KPMG

Mutuals Industry Review 2016

The rise continues

#mutuals2016
November 2016

kpmg.com.au

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2016 highlights

Technology spend increased by 11.3%

(2015: 2.7%)

Gross loans and receivables increased by 9.5%
(2015: 7%)

Residential lending increased by 9.8%
(2015: 7.9%)

Net interest income grew by 6%

(2015: 3.9%)

Non-interest income declined by 0.1%
(2015: increased 3.3%)

Impairment provisions decreased to 0.07% of average gross receivables
(2015: 0.08%)

Deposits up 7.8%
(2015: 7.6%)

18 Mutual banks
of which
5 converted in 2016
(2015: 2)

Operating profit before tax increased by 2.7%

(2015: 2.9%)

Capital levels decreased to 17.5%
(2015: 18%)

7 Mergers completed

(2015: 3)

Number of branches decreased by 7 to 820

(2015: 827)

Introduction

2016 saw Australia's credit unions, building societies and mutual banks (together 'the mutuals') perform strongly in an environment of low economic growth, interest rates and inflation. Balance sheets strengthened through above system asset growth of 7.8 percent compared with 5.1 percent for the overall banking industry. Profitability metrics were up, with $626 million profit before tax reported for the year, an increase of 2.7 percent.

The climb continues for the mutuals, with positive financial results in 2016 steering them towards greater growth supported by stronger capital bases. The results have emerged on the back of:

- Growth in lending portfolios supported by elevated activity in the residential property market;
- Continuation of strong credit risk management practices and well-defined risk appetites;
- Expansion of distribution networks leveraging digital reach and third-party distribution channels;
- Dividends from increased technology spend on new mobile platforms as well as transaction origination and servicing capabilities;
- Partnerships with start-up fintech companies which carry the prospect and opportunity for future disruption and growth in the sector; and
- Continued strengthening of staff capabilities and competencies.

Looking forward, we see this momentum will continue; however, in particular, three key actions will support growth, and reduce the gap between the mutuals and their larger competitors.

#1 Regulatory reform

Recognising the need for prudent lending practices by Australian banks, the 10 percent cap for investment property lending imposed by the Australian Prudential Regulation Authority (APRA) in 2016 is unfairly impacting growth opportunities for the sector. This cap, applied equally across-the-board to all authorised deposit-taking institutions (ADIs), disadvantages the mutuals in absolute dollar terms.

A graduated approach to the lending cap across ADIs will provide an improved regulatory setting that is fairer for smaller players and more in line with best practice, whilst still reinforcing sound residential lending.

#2 Innovation

In last year's report we highlighted how the simple business models of mutuals make them more nimble than larger institutions when implementing technological change. We continue to see this as a key advantage for mutuals to penetrate the market with new creative ideas whilst others are still undergoing a slower transformative overhaul of their business models. This is an opportunity that the mutuals are well placed to exploit. The mutuals are beginning to generate real commercial value from collaboration with fintechs - this will continue as digital capabilities challenge the industry.

A digital world

The game changer megatrend is the ability of technology to eliminate the need for costly back office support, origination and servicing processes. In the digital world, the future of the branch continues to be debated and analysed. With a national footprint of 820 branches in 2016, the mutuals have widespread coverage across Australia. The challenge is to make branches more relevant and meaningful to members. We see the role of the branch changing to a place for members to come and perform a variety of activities, including:

§ A financial health-check
§ Advice on starting a new business
§ Advice on basic accounting and tax matters
§ Completing business transactions
§ Attending a training course
§ Holding a community group meeting
§ Using the branch as a co-working space
§ Attending group personal training sessions.

Consequently, the branch will become an even more important component for the success of the mutuals. In our outlook to 2030, we see a realistic possibility that retail banking will change from being hidden to completely invisible. To respond to this, the branch will be the glue that connects members to what they are aiming to achieve, to their friends, to their customers and to the broader community that the mutual supports.

#3 Challenging from all sides

Drawing from the profile of the UK's challenger banks, which grew lending assets by 31.5 percent and increased pre-tax profits by £194m in 2016, we have noted some reasons for their outperformance. These can be adopted by mutuals to expand growth and improve competitiveness.

UK Challenger Banks	Mutuals
Significantly lower cost-to-income ratios	◐
Target lending niches	●
Simpler product sets	◐
Better savings rates	◐
Sophisticated marketing strategies or collaboration with non-bank channels such as technology or fintech companies	◐
Digital differentiators – pushing personalisation, open ecosystems, transparency and predictive intelligence through their products for genuine differentiation	◐

●	Largely achieved
◐	Progressive achievement

The mutuals have had success in most of these areas, however there is opportunity for further improvement. In many ways, these points are connected, with operational cost leverage largely attributed to simpler business models, tailored and targeted products, smaller physical branch networks and more business processes going digital.

Over the years, the mutuals have made progress on rationalising from within, however, opportunities for further efficiencies beckon to push down costs and boost overall performance.

In March 2016, the Senate Economics Reference Committee released its report on the role, importance and overall performance of cooperative, mutual and member owned firms in the Australian economy.

In this report, the Senate made 17 recommendations – 6 of which related to Capital and Regulations affecting the sector.

We encourage the government to respond to this report as a priority, given a number of the recommendations have important implications for the future growth, diversity and strength of the mutuals sector.

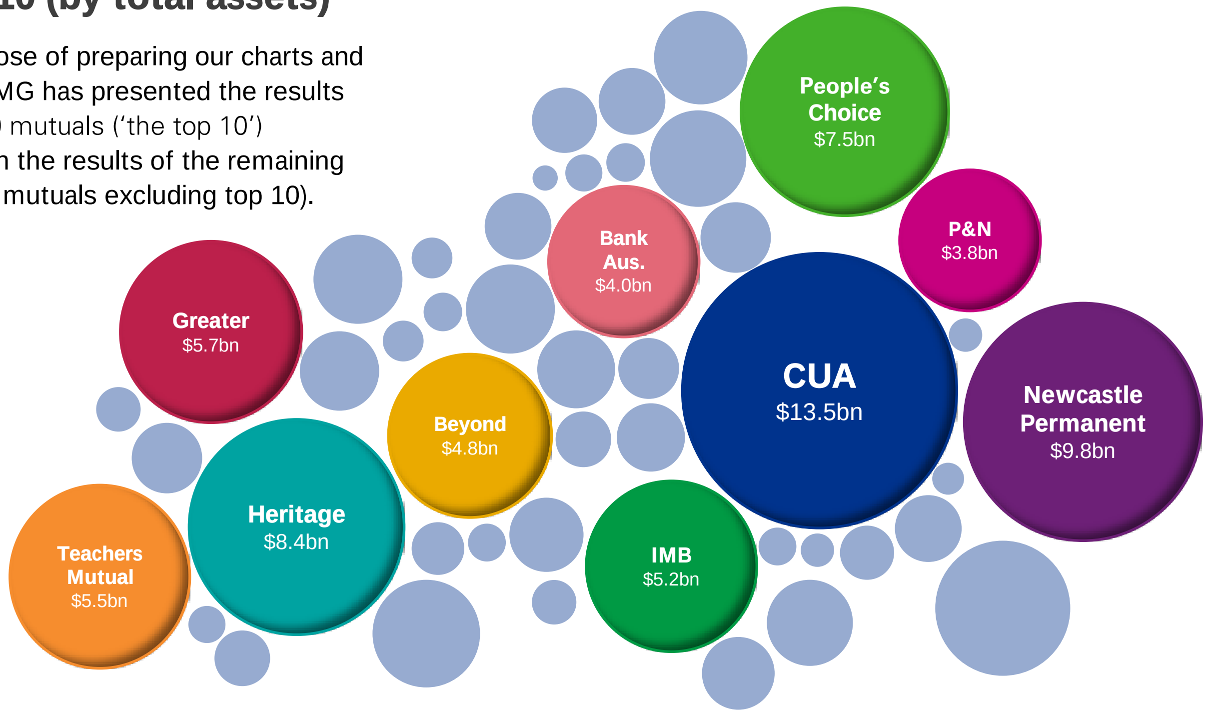
Implementing the recommendations of the Committee will be a key step for the mutuals to continue to position themselves as a challenger in the Australian banking landscape. In order to grow, the mutuals should be immersed in an environment that encourages broad-based and inclusive opportunity for all players in the industry. This will promote greater diversity and competitiveness in the market.

"Reform priorities should be directed towards policies that foster investment, trade and innovation; lift productivity; and drive jobs and growth."

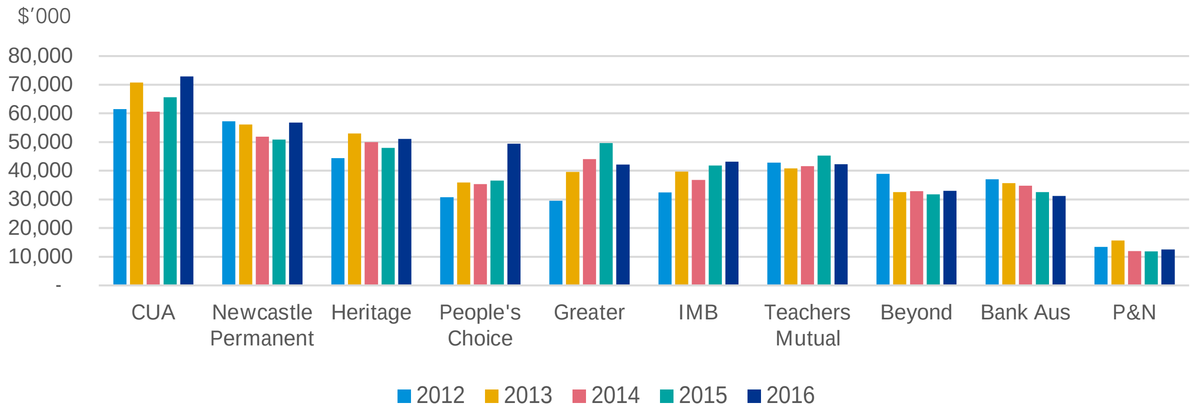
Scott Morrison, Treasurer
IMF Statement

The top 10 (by total assets)

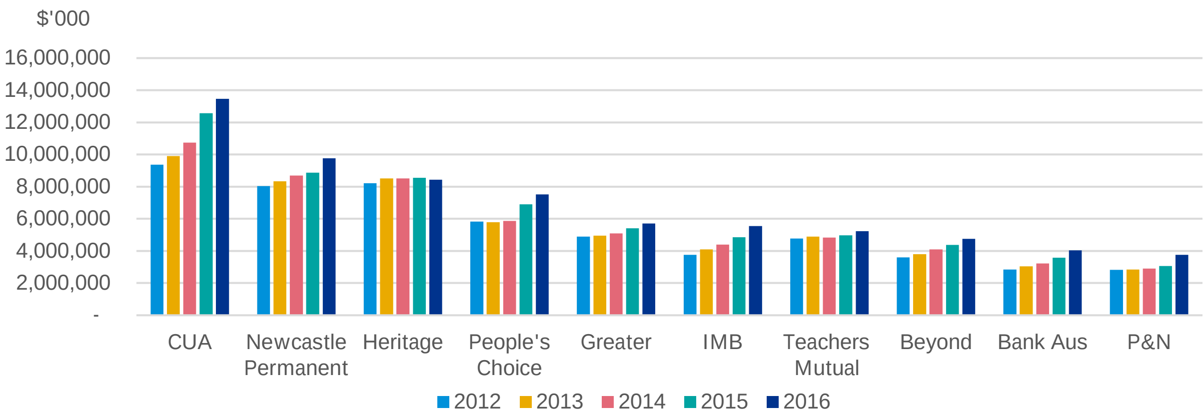
For the purpose of preparing our charts and analysis, KPMG has presented the results of the top 10 mutuals ('the top 10') together with the results of the remaining mutuals (i.e. mutuals excluding top 10).



Total profit before tax (2012-2016)



Total assets (2012-2016)



Financial results

The 2016 reporting season has seen the mutuals deliver another positive year of performance. This result has strengthened their capital bases, providing a solid platform for growth whilst maintaining resilience through a sizeable buffer above required regulatory capital ratios.

Assets

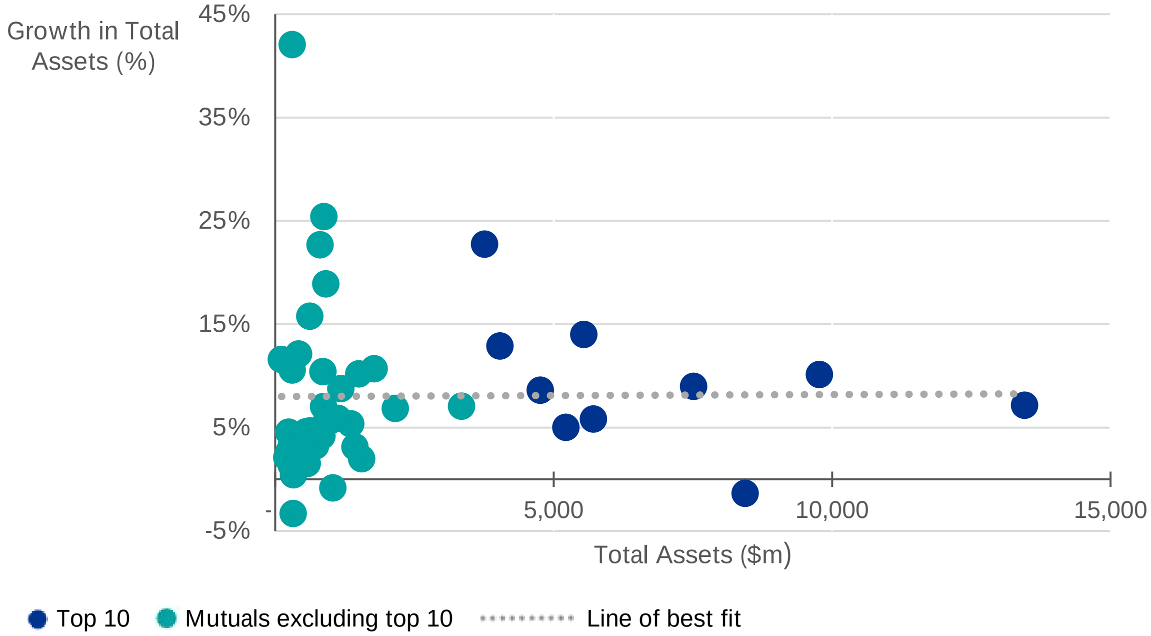
Total assets increased by 7.8 percent (2015: 7.6 percent) driven by the ongoing residential property price growth, whilst total assets for the major banks fell 2 percent (2015: grew 9.7 percent).

2016 saw the mutuals benefit from increased penetration into the residential lending market. Borrowers increasingly saw the mutuals as an attractive choice through their online and branch offerings as well as increased third party distribution. The uptake resulted in 9.8 percent growth of the residential lending book across the sector.

Loan portfolio

Loan composition remained largely the same in 2016, with residential lending continuing to make up the majority of the loan portfolio at 93 percent. The mutuals continue to primarily service individuals, with commercial lending remaining the smallest contributor to the mutuals' loan portfolios at 2 percent. The value of the average loan portfolio across the industry will continue to trend upwards with increasing residential house prices together with growth of new members.

Size vs growth in total assets 2016

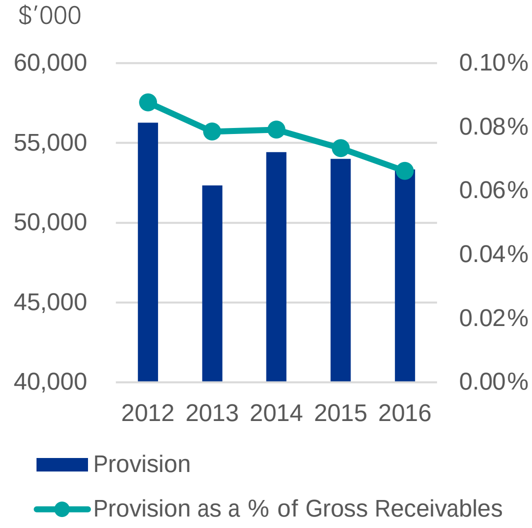


Asset quality

Impairment provisions fell by 1.2 percent to $53 million (2015: $54 million), reflecting the high quality of the mutuals loan portfolios.

Impairment losses of $28 million have remained low year on year.

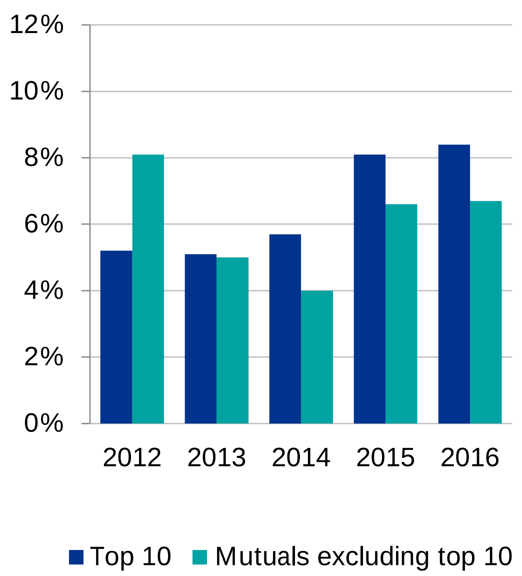
Impairment provisions



Deposits

Deposits have grown 7.8 percent (2015: 7.6 percent) with the top 10 mutuals increasing deposits by 8.4 percent (2015: 8.1 percent).

Growth in deposits



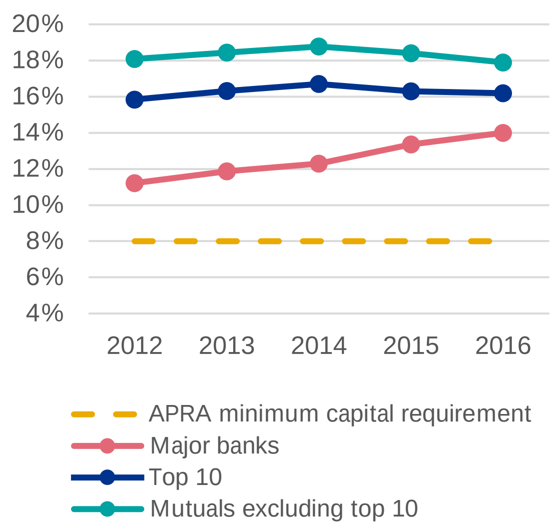
2016 has seen the continued dependency on retail deposits as the main source of funding, which in turn has seen an avoidance of costs generally attached to funding from wholesale markets. Wholesale funding continues to be limited with the concentration of funding at 84 percent retail and 16 percent wholesale. As the mutuals continue to grow and long term interest rates remain low we expect to see increased use of wholesale funding and derivatives to manage interest rate risks.

Capital

Average capital adequacy ratio decreased to 17.5 percent (2015: 18.0 percent). The ratio for the top 10 mutuals decreased by 10 basis points from 16.3 percent to 16.2 percent.

Whilst there has been improved efficiency in capital investment across the sector, the average capital adequacy ratio is substantially higher than APRA's minimum capital requirement. Excess capital represents a waste of resources, however effective capital deployment is constrained by limited liquidity support during periods of stress as well as lack of access to wholesale funding. We continue to support the need for changes to the Australia's financial system that will encourage effective utilisation of resources to support strategic objectives as well as fund the productive capacity in the Australian economy.

Average capital adequacy ratio

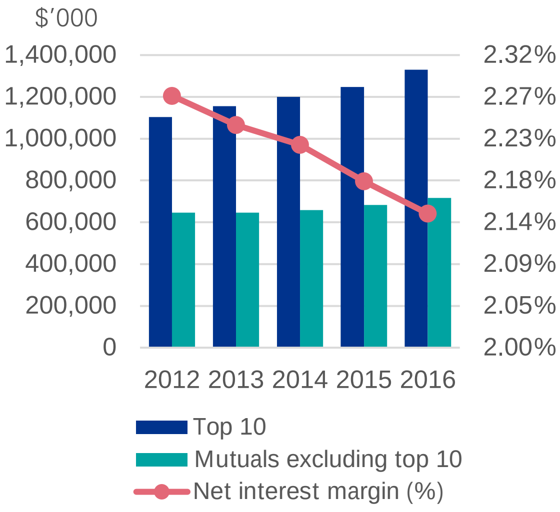


Net interest income

The mutuals reported net interest income of $2,047 million (2015: $1,931 million), of which 65 percent was earned by the top 10 mutuals. Net interest margin continued to tighten and decreased to 2.14 percent (2015: 2.18 percent).

Net interest income increased by 6.0 percent, driven by growth in lending on the back of new home loan products and interest rate repricing. The top 10 mutuals experienced growth of 6.6 percent versus the rest of the sector at 4.9 percent. However, the net interest margin (NIM) continued to narrow.

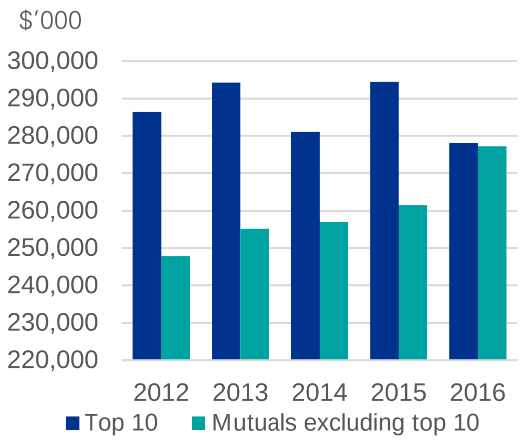
Net interest income and net interest margin



Non-interest income

Non-interest income was down 0.1 percent from last year at $555 million (2015: $556 million).

Non-interest income



The top 10 mutuals drove the decrease in non-interest income, falling 5.6 percent to $278 million (2015: $294 million). Non-interest income for the remainder of the sector, on the other hand, achieved 6.0 percent growth to $277 million during the year (2015: $261 million).

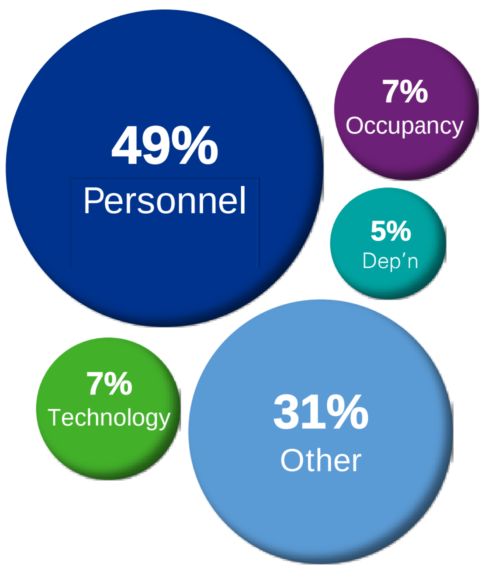
As competition intensifies throughout the sector, the mutuals should consider expanding their current product and service offerings to source alternative income streams. For example, insurance products and wealth management offerings are areas that the mutuals have potential to tap into for further non-interest income growth.

Costs

Total operating expenses increased by 3.4 percent to $1,946 million (FY15: $1,883 million), whilst the average cost to income ratio decreased to 74.8 percent (2015: 75.7 percent).

Cost control continues to be a priority, with most survey participants believing that the key to accelerating the execution of their strategy is to streamline internal processes. This is being achieved through a simplification of processes and back office operations as well as reducing points of friction with customer interactions.

Composition of costs - 2016

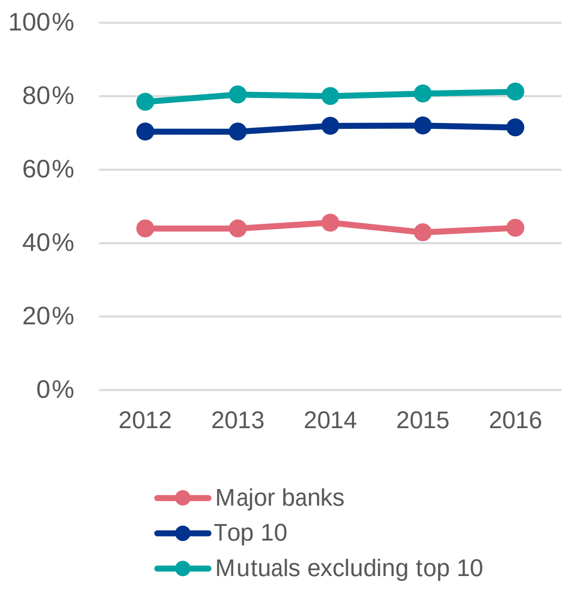


"The increase in expenses reflects the costs associated with implementing a number of key strategies including organic growth via new branches, digital initiatives and a strengthening of IMB's management structure. IMB also invested in increased training for our staff and an increase in our marketing spend has supported the strong growth in both loans and deposits."

Rob Ryan, CEO - IMB

Personnel expenses remained the dominant expense at $949 million, representing a 5.6 percent increase from last year. Ongoing investment in employees through training is a positive driver in improving business performance, customer service and staff morale. With technology infiltrating all facets of business, the need for employees to be tech-savvy, even in non-IT positions, is ever more important. The mutuals must ensure their workforce are prepared and equipped with the right skills to implement business technology and execute strategy and change now and in the future.

Cost to income ratio

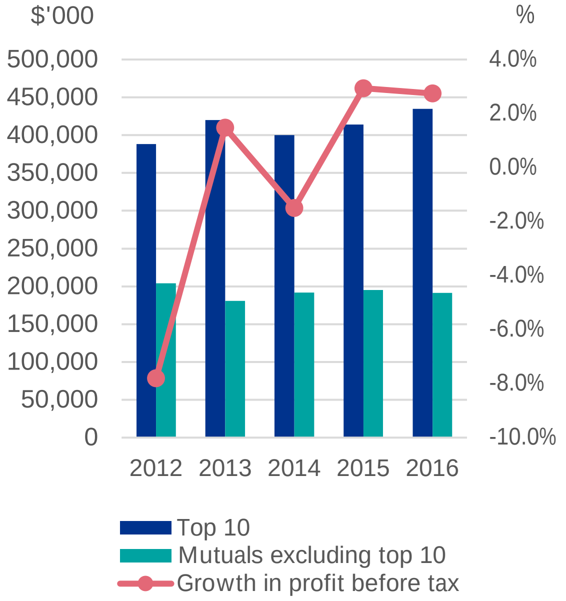


Whilst the top 10 mutuals have a small advantage over the rest of the industry in terms of their economies of scale, the sector lags the major banks who have consistently had a cost to income ratio of roughly 44 percent over the past 5 years. This disparity highlights the opportunity for the mutuals to further leverage their cost base particularly given high capital levels.

Profits

The mutuals achieved a combined overall profit before tax of $626 million which is a 2.7 percent increase from prior year. This was driven by 5 percent growth generated by the top 10 mutuals (2015: 3.5 percent). The increase in profits arises from the increase in loans and advances and net interest income as well as a strong focus on cost control. Through innovation and increased market awareness, the mutuals are positioning themselves as a competitive banking alternative.

Profit before tax



The proposed merger between QT Mutual Bank and RACQ is a very interesting new approach to achieve growth and scale benefits. The merger announcement noted that the vision is to establish a scale-able customer owned banking platform to achieve significant growth and expansion.

More in return

As customer-centric and community-based organisations, the mutuals are more than a financial institution, with competitive products and great personal service. The mutuals also put their profits back into their members through active contribution to the communities and causes that are important to them.

Greater Bank's charitable foundation announced seven new charity partnerships (which include Beyondblue, McGrath Foundation and OzHarvest). The concentration for these partnerships lies in the focus of individuals requiring mental health assistance, indigenous youths, those impacted by cancer, as well as disadvantaged youths.

Credit Union Australia's Community Care program offers $5,000 grants to schools within a set radius of selected CUA branches. These schools nominate projects for community voting, with the community ultimately deciding the recipient schools of the grant. After winning $5,000 from CUA Community Care last year, Diamond Valley Special School completed the build of an independent living centre that will give their students with varying intellectual and physical disabilities a brand new space to live and learn the skills they need for independent living, ultimately making sure they take care of their health and wellbeing in the future.

Source: Credit Union Australia

P&N Bank formed a community platform known as the Flourish Foundation which includes a spread of initiatives, including:

- Helping &nds – enables P&N members to nominate deserving community groups or small not-for-profit organisations within their local community or social circle that require financial assistance and services support.
- Flourish@Work – promotes active participation in volunteering activities amongst P&N staff members.

Newcastle Permanent's staff donated over 1,000 hours of their time in 2016 to help community organisations in their local area through their Staff CommunityAssist Program which gives employees paid leave days for volunteer activities. Collectively, NPBS staff also contributed almost $60,000 of their fortnightly salary for donation to charities and local community groups through the program.

"It is important to note however that financial performance alone is not the only measure of success at Regional Australia Bank. Being a proud mutual bank we are also heavily focussed on the relationships that we have with our members and local communities, having donated almost $1 million in financial and in-kind assistance."

Regional Australia Bank,
Annual Report 2016

People's Choice staff contributions to the community continued to be significant, with a 180 percent increase in participation year on year. Some 656 volunteers contributed 2,360 hours for 23 charities and community partner organisations.

"The People's Choice Community Lottery rewrote the record books, helping 1,101 charities, sporting clubs, schools and community groups…returning a record $1,607,814 to the community."

People's Choice,
Annual Report 2016

Source: Community First Credit Union

"Our concept of community is a holistic one. We aim to support charities and groups that support the community. We offer products that deliver mutual benefits."

Community First Credit Union,
Annual Report 2016

Beyond Bank's community efforts has spanned across 376 community organisations, made possible through individuals banking in their designated Community Reward Savings Accounts product. Specifically, individuals nominated a participating not for profit group (including charities, local sporting clubs, schools or local community groups) from an eligible panel, and a percentage of the average annual balance across all savings accounts linked to the nominated cause is distributed to the organisations.

Source: Beyond Bank

Victoria Teachers Mutual Bank's Student Teacher Awards and Teaching Initiatives Program (TIP) delivered grants to high achieving pre-service teachers and offered assistance to foster innovation within preschools and school environments. The 2016 TIP grant recipients shared funding to specifically support teaching practices in the following areas: general curriculum, indigenous culture, sustainability and engagement with Asia.

Unity amongst the mutuals

The Laos Project which commenced in mid-2014 continued to gain momentum in 2016 through the combined forces of Bank Australia, Regional Australia Bank, Select Encompass, Fire Brigades Employees', First Choice, Maritime Mining & Power, MyCU, Sutherland and WAW. The project focused on the provision of financial assistance and support to 25 credit unions in Laos, concentrating on staff development, financial literacy competencies, and implementation of policies and systems.

The introduction of Apple Pay will bring the tap-and-go payments platform to over 2 million members across the mutuals sector, enabling them to make convenient and secure payments with the swipe of their hand.

The next wave – Apple Pay

Apple recently signed a deal with payment services provider Cuscal to launch Apple Pay, a contactless payment app for iPhone and Apple Watch, later this year.

29 mutuals will be amongst the first wave of banking institutions rolling out this service.

These include:

- Bank Australia
- Beyond Bank Australia
- Big Sky
- CAPE
- Community First
- CUA
- Credit Union SA
- Defence Bank
- EECU
- First Option
- Goldfields Money
- Goulburn Murray
- Holiday Coast
- Horizon
- Central West
- Illawarra Credit Union
- InTech
- Laboratories
- Northern Inland
- People's Choice
- Police Bank
- QT Mutual Bank
- Select Encompass
- South West Slopes
- Sydney Credit Union
- Teachers Mutual Bank
- The Mac
- Warwick Credit Union
- Woolworths Employees' Credit Union.

A digital landscape

The business world continues to change and with every move comes a new challenge for the mutuals. Technology and innovation remain on the frontline, relentlessly questioning the traditional ways of doing business by pushing the possibilities and capabilities of its use.

2016 saw technology investment increase by 11.3 percent. There have been many technological improvements driven by the ongoing evolution of digital banking, mobile technology and the internet of things. Accessibility and personalisation remain highly valued by customers and are beginning to feature more in products and services. This digital mindset remains vital to keep up with the changing landscape.

Technological advancements and creative problem solving through innovation have infiltrated all aspects of business from points of research to operational functions to customer delivery. In particular, the top two uses of technology by survey participants were to drive change and reinvigorate internal processes to achieve cost and labour efficiencies in the way human and technological resources are doing things.

Top technology and data analysis uses in 2016

"To prepare us for the New Payments Platform, Police Bank is upgrading its core banking platform as well as establishing the necessary links and controls… We also look to prepare for new payment innovations such as Apple Pay."

Police Bank,
Annual Report 2016

Whilst the benefits of cost reduction and improved profitability can be realised and passed onto customers, we also see opportunity for further value creation in the innovation space. Fresh ideas and solutions in the form of new products and service offerings show that the mutuals are listening to, and evolving with, their members. With a customer-centric ethos and purpose, the mutuals are well-placed to create the right tools to respond to the changing digital habits of members and tailor offerings to their specific needs.

The mutuals will continue to invest time and resources in designing, developing and deploying ideas which members will find beneficial.

Digital highlights

First Electronic Mortgage

A member of Bank Australia was able to complete all the necessary documents for her mortgage via her banking portal, paper free.

This was done through PEXA, the online property exchange network that enables financial institutions, such as Bank Australia, to settle and lodge financial documents electronically. Traditionally, the mortgage settlement process would take at least seven days, however PEXA makes it possible for settlement to occur on the same day.

ReadSpeaker

Holiday Coast Credit Union linked up with ReadSpeaker to provide accessible technology for the vision impaired, elderly and members with literacy limitations. The collaboration launched a text-to-speech functionality on HCCU's website, where online customers can access a player that will read the webpage content out loud.

Fingerprint login

Security, speed and convenience continue to be sought by customers when accessing their bank accounts on mobile devices. A number of the mutuals introduced fingerprint login functionality, which allows customers with compatible devices to securely log into their mobile banking app using a swipe of a finger.

SMS verification

The mutuals are recognising the need to increase online security across all devices to boost members' confidence over the safety of their information. Qudos Bank introduced QSafe SMS to its members earlier this year. QSafe SMS supplements members' login and password, acting as a second layer of security authentication. When members initiate a new transfer or BPAY payment, a unique code is sent to their nominated mobile number in order to complete the transaction.

"Our responsibility is to embrace innovation and fast thinking to make sure shifts in our business environment can benefit our customers."

Bank Australia,
Corporate Report 2016

Android Pay

A development this year has been the establishment of a mobile banking payment platform for Android devices. Some 10 credit unions launched Android Pay, which has enabled members to use their phone as a 'digital wallet'. With the app, members can place their smartphone near a contactless terminal and their purchase is charged to their debit or credit card, or a range of other companies' loyalty or gift cards.

Source: P*eople's Choice*

Fintech

CUA ran its Sponsored Entrepreneur Program for the second consecutive year. This program provided five startups with three months of fulltime desk memberships, structured mentoring and access to training and networking events. CUA's backing of these up and comers is just one example of how the mutuals are attempting to help foster innovation.

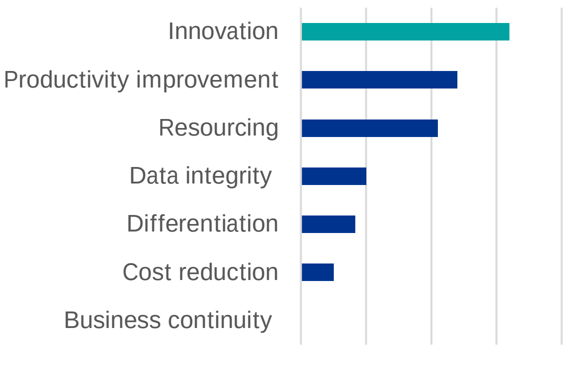
The innovation agenda

Innovation has remained the top business challenge, with the majority of survey participants still seeing their organisation at a foundational stage. For these mutuals, innovation is occurring on some projects or within some departments, however there is no repeatable approach. To evolve with the transforming digital world and remain a relevant challenger in the industry, this needs to change. Innovation should be embedded in everything the mutuals do and have a defined and controlled direction as part of its natural integration within the organisation.

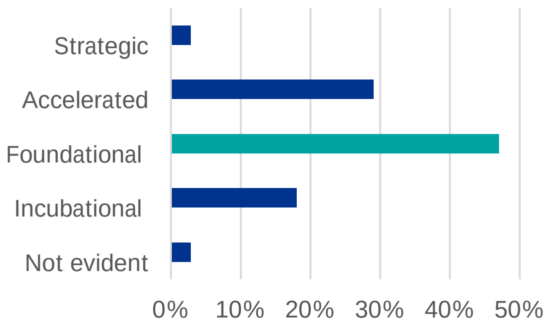
New ideas and creative solutions are widely recognised across the sector as opportunities to create value for customers as well as take market share. However, the up-front cost and speed at which customers are expecting the mutuals to respond have created significant pressure. In last year's report we highlighted that collaboration with emerging start-ups and sharing of resources within the sector are viable and cost-effective alternatives to building and implementing such ideas alone.

In 2016 we saw some great commercial results delivered through these partnerships, such as the KPMG mLabs initiative. We believe this momentum will continue, boosted by the Government's regulatory reform which is encouraging innovation and collaboration with the intention to drive national growth and productivity.

Top business challenge for the next year



Where the mutuals see themselves with respect to innovation

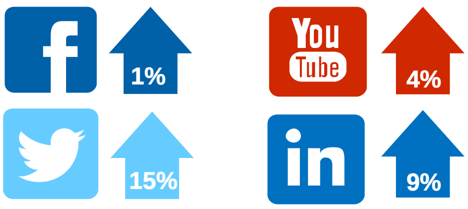


Social media insights

In an age of constant thumb tapping and online sharing, social media continues to be a necessary integration into the way the mutuals connect with existing and potential customers.

2016 saw the footprint of mutuals on social media platforms grow by 18 percent, with 95 percent of survey participants acknowledging it has some degree of strategic importance. Facebook and Twitter continue to be the most popular avenues to reach consumers, with 94 percent of the mutuals having a presence on Facebook (2015: 93 percent and 70 percent on Twitter (2015: 55 percent).

Growth in social media followers from 2015

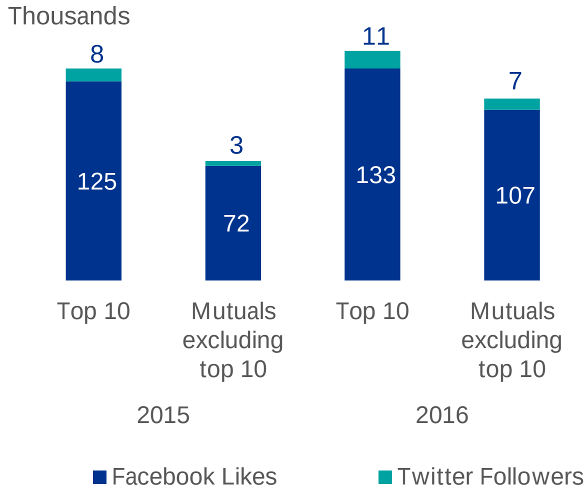


The increase reflects the acknowledgment of the digital world and how social media has become a familiar interaction in the way people communicate with each other. Whilst the mutuals have a smaller following, as compared to the major banks, activity is not dwarfed. The top 10 produce an average 1.7 tweets per follower versus the major banks who produce an average 0.5 tweets per follower.

"This year we added Instagram to our social media stable of channels that are being used to share information and engage with customers, our partners and the broader community."

Greater, Annual Report 2016

Social media followers



We see strong customer engagement on social media channels, with posts used not only as an advertising tool to promote products and services, but also as an opportunity for the mutuals to share their success stories regarding community initiatives and events.

Results from our qualitative survey showed that 94 percent of survey participants are actively targeting younger generations, however only 50 percent of participants are having success in gaining market share with this demographic. Active social engagement therefore becomes particularly important when engaging with the younger generation and responding to their digital habits. Social media represents a gateway for the mutuals to reach this cohort, grow their brand and build relationships in a cost-efficient manner. Every post, image or video shared is an opportunity for connection, positive interaction and customer conversion.

Changes for growth

2016 has been another positive year of growth for the mutuals. Still, the outlook remains challenging against the backdrop of a competitive landscape driven by technological change, continued dominance by larger competitors, and regulatory pressures. To navigate through this changing economy, the mutuals must be supported by a diverse, competitive, and innovative environment.

The sector continues to be a source of productivity growth; contributing $7 billion to the total growth of assets of $225 billion across all ADIs in 2016. However, the rise of the mutuals continues to be constrained by external factors. In particular, the 10 percent investment property lending growth cap has slowed loans to investors and held back growth opportunities. With residential investment lending at around $500 billion for all ADIs, the expected market growth with a 10 percent cap is $50 billion. With the mutuals' investment lending at some $20 billion, a 10 percent lending cap effectively means $2 billion loan growth is available for the mutuals, versus $48 billion for larger institutions. Consequently, under the cap, the mutuals are restricted to a maximum of 1 percent market share of investor lending growth.

94 percent of survey participants do not consider APRA's 10 percent investment property lending growth cap to be fair.

We consider that a graduated approach to the lending growth cap would be fairer and closer to the IMF's goals. This would preserve a level of competitiveness and opportunity for the mutuals, whilst reinforcing sound lending practices.

This issue brings to the forefront the inhibitory nature that regulation can have to growth, value-creation and prosperity in an organisation and the wider economy. Policymakers should look to reforms that enable the mutuals to make their own decisions to eliminate risks and allow them to flourish with appropriate regulatory oversight. This action supports the Australian Government's public commitment to cutting red tape by $1 billion every year and improving competition policy; both of which are aimed at building a stronger, more productive and diverse economy. For organisations, this means big and small players get a 'fair-go', and from an individual consumer perspective, it means improved customer outcomes as the most cost-effective products will dominate. In support of these priorities, we consider that making some changes to current regulations will reduce counter-intuitive business outcomes and shift energies towards opportunities that lift growth and prosperity for individual businesses and the country as a whole.

The Senate Inquiry into Co-operatives and Mutuals issued its report in March 2016 with 17 recommendations.

As at the date of this report, the Government has not responded to the recommendations.

A summary of the recommendations is as follows:

1. Collect better data for the sector;

2. Improve representation in policy discussions;

3. Encourage the establishment of new co-operatives and mutual enterprises;

4. Corporations Act explicitly defines a mutual enterprise;

5. The role of directors in mutual enterprises is defined in the Corporations Regulations;

6. Ensure the continual improvement to advice, guidance and information provided at all stages in the establishment, governance and regulation of the sector;

7. Increase education and training about the role of the sector;

8. Improve the recognition and understanding of the sector;

9. Accreditation bodies include knowledge of the sector as part of licencing;

10. Amend the Indigenous Advancement Strategy to allow increased access to grant funding;

11. Increase access to grants;

12. Consider the sector when preparing a Regulatory Impact Statement that accompanies new regulatory policies;

13. Ensure that the regulatory burden for the sector aligns with the needs of these organisations and ensures they are not disadvantaged relative to companies of a similar size;

14. Evaluate solutions to bring co-operative shares under the definition of capital under AASB132;

15. Support innovative market-based approaches to raising capital;

16. APRA set a target date for the outcome on issues of capital raising and bring those discussions to a timely conclusion; and

17. Evaluate amending the Corporations Act 2001 to provide co-operative and mutual enterprises with a mechanism to enable them access to a broad range of capital raising and investment opportunities.

KPMG supports the recommendations of the committee. Of the recommendations, the matters which should be considered as a priority are:

Capital (Recommendations 14, 15, 16, 17)

The mutuals hold additional capital over regulatory minimums. If themutuals were able to hold capital levels consistent with their larger competitors at around 13.5 percent, loans could increase by some $25 billion to generate additional profits of $375 million assuming a 1.5 percent spread. This would equate to a 25 percent increase in size and 60 percent increase in profitability.

Additional access to capital would have the follow-on benefit of reducing excess liquidity levels which are generally maintained across the industry.

Regulation (Recommendations 12, 13)

The sector continues to deal with regulations that apply to all ADIs. We consider there are a number of quick wins that could be achieved by amending various regulations affecting the sector.

"One of the things that the recent Senate inquiry into mutuals and member-owned firms demonstrated was the great opportunity we have to build the level of knowledge and understanding our politicians have about our sector. We need to be very persistent to ensure our needs are taken into consideration when government makes policy decisions.

Our industry needs to do more to educate our regulators about the impact their decisions are having on our ability to compete.

CUA has a key role to play in being an advocate for member-owned organisations."

CUA,
Annual Report 2016

Some examples of potential regulatory changes include:

§ Allowing the mutuals to use the name bank;

§ Allowing organisational structures and business positions to be determined based on organisational circumstances rather than prescriptive requirements;

§ Integrating CPS220, CPS 232 & ICAAP audits with the APS 310 audit;

§ Removing unnecessary annual report disclosures or allowing disclosure via the institution's website;

§ Removing entity standalone disclosures where they do not provide useful additional information;

§ Allowing prudential ratios to be analysed across agreed member groups;

§ Allowing the mutuals to agree a standard GST recovery rate rather than individual entity calculations;

§ Agreeing a standard FBT charge per employee rather calculating FBT on each expense (subject to agreed exclusions such as school fees and holidays);

§ Allowing the mutuals to form one tax consolidated group; and

§ Allowing the mutuals to return franking credits through "designated" deposit accounts.

There are some important and quick productivity wins that can be achieved; however, they are currently being held back by various regulations. A reduction or, at a minimum, simplification of rules will promote greater competition in the banking sector, facilitate a higher level of collaboration between the mutuals and provide a greater platform for growth. The design and execution of any changes will take time and require careful consideration. Consequently, the response from the government on The Senate inquiry should be prioritised to continue the process of much needed reform.

Building a sustainable wealth offer

Customers are constantly looking for a personalised financial experience; a one-stop-shop solution that covers personal banking, insurance and wealth. With customers increasingly willing to engage with non-traditional financial institutions, the mutuals can leverage their competitive advantage to meet demand for customer-focused wealth products.

With competition intensifying, the mutuals are looking to find new avenues for attracting new and retaining existing ones. Recent changes in the sector caused by consolidation and adoption of new technology solutions, as well as the sector's high customer satisfaction, provide a robust foundation for the mutuals to launch wealth product and service offerings. Introducing various investment products and superannuation and pension accounts, and providing financial advice and alternative distribution networks, will enhance the mutual core capabilities and add long term sustainable value to customers.

Competitive advantage

One could argue that these products could just as easily be provided by all in the industry, however the mutuals have a competitive edge that better positions them to provide wealth offerings that would be valued by consumers. The customer-owned structure of the mutuals prioritises customer experience over financial returns. This close relationship means the mutuals know their customers' profile and needs, enabling them to create the right product fit for their members and deliver them on a foundation of trust, knowledge and experience; all of which are important to customers when providing financial advice.

Benefits for the mutuals

§ Customer satisfaction will improve as customers are provided a more comprehensive service
§ Share of customer wallet will increase as existing customers engage the mutuals as a single trusted partner for their banking, investment and superannuation needs
§ This will be an additional income stream, which will become increasingly valuable as net interest margins continue to tighten.

Benefits for customers

§ Increased simplicity dealing with a single provider for their banking, insurance and wealth needs
§ Improved satisfaction from a trusted partner
§ Potential savings on account and advice fees which are currently incurred from different institutions.

To introduce a new wealth offering, a staged process is required to continually assess its viability as well as to manage risk and limit required investment throughout the process.

Data quality

A surfacing issue across financial services is the need for improved data management. With technological advancement rapidly on the move and operating systems becoming more intricate and integrated, data management is no longer just about meeting regulatory requirements and reporting; it has become a precondition to any data analysis used to make valuable business decisions.

In a big data era, organisations have access to ever increasing volumes of data. The volume of data available to businesses invites opportunities for analysis, where data can be aggregated, decomposed and reorganised in an array of ways to gain valuable insights for better decision making. However, this can only be achieved when the data is accessible, reliable and of a high quality.

84 percent of CEOs from the world's leading companies are concerned about the quality of the data they are basing their decisions on.

Source: KPMG 2016 Global CEO Outlook

Currently, data quality remains an ongoing challenge as it is consistently degraded by inaccuracies, incompleteness and duplication. Underpinning this is a cultural issue of who owns the data and who is accountable for its quality and integrity. With the diversity of data sources, producers and users of data may not be the same. Data providers generally lack a clear understanding of what needs to be provided to data users, and this often leads to a misinterpretation of the data. A large portion of time is also spent by management aggregating, reconciling and making manual adjustments on datasets, which is inefficient and impairs timely decision making. This also makes it a significant exercise to produce relevant data when addressing ad-hoc requests from management and regulators.

An integrated and dynamic approach to data management will enhance the accuracy and integrity of data and enable the mutuals to make reliable and better informed decisions. The mutuals need to have a clear understanding of how different business units within their organisation handle data, and look for ways to generate synergy through interdivisional collaboration to streamline data extraction, collection and presentation processes. These should be clearly documented and automated where possible to improve consistencies across business units.

Not only does good data management create organisational efficiencies and quality data reporting; it also opens time and resources to analysing information for actionable insights – where the real value is born. This action is supported by the Australian Government's goal of cutting red tape by $1 billion each year. For the mutuals, this means greater focus can be turned on improving existing products and services, identifying opportunities for innovation and planning the next strategic moves.

For more information, refer to KPMG's report **Raising the Bar – Aligning and enhancing regulatory reporting for greater strategic advantage.**

KPMG mLabs

In 2016, KPMG launched the Mutuals Fintech Accelerator Program,mLabs", which connected 7 mutuals to 13 fintech startups. The 12-week program was a platform for collaboration, aimed to accelerate innovation by identifying and developing commercial solutions to business and industry challenges.

The program saw the mutuals work closely with the fintechs to ideate new solutions, test assumptions and co-create and prototype products and services. The mutuals also gained access to expertise from mentors and industry advisors.

"The mLabs program has given Heritage Bank exposure to innovative technology with the potential to help us provide a better customer experience and improve our operations. It was great to go through the program with other mutuals as it soon became clear we all share common pain points and issues. The structure of the program, and the support from KPMG, ensured we came away with excellent outcomes."

Peter Lock, Heritage Bank, CEO

"The program was an excellent opportunity to work with startups who continue to challenge financial institutions to 'lift their game' and provide fresh ideas around products and services that cater to customers' needs."

Sue Coulter, CUA, Chief Digital Officer

The program resulted in 18 active commercialisation opportunities being pursued; two of which were collaborative projects involving multiple mutuals working together with a startup. The KPMG mLabs program will return in 2017.

The initial 13 fintech startups included:

Avoka (avoka.com) – Customer acquisition workflow software.

Brighte (brighte.com.au) – Point of sale finance.

Chekk (chekk.me) – Digital identity enabling consumers to own, manage and share their personal data with other individuals and businesses, supporting improved customer experience and interactions.

Cloudcase (cloudcase.net) – Omni-Product loan origination software enabling financial institutions to on-board customers and originate any financial product.

DSYNC (dsync.com) – Enables users to integrate both cloud and on premise applications together with free data mapping and out of the box connectors to synchronise website, point of sale, inventory, ERP, CMS, loyalty, email and finance systems together.

Easyshare (easyshare.money) – Online platform designed to simplify the payment of shared house, residential and commercial rent, bills and expenses.

Edstart (edstart.com.au) - Provides a simple, low-cost financing solution, leveraging the latest technology to deliver a service to customers which is both easier to use and lower cost than traditional finance providers.

Flamingo (flamingo.io) – Provides SaaS platforms that assist companies with complex products to sell more online and to on-board and retain customers.

Moneycatcha (moneycatcha.com) – Blockchain enabled loan origination solution to deliver significant competitive advantage through improvements to speed, efficiency and security.

Moroku (moroku.com) – Operates at the intersection of mobile, gaming and social media to create engaging banking and payment experiences that promote customer learning and brand loyalty.

Pocketbook (getpocketbook.com) – Free budget planner to make managing personal finance simple.

Simplekyc (simplekyc.com) – Hassle free, business process management solution for both large and small entities to reduce the man hours involved in on-boarding new customers.

Spriggy (spriggy.com.au) – Builds important money habits with prepaid cards and a purpose-built mobile app to teach 8–18 year olds vital earning, saving and spending skills with real world practice.

Visit our Mutuals Fintech Accelerator Program webpage for more information.

EVA – the Invisible Bank

We have seen significant technological change over the past decade, however banking is only at the beginning stages of its transformational journey.

Time and time again, we have witnessed the transformation of what was once considered a radical idea become a commercial reality…so what will be the next face of banking? Our vision is that by 2030, retail banking will change from being hidden to completely invisible. Consumers will interact with an 'Invisible Bank', embodied by a personal digital assistant; namely, EVA (Enlightened Virtual Assistant). Driven by the evolution of artificial intelligence, EVA will interweave banking seamlessly with the everyday lives of consumers. It will be constantly available and can be personalised to the needs of consumers, helping them live a comfortable, efficient and well-balanced life.

The possibilities with EVA include:

- Accessing payments data for nutritional information and match the health data from a wearable device;
- Constant checking of the best ways to manage short term cash and fix financial issues;
- Matching preferences and diary availability with relevant merchant offers; and
- Connecting to booking systems, arranging payment and updating diaries.

To make EVA a reality and for a real shift in banking to occur, advanced data analytics, artificial intelligence, application programming interface (API) and cloud technology need to be combined and built through a core platform from scratch. For the mutuals this movement is an easier and more fluid transition, as it is supported by their work with fintechs and better aligned to their simpler business models, value proposition, and growth aspirations.

Visit our website for a copy of the report: **Meet EVA – the future face of the Invisible Bank.**

Video insights and perspectives

Visit our website to view a series of videos providing perspectives on the 2016 results and insight into industry issues and transformation affecting the sector.

- Peter Russell provides insight into the key components of the results and the outlook for the sector
- Daniel Knoll shares his observations of retail banking trends around the world following his recent European study tour
- Natalie Raju reflects on the mutuals results from a tax perspective
- Tim Aman discusses the potential impact of the US election result on the mutuals
- Graeme Scott discusses the digital transformation of the banking industry and how technology is propelling the industry forward
- Sacha Korchinski shares her experience of banking with a mutual and as a millennial, and what she hopes to see in a 'mutual of the future'
- Dimi Kumarasinghe discusses how the mutuals can benefit from the rise of start-ups in the financial services industry
- James Black shares some insights from the KPMG's Fintech accelerator program, mLabs, and highlights some of the opportunities that have resulted from the program.

Survey scope and contributions

This report is based on an analysis of the financial results of the mutual banks, building societies and credit unions as regulated by APRA at 30 June 2016. The survey results represent over 95 percent of the mutuals sector by total assets and profit before tax.

Within this report, KPMG has adjusted a limited number of balances to reflect significant one-off events or where information has not been provided.

As part of the survey, KPMG requested participants to complete a qualitative questionnaire to understand their views on the forces and opportunities shaping the businesses they lead, covering topics such as: business direction, risks, technology, the youth market and sector collaboration. The response rate was 72 percent. The results of the questionnaire are included throughout the report.

KPMG have also developed interactive dashboards using Excel and PowerBI, as well as a Z-score performance assessment, and are available on request. To request a copy please email AU-FMMutualsSurvey@kpmg.com.au.

KPMG would like to thank each organisation that participated in the survey. This survey would not be possible without your support.

The KPMG Mutuals Industry Review 2016 team

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