S&P Global
Ratings

Research

Larger, Well-Managed Australian Mutuals Will Prevail As Market Consolidates

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Overview

- We expect Australia's mutual banks to remain competitive, but consolidation is inevitable. Larger mutuals will strengthen their position as the number of players in the sector falls.
- We see mutuals continuing to expand outside their traditional common bonds to drive organic growth and merger opportunities
- Mutuals' capital levels are likely to remain very strong. We expect a recent change in law--that allows mutuals to issue regulatory tier-1 capital instruments--will not have a significant impact on their capital structures in the next few years.
- Fintech is likely to fuel further competition; the smaller size of mutuals will allow them to more swiftly adopt new technologies, in some cases.
- The mutual sector will remain a small cog in the wider banking industry. Mutuals will continue to benefit from appeal to customers based on their member common bond. Environmental, social, and governance (ESG) factors could also play an important role in the mutuals' long-term business viability.

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S&P Global Ratings expects fierce competition from Australia's larger banks to force consolidation and evolution in the mutual banking sector. When the dust settles, those that remain will be larger and more sophisticated than the mutual sector players of today.

We expect the combined mutual banking sector to remain a small part (currently 2.5%) of the overall Australian banking system, which the four majors dominate with about 80% market share. The major banks benefit from substantially better economies of scale, access to cheaper and broader funding sources, and more diverse revenue streams. Nevertheless, we believe that mutuals that successfully leverage technology, improve economies of scale, and increase their awareness of ESG issues will be best placed to protect their niches. We expect that such mutuals with defendable business models will continue to enjoy good credit profiles on the back of their very strong capital levels. In contrast, the long-term business viability of many smaller and less progressive mutuals is at risk, in our view.

We define mutuals to include credit unions, building societies, and other mutual institutions that have been awarded a mutual banking license by the Australian Prudential Regulatory Authority (APRA). We rate 15 of these entities in Australia (see table 1).

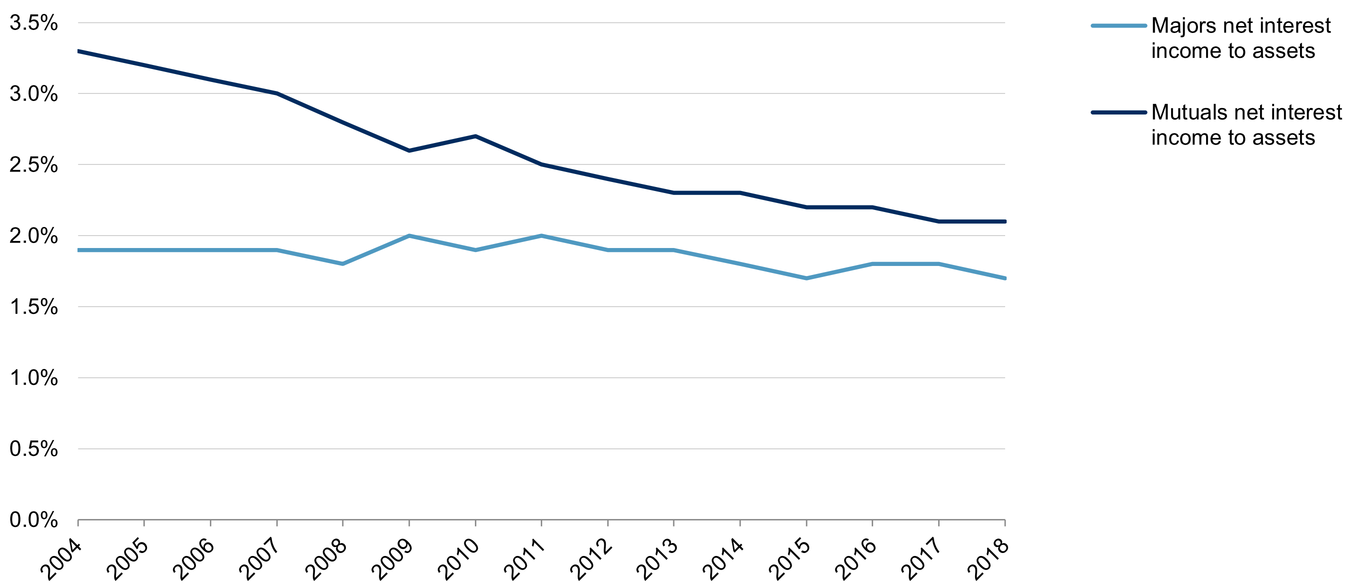
Size Matters--Scaling Up through Consolidation

Continued consolidation within the mutual banking sector is inevitable, in our view. Substantially higher operating and funding costs have materially impeded mutuals' ability to compete with the major and regional banks. Enhancing the scale of operations through mergers is one obvious way for the mutuals to neutralize some of these comparative disadvantages, particularly in the face of rising regulatory and compliance costs. In addition, IT investments in some areas are more viable for the larger banking institutions, in our view.

Although mutuals' margins remain higher than those of the major banks, they have compressed faster than major bank margins over the last 10 years in particular, as competition in the mortgage market has increased (see chart 1).

Chart 1

Price Competition Driving Margin Compression



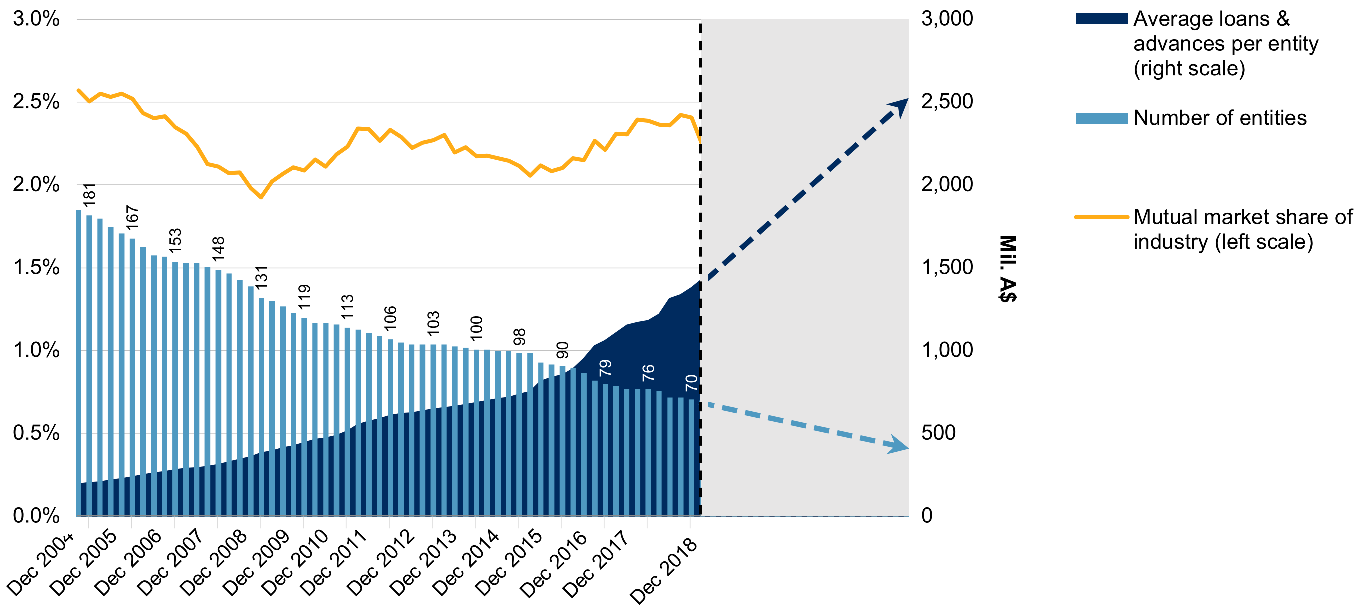
Source: S&P Global Ratings, APRA.

Increased penetration of online strategies and mortgage brokers has materially improved banking customers' ability to compare prices and products. Consequently, mutuals' interest margins have converged with those of the major banks--accelerating consolidation in the industry that has been evident for some time. The sector currently has 70 operating entities with A$117 billion in total assets, compared with 184 operating entities with total assets of A$44 billion in 2004 (see chart 2).

Overall, larger mutuals continue to grow their position within the sector's balance sheet, while smaller mutuals are finding it more difficult to compete. The strong growth in larger mutuals has occurred through both organic and inorganic means, while outpacing system growth in recent years. In our view, mutuals will continue to expand outside their traditional common bonds to facilitate future merger opportunities.

Chart 2

Consolidation Continues As Larger Mutuals Increase Share Within Sector



Source: S&P Global Ratings, APRA.

Mutuals Have A Competitive Advantage In Some Parts Of The Digital Space

Many mutuals are in a better position to update their digital systems than Australia's bigger major and regional banks, for whom capital investments in large legacy systems pose constraints. As a result, these mutuals have been early adopters of new customer-facing technologies, particularly where they can benefit from industry collaboration. Two recent examples are the implementation of the New Payments Platform and the introduction of Pays, both through Cuscal Ltd., resulting in many of the larger mutuals being first to market with these products.

We expect that mutuals will continue to transform their digital offerings while streamlining their backend digital systems (such as core banking platforms) to reduce costs. Such transformation is likely to occur on cloud-based systems, which should reduce personnel and other operating expenses.

Small scale of the mutual players makes it difficult for them to invest in expensive data management while catering to current customer needs, given their customer bases are generally an older demographic that values a physical banking presence. Nevertheless, mutuals that keep pace with technological developments are better placed to attract a younger demographic.

Traditional Niche Customer Base Remains Sizeable

In our view, the values that mutuals champion appeal to a small but still sizeable portion of the Australian banking market. We believe that three factors will remain supportive of the somewhat unique customer proposition that mutuals in Australia offer:

"For the customer" business model: We believe that the not-for-profit and customer-owned features of mutuals remain attractive to a number of customers. In particular, we expect that many customers will remain opposed to the publicly listed, large banks that are incentivized to maximize returns to their shareholders.

Sustainability and social-responsibility values: Currently, not many mutuals are leveraging what we consider a more favorable position on ESG issues compared with their larger competitors. We believe that mutuals' traditional customer base is likely to be more sensitive to ESG issues and an increasing awareness of ESG factors should help mutuals defend their traditional franchise. In addition, the reputation of mutuals has remained largely unscathed in the wake of Royal Commission, media, and other stakeholder scrutiny of the Australian financial sector over the past few years.

Geographic and industry niches: Mutuals have traditionally focused on smaller geographic areas or industry groups. In a number of Australia's smaller cities outside state capitals, the local mutual is a dominant retail banking provider. These mutuals often reinforce their franchise by participating in and sponsoring community events, and supporting social infrastructure. Consequently, local communities tend to have strong bonds with mutuals. Similarly, a number of mutuals focusing on narrow industry groups tend to reinforce a close bond and loyalty within their customer base.

Cross Collaboration And Technology Will Drive Cost Efficiencies And Market Relevance

Mergers are not the only way mutuals can achieve economies of scale. We expect that enhanced cross-sector collaboration and partnerships will supplement mergers in mutuals' quest to improve cost efficiencies. Examples of such partnerships include the Mutual Marketplace established by People's Choice Credit Union and Credit Union Australia Ltd., the use of Data Action's digital platform offering of a standard mobile application across multiple mutuals, and the sector's historic relationship with Cuscal for operational platforms.

We are of the view that the sector will continue to utilize fintech companies to further streamline processes and increase the efficiencies of their digital processes and strategies. The advent of open banking combined with these partnerships should allow mutuals to collect customer data more efficiently and enhance their credit decision processes. Partnerships will allow for more efficient expense verification and provide greater enhancements to measure customer purchasing characteristics and interactions.

Mutuals Offering Contemporary Product Features And Adopting Progressive Management Practices Stand A Better Chance

Notwithstanding potential support from mutuals' traditional customer base, we expect few customers to pay a premium or compromise on contemporary product features or service standards, given that the largely commoditized home loan and deposit products form the bulk of mutuals' business. Consequently, we expect that in addition to improving their cost efficiencies through mergers and collaborations, mutuals that continue their banking evolution will stand a better chance of defending their business position. They have been striving to do this through measures such as:

Expanding beyond traditional niches: We expect that the majority of large mutuals will increase their scale of operations by distributing products and services to customers outside their traditional industry or geography via third-party originators and online originations.

Enhancing their product offering: Changing customer expectations are driving the need for enhanced digital offerings, including a reduced need for physical touchpoints and an increased demand for a seamless customer experience, particularly among younger customers. Larger rated mutuals will continue to invest in enhancing their frontend digital offerings, such as mobile banking applications. In our view, small mutuals that stick to traditional retail banking products and services will face major challenges to remain viable because of their limited economies of scale and the expanding expectations of customers for more sophisticated offerings. Market developments following the establishment of open banking in Australia will be a turning point for new product and service innovation, in our view. Enhancing this need is the demographic shift toward millennials and their demand for more digitally interactive products.

Adopting Progressive Management Practices: Where rigid management structures and key-person risk have characterized some mutuals in the past, we have seen a shift toward more professional and commercially focused entities in recent times. This is evident in the increased depth and quality of mutual management teams over the past decade, with mutuals now having skilled boards with independent directors and strong executive management teams in place. The change in management and board structures has reduced key-person risk and resulted in investment in more sophisticated risk management systems that we view as consistent with that of the industry's larger banks.

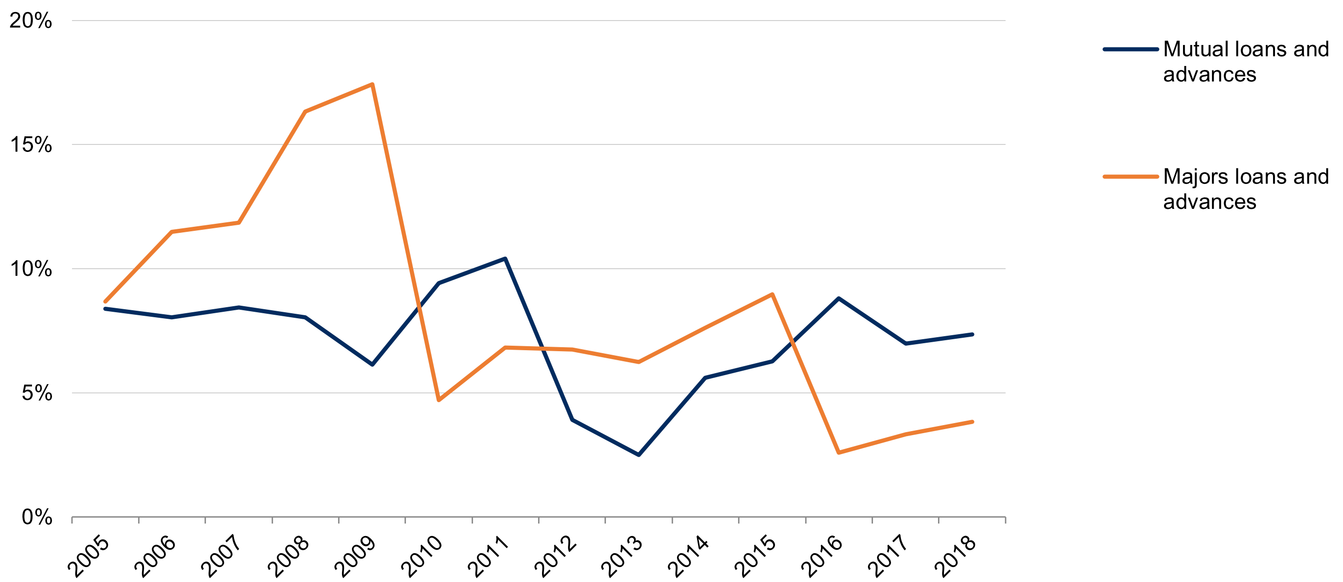
Evolution Will Come With Challenges

Mutuals face a number of risks as the sector evolves. Customers that mutuals acquire through online and third-party originators may not share an emotional bond with mutuals and are therefore likely to be less sticky than the sector's traditional customers. At the same time, mutuals risk disenfranchising their traditional customer base if they are perceived to be straying too far into following the larger banks' practices and culture.

Growth through mergers is likely to be sustainable only if merged mutuals are able to satisfy the niche values offered by the original smaller institutions. We have seen some mutuals achieve this by maintaining the original brands while others have been able to successfully integrate the original brand into their umbrella branding. The mutual sector has grown above system over the past three years successfully targeting customers both inside and outside their niche (see chart 3).

Chart 3

Mutual Sector Has Grown Strongly In Recent Years



Source: S&P Global Ratings, APRA.

Changing Times Could Pose Funding Challenges

Mutuals have traditionally relied on customer deposits as a form of funding their balance sheets. More recently, they have utilized other funding instruments in the form of wholesale funding through securitization, medium-term notes, and negotiable certificates of deposit. The changing funding dynamics have been driven by increased competition in the deposit market and a reduced ability of some within the mutual sector to attract customers through their traditional product offerings.

Changing demand for innovative products will likely see mutuals struggle to maintain their historical strength of attracting and retaining low cost retail deposit funding. There is a real risk they will not be able to attract sufficient new retail funding to fund loan growth ambitions, which will provide funding and earning challenges if they do not take advantage of open banking as well as other operating opportunities such as greater cross collaboration.

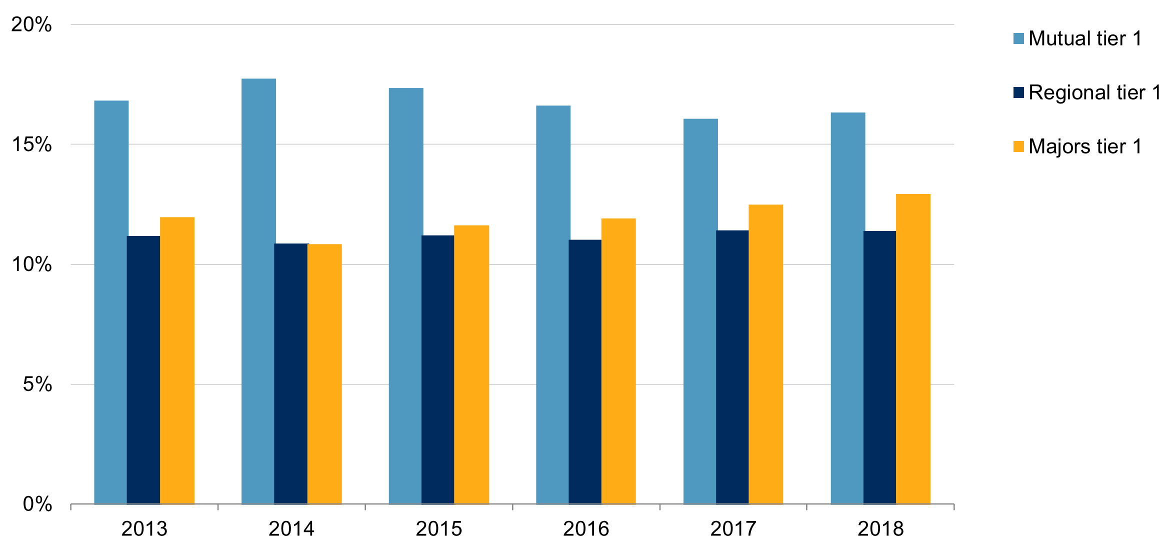
Capital Levels Are Likely To Remain A Point Of Strength

We expect that mutuals will maintain their very strong capital levels relative to peers and regulatory standards. S&P Global Ratings recognizes these capital levels as a strength in assessing all the mutuals that we rate. We also expect that a number of the larger mutuals will continue to utilize capital relief securitization to manage their capital positions and maintain flexibility in their funding structures.

There is a sizeable difference between tier 1 capital levels of mutuals and their larger regional and major bank peers (see chart 4).

Chart 4

Rated Mutuals' Capital Levels Well Above Peers



Source: S&P Global Ratings. Based on 15 fifteen mutual entities that we rate. We have included ING in the regionals calculation alongside Bendigo and Adelaide, Bank of Queensland, and Suncorp-Metway.

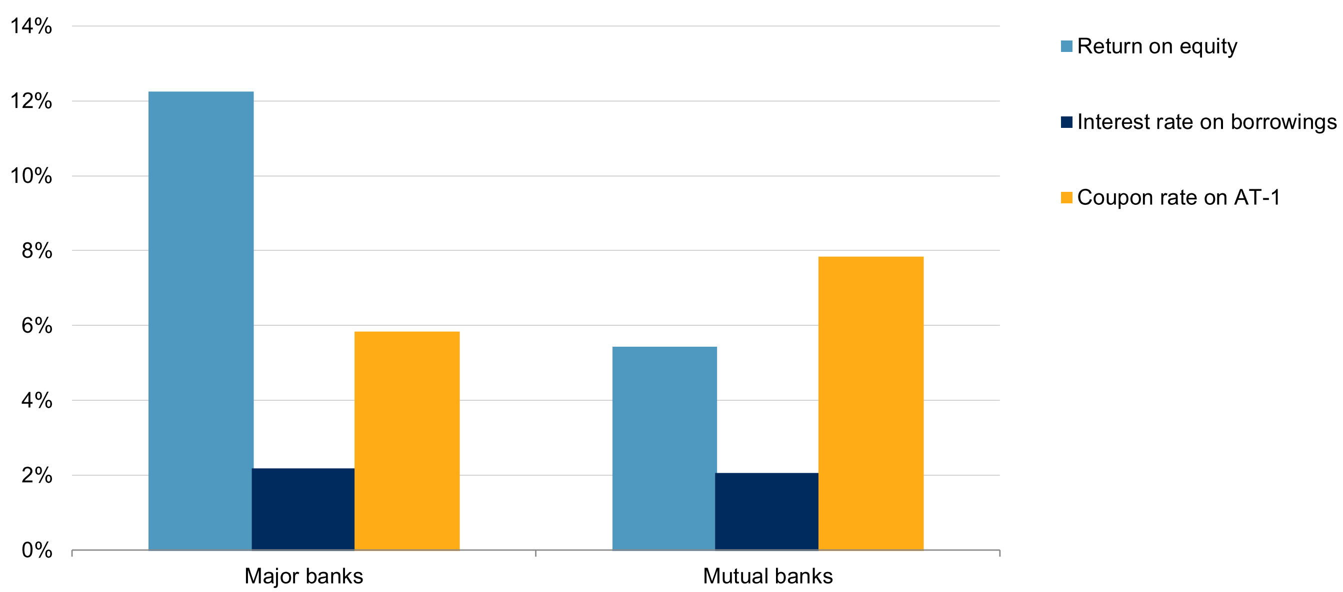
MCIs--Not A Silver Bullet, But Could Accelerate Growth If Profitability Improves

Mutual capital instruments (MCIs) are a type of security specific to the mutual sector. MCIs have similar characteristics to preference shares; such as noncumulative dividends and participation in surplus assets and profits. Mutuals can use hybrid securities to expand their capital base and pursue more capital intensive growth opportunities.

Nevertheless, in our view, most mutuals face material challenges in generating incremental return on equity (ROE) from new projects that would exceed the likely cost of issuing MCIs. We anticipate that even in the current low interest rate environment, mutuals will need to pay a coupon of about 7.5%-8.0% on their MCIs--well above their average ROE of about 5.5%. According to APRA's quarterly banking statistics, the highest ROE averaged across all mutuals in the past five years was 7.1% in September 2016, noting a downward trend since this peak. Consequently, despite a one-off boost to the capital base, without a substantial improvement in mutual sector profitability, MCI issuance is unlikely to be capital accretive on an ongoing basis (see chart 5).

Chart 5

Cost Of MCIs Likely To Be Higher Than Average Mutual ROE



ROE--Return on equity. MCI--Mutual capital intruments. Source: S&P Global Ratings, APRA.

We believe that mutuals' high capital levels offset some of the relative disadvantages they face such as higher operating and borrowing costs relative to scale. The absence of dividend payouts in a mutual structure helps mutuals accumulate capital as they have generally refrained from growing significantly above the returns generated on their capital.

In our view, recent legislative changes that allow mutuals to issue regulatory additional tier 1 (AT1) capital instruments will not materially change the capital levels or composition of these entities in the next two years. Nevertheless, we consider that in the longer term, the larger and more profitable mutuals may be able to use these instruments to support their growth.

Table 1

Australian Mutuals Rated By S&P Global Ratings--Ratings Score Snapshot

	Anchor	Business position	Capital and earnings	Risk position	Funding and liquidity	SACP	Group support	ICR
Rated Entities								
Australian Central Credit Union Ltd. (People's Choice Credit Union)	bbb+	-2	2	0	-1	bbb	--	BBB
Bank Australia Ltd.	bbb+	-2	2	0	-1	bbb	--	BBB
Australian Unity Bank Ltd.	bbb+	-3	1	0	-1	bb+	2	BBB
Community CPS Australia Ltd. (Beyond Bank Australia)	bbb+	-2	2	0	-1	bbb	--	BBB
Credit Union Australia Ltd.	bbb+	-2	2	0	-1	bbb	--	BBB
Defence Bank Ltd.	bbb+	-2	2	0	-1	bbb	--	BBB
G&C Mutual Bank Ltd.	bbb+	-3	2	0	-1	bbb-	--	BBB-
Greater Bank Ltd.	bbb+	-2	2	0	-1	bbb	--	BBB
Members Banking Group Ltd. (RACQ Bank)	bbb+	-2	2	0	-1	bbb	1	BBB+
Newcastle Permanent Building Society Ltd.	bbb+	-2	2	0	-1	bbb	--	BBB
Police & Nurses Ltd. (P&N Bank)	bbb+	-2	2	0	-1	bbb	--	BBB
Police Bank Ltd.	bbb+	-2	2	0	-1	bbb	--	BBB
QPCU Ltd. (QBANK)	bbb+	-3	2	0	-1	bbb-	--	BBB-
Qudos Mutual Ltd.	bbb+	-3	2	0	-1	bbb-	--	BBB-
Teachers Mutual Bank Ltd.	bbb+	-2	2	0	-1	bbb	--	BBB

ICR--Issuer credit rating; SACP--Stand-alone credit profile

Table 2

Key Statistics In Our Assessment Of Australian Mutuals We Rate

	2018	2017	2016	2015	2014
Total assets	5,044	4,789	4,333	3,921	3,587
Average loan growth (%)	6.95	11.86	12.93	7.28	5.14
Net interest income/operating revenues (%)	85.33	83.37	81.29	81.15	80.77

Table 2

Key Statistics In Our Assessment Of Australian Mutuals We Rate (cont.)

	2018	2017	2016	2015	2014
Customer deposit growth (%)	5.11	9.74	9.04	7.36	4.92
Tier 1 capital ratio (%)	16.29	16.04	16.57	17.3	17.7
Return on average common equity (%)	4.19	4.65	5.45	5.68	5.79
Net interest margin (NIM) (%)	2.07	2.09	2.23	2.34	2.37
Cost to income (%)	76.88	75.78	74.52	73.46	73.35
Adjusted non-performing assets/customer loans (%)	0.38	0.4	0.39	0.39	0.38
Net charge off/normalized credit losses (%)	0.02	0.03	0.02	0.02	0.03
Stable funding ratio (%)	103.82	103.18	107.16	109.09	108.22
Core deposit/funding base (%)	84.94	85.74	86.36	90.1	90.55
Short-term wholesale/funding base (%)	7.78	8.51	6.85	5.38	6.33

This report does not constitute a rating action.