser. This is shown in the chart below. Nine percent of mutuals did not offer any type of mobile banking option to their members, down from 16 percent in the previous year.



Challenges

Forty percent of mutuals believe that the key technological challenge for their organisation in the next year is innovation. This was followed by resourcing and productivity improvement. A key challenge is gaining the resources and expertise to develop new technologies and implement them in such a way as to maintain the high level of personal service that the mutual industry specialises in.

It goes without saying that technology is fundamentally changing every aspect of how business and customers interact. This transformation must be embraced and indeed accelerated in order to capture fast-emerging trends and opportunities

CUA, Annual Report

Some innovations being considered include:

Community First – has launched its Moolah ATM, a machine which will provide clubs more control of the ATM they have on their premises. The Moolah ATM gives clubs the option to maintain the ATM itself by setting the fees, personalising advertisements as well as offering flexible and contemporary contracts.

Source: Community First Credit Union

P&N refurbished four branches during the year – "Featuring a technology bar, a member lounge area and increased space for service pods, the inviting fit-outs are a departure from the traditional looking bank branch."[6)]

IMB - "We enhanced our mobile website with some new and improved functionality. The new look of the m-site is easier and more convenient to use and was designed to deliver a better member experience"[7)]

Greater Building Society - "Changes were made to Internet Banking to make the service even greater for customers. A tipping point was reached late in the financial year with more customers now accessing Internet Banking via mobile devices than through personal computers"[8)]

Heritage - "We have adopted a five-year Digital Blueprint that sets out our ongoing upgrades to online banking services that will keep pace with customer demand"[9)]

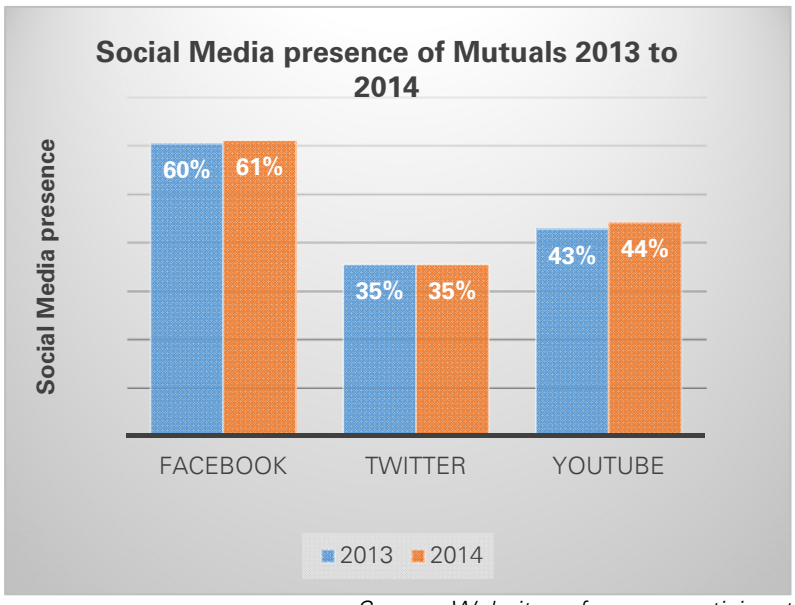
KPMG's survey *Digital perspectives – Insights through to Outcomes* found that 95 percent of young professionals prefer online and mobile channels for day-to-day banking with low account fees and no ATM fees at any bank as the key reasons why they stay with their bank. The implication of this is mutuals must be able to design competitive offers while leveraging digital channels to reduce their cost base and enhance customer experience.

Social Media

Social media remains an area where more needs to be done. Although it is a great monitoring tool for customer services and brand reputation, activities and engagement observed in the mutuals is still emerging.

Thirty-one percent of the participants think social media is very important to their strategy and rank social media as the third most important advertising channel for their products in the next year behind word of mouth and website and emails.

The level of activities and engagement on social media is largely unchanged in 2014. The graph below shows only marginal increases in the industry's social media presence. To increase awareness of customer-focused services and innovative new products mutuals must consider exploiting social media channels to increase their brand awareness.



Source: Websites of survey participants

Social media allows active communication with customers, to increase brand reputation.

Let's take an example scenario, John is looking to purchase a new home. He took to twitter to announce his intentions, using the hashtags #mortgage #homeloan and #firsttimebuyer. A proactive mutual with an active social media presence would explore these trending hashtags. In this instance they could respond to John's tweet and offer him a special deal as a first time home buyer! Congratulations John!

Challenges to building an effective social media presence will be constraints in budget, low response levels of members, and maintaining consistent engagement.

What mutuals can share on social media can include:

- brand awareness and news updates
- educational content and Content aimed at younger generation
- Products, contests and events.

Qantas Credit Union acquired naming rights to the former Sydney Entertainment Centre in late 2013 and renamed it to Qantas Credit Union Arena. With more than 8.5 million visitors Qantas Credit Union Arena opened up a new opportunity for Qantas Credit Union to promote its brand.

Twitter messages containing 'Qantas Credit Union' (KPMG Data Analytics) – 'Qantas', 'Credit', and 'Union' are the most repeated words followed by words relating to performances.

Source: KPMG Data Analytics

15 Industry Landscape – Financial System Inquiry

KPMG's submission to the FSI in March 2014 included issues relating to the mutuals with a view to enhancing the resilience and competitiveness of the industry.

We are arguing for a more even playing field in the financial services sector so that Australians can enjoy greater competition. In particular, we would like the capital risk weightings for mortgages to be consistent across all authorised deposit taking institutions.

ADCU, Annual Report

Category	Key points
Risk weighting under Basel	Assessment of the current risk weightings with a view to exploring the scope for a concessional risk weight being available for low-risk lending (such as residential lending), similar in nature to that available under an internal model framework, provided that an ADI satisfies specified requirements in relation to their risk management policies and practices.
Bank licensing	Lowering the minimum absolute capital level for bank licensing, and instead place emphasis on an ADI having a minimum risk-weighted capital ratio and leverage ratio.
Recognition of debt for capital purposes	Currently, APRA does not allow debt instruments to be recognised for capital purposes unless the debt instrument can be converted to equity or written off. Consideration needs to be given to the options to address this, potentially including amendments to the law to enable mutuals to issue perpetual debt instruments with contractual provisions enabling the debt to be written off upon specified points of non-viability being triggered.

16 Outlook and challenges

49 percent
of mutuals believe that the biggest driver for their growth in 2015 will be in Residential Lending.

40 percent
of mutuals believe market awareness of competitive choices is the one hurdle to gaining a greater market share.

96 percent of
Mutuals stated that they are targeting the younger generation but only

50 percent
have experienced success in gaining market share.

Growth and differentiation

Growth and profitability were identified as the biggest challenges facing mutuals in 2015, especially in light of capitalising on the recent price growth in the residential property market. With increasing house prices and low interest rates, many mutuals have developed refreshed strategic plans, especially in regard to market share, increasing membership rates, raising brand awareness and accessing cheaper loan funding.

Sixty-eight percent of mutuals regard the big four banks as their greatest competitors, an increase from 48 percent in the previous year. The mutuals industry is able to bridge this gap through increasing brand awareness, member numbers and investing in technological innovations.

Customer ownership is a true differentiator with member banking and customer satisfaction consistently prized qualities across the industry. The challenge is exposing this level of customer care to the many residential home buyers who are unaware that mutuals offer a competitive alternative to the services provided by the big banks.

Another challenge is synchronising impersonal online and mobile banking services with the customer-focused acumen that is the brand strength of many mutuals. Many mutuals have developed up-to-date online and mobile applications to meet the demands of their customers and have tailored them in such a way so as not to detract from the personal level of service that they are known for, such as Heritage Bank allowing customers to "nickname" their online accounts.

Targeting a younger demographic

A key focus is expanding market share beyond the traditional market and acquiring a younger customer base. The younger generation will ultimately become the main customer demographic for the next few decades and is a market in which mutuals want a greater foothold.

A key hurdle why young professionals stay with their banks is because it is "too much trouble to change" to another provider. Initiatives adopted by the mutuals include:

- acquiring members from a young age through student and youth banking programs such as IMB's Zoo Account
- student scholarships and community projects such as P&N Bank's Student Scholarship program and Encompass' presence at Sydney University's Orientation week

Source: Encompass Credit Union

We continue to lead the mutual banking sector in membership growth and in attracting younger members, with nearly half our new members under 30 years of age

People's Choice Annual Report.

- streamlining the switching and new account opening process and designing incentives to lure customers across, for example Teacher's Mutual Bank has created a 1, 2, 3 switching process.

Product innovation and service capabilities

The rapid pace of new product offerings and innovations presents unique opportunities and challenges. Mutuals have responded encouragingly to the changing needs of their members developing new technologies and service capabilities that not only add value to the member's banking experience but have kept pace with many of the service offerings of the big banks.

Greater Building Society and IMB offer Xero and MYOB BankLink, a form of online, cloud-based accounting software that allows small-to-medium sized businesses to work with their accountant and manage their business finances. This online connectivity eliminates the need for manual data upload.

Heritage Bank has also made headway in innovation through the invention of the "Power Suit" with Australian tailor M.J. Bale. A contactless payment chip and antenna are fused into the sleeve of the suit which allows its wearer to pay for purchases 'invisibly' with a wave of their sleeve anywhere Visa PayWave is accepted.

Source: Heritage Bank

People's Choice has widened its service capabilities by its new strategic alliance with BT as wealth management partners.

The onset of branch modernisation and refurbishments has also been a consistent trend with many boasting contemporary new banking facilities and designs.

Mutuals have demonstrated their ability to develop new technologies. Acquiring resources and developing an innovative new product or service offering represent significant hurdles, but once these are overcome, mutuals stand to benefit from the improved customer experience and satisfaction that is borne from these innovations.

Gender diversity

The level of female board members and executives has largely remained the same from last year, and again on par with the major banks. Female directors made up 22 percent of boards (approximately 109 female directors in total). Sixteen percent have no female directors, and 13 percent have a female chairperson.

Survey scope and contributors

This survey includes all nine building societies, 10 mutual banks, and 44 of the 84 credit unions authorised by APRA at 30 June 2014. Based on aggregate statistics, survey participants represent 97.3 percent by total assets and 97.7 percent by profit after tax.

Within this report KPMG has adjusted a limited number of balances to reflect significant one-off events. This has resulted in some differences with totals in the datasheet, which are unadjusted.

As part of the survey, KPMG requested participants to complete a qualitative questionnaire covering topics such as: business direction, technology, branches, social media, risks, the youth market and collaboration. The response rate was 70 percent.

In addition to the contributors listed on the Contact us page, the following people from Sydney office made significant contributions to this publication:

Adeel Khan

Ba-Ul Ji

Britta Warn

Claire Gilmartin

Helen Nguyen

Ignacio Suazo

Juan Ibarbia

Min-Soo Park

Tanya Voronina

End notes

1 Unless otherwise stated, 'building societies' refers to the nine building societies surveyed, 'credit unions' refers to the 44 credit unions surveyed and 'mutual banks' to the 10 mutual banks surveyed. Further information on the scope of the survey is provided in Appendix 1.

2 Members, branches and employee movements calculated excluding the impact of mutuals who decided to not disclose their balance in 2014 and/or 2013.

3 Regional banks benchmarked are Bendigo and Adelaide Bank, Bank of Queensland, and Suncorp (Banking division only)

4 Credit Union Christmas Pageant website (http://www.cupageant.com.au/)

5 Newcastle Permanent Building Society website (http://www.newcastlepermanent.com.au/)

6 P&N Bank Annual Report 2014

7 IMB Annual Report 2014

8 Greater Building Society Annual Report 2014

9 Heritage Bank Annual Report 2014

kpmg.com.au

Contact us

Financial Services

Peter Russell
National Head of Mutuals
Partner
+61 2 9335 7731
parussell@kpmg.com.au

Kevin Smout
WA Mutuals Sector Head
Partner
+61 8 9263 7105
ksmou@kpmg.com.au

Brendan Twining
NSW Mutuals Sector Head
Partner
+61 2 9335 8400
btwining@kpmg.com.au

Ian Pollari
National Banking Sector Leader
Partner
+61 2 9335 8408
ipollari@kpmg.com.au

Darren Ball
SA and VIC Mutuals Sector Head
Partner
Tel: +61 8 8236 3197
darrensball@kpmg.com.au

Daniel Knoll
Business Performance Services
Partner
+61 2 9455 9148
danielknoll@kpmg.com.au

Jillian Richards
QLD Mutuals Sector Head
Partner
+61 7 3233 3108
jrichards@kpmg.com.au

Geoffrey Yiu
Tax
Partner
+61 8 8236 3267
gyiu@kpmg.com.au

Stephen Hastings
Advisory
Director
+61 2 9295 3998
shastings@kpmg.com.au

Natalie Raju
Tax
Director
+61 2 9335 7929
nraju1@kpmg.com.au

Alison Marshall
Tax
Director
+61 2 9335 7386
armarshall@kpmg.com.au

November 2014