MERGER AND ACQUISITIONS IN THE MUTUAL BANKING SECTOR

MERGERS BETWEEN AUSTRALIAN MUTUAL BANKS ARE NOT A NEW PHENOMENON. IT'S INTERESTING TO NOTE THAT SINCE 2005, THE NUMBER OF MUTUAL BANKS HAS SHRUNK FROM MORE THAN 170 TO LESS THAN 65 TODAY. THERE HAS BEEN A NINEFOLD INCREASE IN THE AVERAGE ASSET SIZE OF AUSTRALIAN MUTUAL BANKS OVER THE SAME PERIOD.

TRENDS AND OPPORTUNITIES

Whilst the trends and rationale driving mergers remain the same, in recent years, the motivations to enact change and consolidation have become more pressing across the mutuals sector in Australia. On top of that, structurally lower net interest margins combined with permanently high cost-to-income ratios have resulted in profitability in the industry being under pressure. Moreover, limited profitability has restricted the ability of the mutual banks to invest in transformation projects (including of systems and processes) required to compete with other lenders on customer experience and on value. The merger activity that we are seeing reflects this context, as Australian mutual banks scale to become more cost-efficient and to invest in technology.

People's Choice

Both the ground breaking Newcastle Permanent / Greater Bank and Heritage Bank / People's Choice mergers are subject to member approval votes in 2022. Consummation of these plans would create two new top-10 mutuals with each approximately $20 billion in assets.

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The data from KPMG's annual Mutuals Industry Reviews set out the following trends. Over the four years between FY17-FY21, net interest margins across the industry have fallen by 30 basis points to 1.8 percent, while the average cost-to-income ratio has increased by over 2 percentage points to 78 percent. As a result, and despite total asset growth of 39 percent over this period, profits before tax for the sector remained almost flat from $634 million in FY17 to $685 million in FY21. At the same time, the requirement to invest in regulatory compliance has increased, while other industry developments (e.g. NPP, Open Banking, cyber security) have also required significant investment. This is before considering the need to keep up with commercial banks and fintech like digital wallets, banking apps and digital mortgages.

FACTORS TO CONSIDER POST-MERGERS

This year's responses from Australia's mutual banks to KPMG's annual survey demonstrate that the sector as a whole expects these trends to continue. 48.8 percent of mutuals expect their net interest margins to fall by more than five basis points over the next three years. Combined with an expectation by 14.6 percent of mutuals that their cost-to-income ratio will deteriorate by more than 2 percent points in the same three years, this will further reduce the ability of the sector to invest in its development and growth.

With these continued trends and pressures, the mutuals themselves are still expecting more merger activity. 24.4 percent of mutual respondents anticipate being involved in merger activity during 2022, while 19.5 percent are considering the possibility. This is an increase from the responses in 2020 (22.7 percent anticipating and 20.5 percent considering) and 2019 (15.2 percent anticipating and 26.1 percent considering).

As we note the expected acceleration in mutual bank consolidation, it is essential to consider how these mergers deliver member benefits. Many success factors in bank mergers, including strategy and valuation, are often addressed through due diligence. In addition, there are numerous success factors relating to the execution and post-merger integration and managed through integration planning. However, mergers between mutual banks are special because they entail several unique success factors related to the tension between financial vs non-financial values.

WEIGHING UP THE BENEFITS OF MERGING

On the financial side, cost synergies in mutual mergers should come from labour efficiencies, optimised property costs (including branches), greater marketing efficiency, shared technology costs and lower capital costs (including through greater lending diversification).

However, on the labour, property and marketing side, this can clash with member expectations regarding non-financial value: expectations regarding (local) employment, customer experience relating to branches and the unique brand association with a local community or specific occupation.

In most cases, mutuals require 75 percent of participating members to support a merger proposal in a member vote. Because of the need to secure majority member support, this often results in non-financial value (such as brand and identity promises, branch network maintenance and job guarantees) reducing the financial synergies realised in the first years after the merger. At the same time, the integration costs for a merger between mutual banks can significantly impact financial results.

LEVERAGING A MERGER FOR LONG-TERM SUSTAINABILITY

KPMG's analysis highlights that out of the 16 mutuals that merged with a competitor during the FY12-20 period, 13 of them increased their cost-to-income ratio after the merger. While some of this may be due to underlying cost drivers (such as the need to increase expenditure on regulatory compliance), some of this is the result of integration efforts not delivering the potential benefits. Those mutuals that successfully address these success factors can use consolidation with their peers to improve their competitiveness with greater cost efficiency, profitable growth and investment in technology and customer experience.

Ultimately, industry trends and the increasing pressures on financial performance will continue to drive consolidation in the sector. However, the effectiveness of these mergers to create genuine change and improvement will determine the long-term sustainability of the Australian Mutuals sector.

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