CAPITAL MANAGEMENT AND SUPPORTING FUTURE LENDING GROWTH FOR MUTUALS

INTEREST RATES ARE AT A RECORD LOW WITH THE RBA CASH RATE SITTING AT JUST 0.10 PERCENT. SO WHAT'S ON THE HORIZON? WHAT DOES IT MEAN FOR THE AUSTRALIAN MUTUAL INDUSTRY TODAY?

While the low interest rate environment can help sustain profits in the mutual sector by offsetting weak economic activity, the effect is likely to be short-term. Over a more extended period, sustainable performance will depend on the funding and lending framework, product mix, business operations and portfolio quality.

DIRECT IMPACTS TO THE MUTUAL BANKING SECTOR

The cash rate has historically served as an anchoring point for other interest rates in the Australian financial system. In line with this, the mutual sector has been vigilantly monitoring and adjusting its lending and deposit rates to keep pace. These adjustments are ultimately a function of pricing power and portfolio quality and mix. With a higher proportion of retail deposits and limited pricing flexibility, the mutual sector profits are arguably more vulnerable to a sustained low-interest rate environment.

MARKET REBALANCING ACTIVITIES

Consumer behavioural dynamics through accelerated savings and access to cheaper debt are also shifting in the current environment. The proportion of new mortgages with debt-to-income ratios of at least six times has soared from 16 percent last year to 22 percent in June 2021 . As a result, APRA's recent decision to increase the serviceability buffer is unsurprising – a move to cool an already heated property market.

A post-COVID economic growth pathway coupled with future interest rate increases warrants a targeted approach to capital management. It remains to be seen whether some lenders will skew their books to higher risk lending to grow lending margins, thereby risking higher capital costs and potential losses. Accordingly, the Australian mutual sector will need to prepare for higher future funding costs and constrained access to capital.

REGULATORY CAPITAL REFORMS AND CUSTOMER JOURNEY TRANSFORMATION

Despite their limited ability to access external capital, the Australian mutual sector faces a unique opportunity in the forthcoming updates to the Australian Prudential Standard 112. This standard stipulates how credit risk weighted assets are calculated under a revised standardised approach from January 2023.

One of the fundamental changes will be increased granularity in estimating risk weights for standard mortgages based on factors such as loan-to-value ratios and loan type. Mutual banks in Australia are typically skewed to 'lower risk' mortgages and may enjoy capital benefits upon transition. Furthermore, we expect the standard to tilt the market in the favour of mutuals through a narrower gap in capital requirements between IRB and standardised banks. Amidst the numerous headwinds the mutual sector faces, this may provide a competitive advantage in pricing opportunities. Capital impact analysis and stress testing activities will be critical risk management tools in sizing up these opportunities.

Equally, leveraging technology for a streamlined customer journey will prove essential to maintaining portfolio growth. Many mutual banks are transforming existing processes around static-document and manually intensive credit processes into data-led automated decisioning. Collaboration with Comprehensive Credit Reporting (CCR) initiatives can be a powerful tool to cement the customer service and relationship-oriented business model that Australian mutual banks already leverage. Increased speed, improved conversion and an enhanced customer experience are central to these transformation programs.

NEXT STEPS FOR MUTUAL BANKS

The intersection of monetary policy, regulatory intervention and fiscal levers to maintain financial resilience in the Australian economy, means that Australian mutual banks will need to adapt swiftly to preserve a competitive position. Over the longer term, enhancing and investing in customer journey initiatives will enable the mutual sector to leverage its relationship-oriented business model for portfolio growth. These initiatives include automated credit decisioning, simplified processes and CCR participation to provide detailed profiles of target customers.

In the immediate future, prudent risk management warrants using tools such as scenario-based modelling and stress testing to better understand the effects of upcoming capital reforms. Impact analysis around risk-weighted asset calculations will prove critical in navigating capital ratios and, ultimately, profitability pathways for Australian mutual banks.

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