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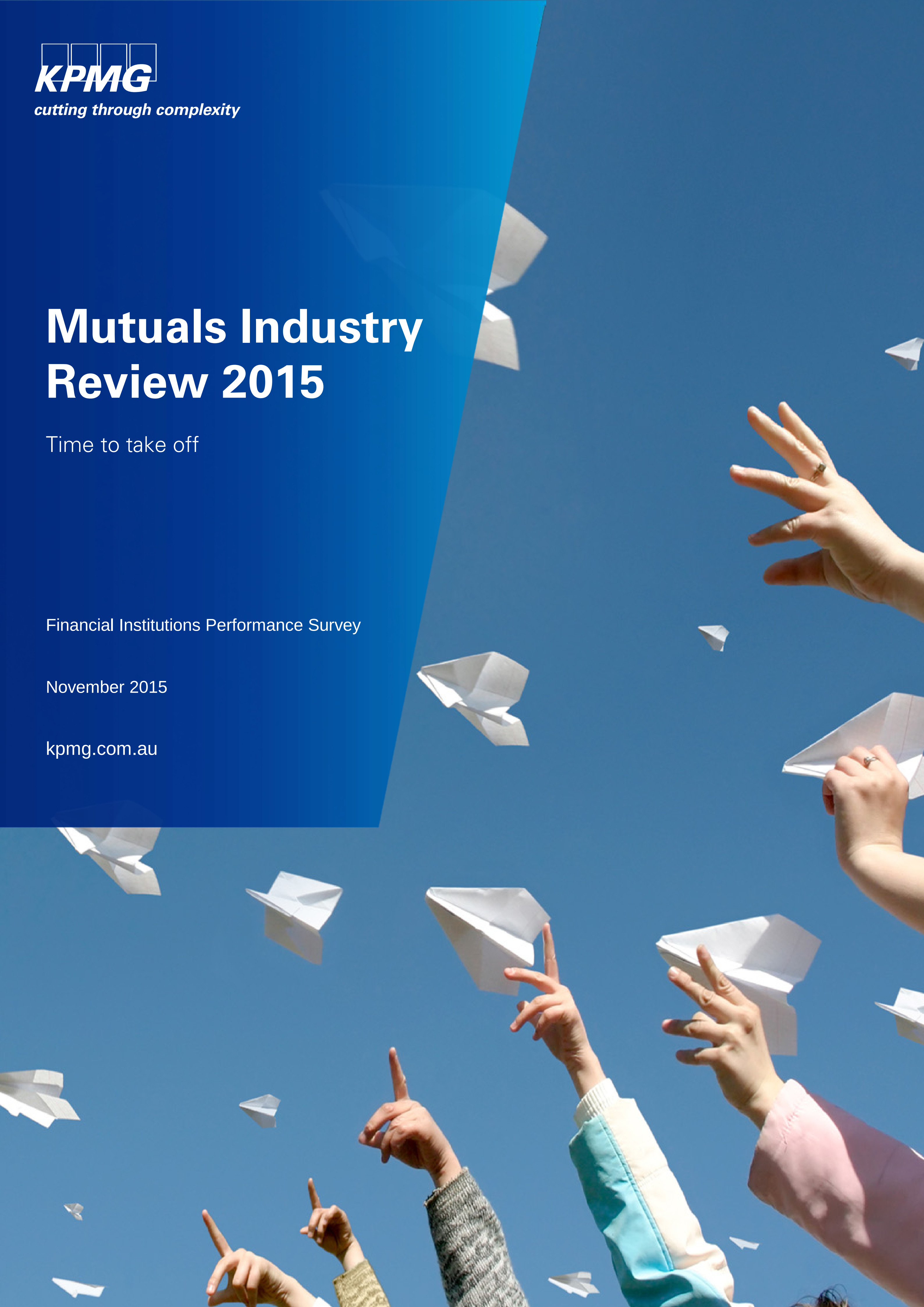
cutting through complexity

Mutuals Industry Review 2015

Time to take off



Financial Institutions Performance Survey

November 2015

kpmg.com.au

Contents

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#mutuals2015

1 Introduction

2015 marks the return of solid growth for Australia's credit unions, building societies and mutual banks (together 'the mutuals') as total assets grew by 7.4 percent and overall profitability remained strong. Total profits for the sector after tax were $449 million. The past 4 years' profit of $1.8 billion provides a strong addition to the overall sector capital base of $7.6 billion.

In 2015/16 we see **six key trends** benefitting the mutuals:

#1 The introduction of capital reforms for residential investment lending, as recommended by the Financial System Inquiry, has levelled the competitive balance across the industry to the benefit of mutuals. In simple terms, as larger banks have raised interest rates on investment and residential loans, mutuals offerings have become more competitive.

#2 Overall lending growth across the industry will continue to be constrained by APRA imposed lending caps requiring consumers and investors to look more broadly to satisfy their financial requirements.

#3 Innovation will occur at a faster pace as technology improvements provide more convenient banking solutions, reducing costly face-to-face transactions.

#4 The cost of technology solutions will fall, allowing mutuals to invest in new and improved business methods.

#5 Financial technology start-ups ('fintechs') will emerge with new business models and concepts that can be implemented and embraced quickly by the mutuals.

#6 The mutuals will make further progress rationalising from within, with the need for greater collaboration intensifying, to provide a greater range of products and services to new and existing customers.

Snapshot of key financial findings

Impairment provisions remain low at **0.08** percent of average gross receivables (2014: 0.08 percent)	**Capital levels** remain unnecessarily high at **17.8** percent average capital adequacy ratio (2014: 18.3 percent)	**Net interest income** grew by **4.0** percent (2014: 2.9 percent)
Non-interest income grew by **2.0** percent (2014: -1.8 percent)	**Total members** increased by **0.5** percent (2014: 0.4 percent)	**Total branches** reduced by **3.3** percent (2014: -3.0 percent)

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In the new world, small can be a competitive advantage as it allows the opportunity to seamlessly join the digital ecosystem and grow without prohibitive start-up costs.

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Mutuals face a number of challenges to increase collaboration and innovate existing business models. The 2015 results show mutuals are moving in the right direction but there is a great deal more required. The mutuals have timed this heavy lifting well as they enter a new phase of rapid innovation and change with the emergence of fintech start-ups having a profound and positive impact on the financial services landscape.

Mutuals can rent core capabilities and focus on what they do best – add real long term sustainable value to the customers they serve. Sourcing core capabilities externally means no longer having to build your own infrastructure with manageable implementation risks at a substantial cost advantage.

The areas where fintech start-ups are emerging cover customers and growth, risk and efficiency. In this report we highlight some emerging fintech start-ups and the services they have developed.

The list of offerings is comprehensive providing new capabilities that add value with improved customer services. Many solutions include the ability to perform the service anywhere, anytime in a cloud based environment, meaning new capabilities can be developed in weeks rather than years.

The changes coming are as profound as the disruption we have seen in the music industry. Like the music industry, the people who will win are those that create the content and have the connection with the customer. Everything in between may change, rationalise or disappear but as long as the customer wants to do business with you ahead of a competitor your business will thrive and survive. The new market dynamics are good news for mutuals, where customer connection is paramount and where the value proposition really adds up.

The results of the survey continue to support the need for changes to Australia's financial system.

In relation to resilience measures, the government notes that "our major banks have adopted similar business models, with home mortgages accounting for around 60 to 70 percent of their domestic lending. This creates some concentration of risk in the system". One solution to this is providing an improved framework for mutuals to grow and improve their competitiveness. As noted in our survey, capital of 17.8 percent for the overall sector is well above minimum requirements.

This results in capital that is not being effectively deployed to fund productive capacity in the Australian economy and, in effect, represents a waste of effective resources. Total capital available in the mutual sector is $7.6 billion. The mutuals could increase residential home lending by some $25 billion if the capital adequacy ratio fell to an industry benchmark of 13.5 percent, which would increase the size of the sector by over 25 percent.

Mutuals tend to hold more capital due to their inability to source new capital via share issues in a period of stress and the prohibitive establishment costs associated with accessing wholesale funding to support lending growth. We see two opportunities to resolve this problem.

Firstly, the establishment of a liquidity support scheme to support mutuals in a period of stress and, secondly, supporting securitisation issues by mutuals by purchasing tranches of notes subject to meeting appropriate credit criteria. Currently, many mutuals are precluded from accessing the securitisation markets due to the cost of a credit rating and the establishment costs of securitising assets.

In relation to customer outcome measures, we continue to support the liberalisation of the use of 'banking' or 'bank' given as an ADI a mutual satisfies the same regulatory requirements as a bank.

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We note that the government did not agree with the inquiry's recommendation to prohibit limited recourse borrowing arrangements by superannuation funds. This is positive as mutuals have limited lending to super funds.

The survey also includes 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 thank each organisation that participated in the survey. This survey would not be possible without your support.

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. mutuals excluding top 10).

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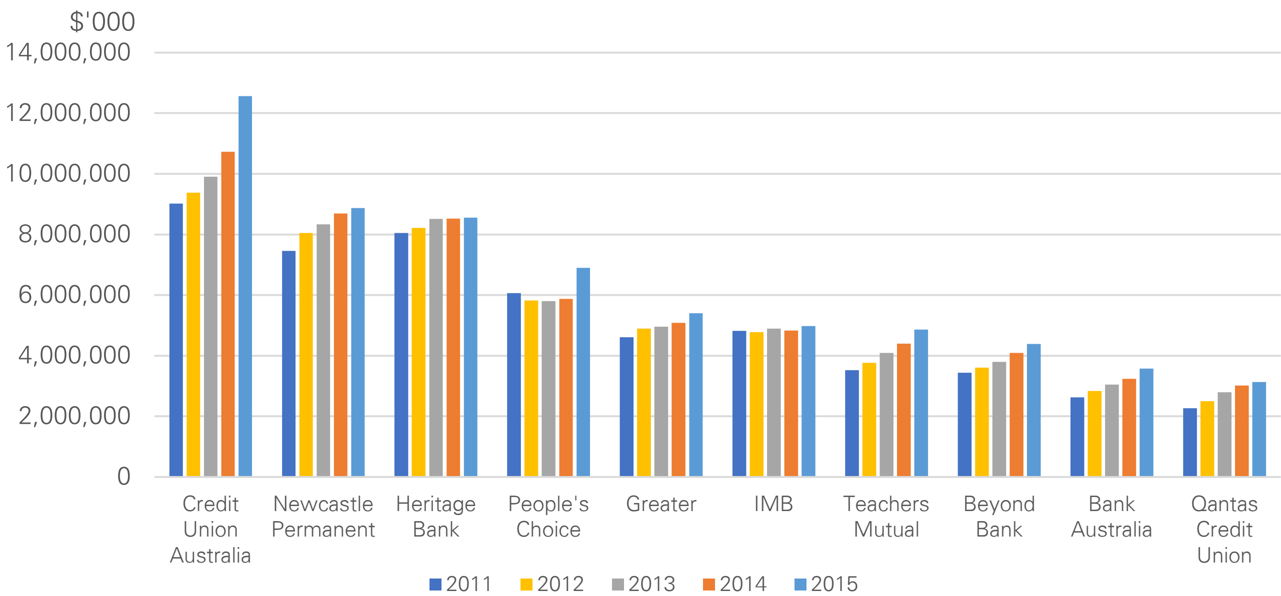
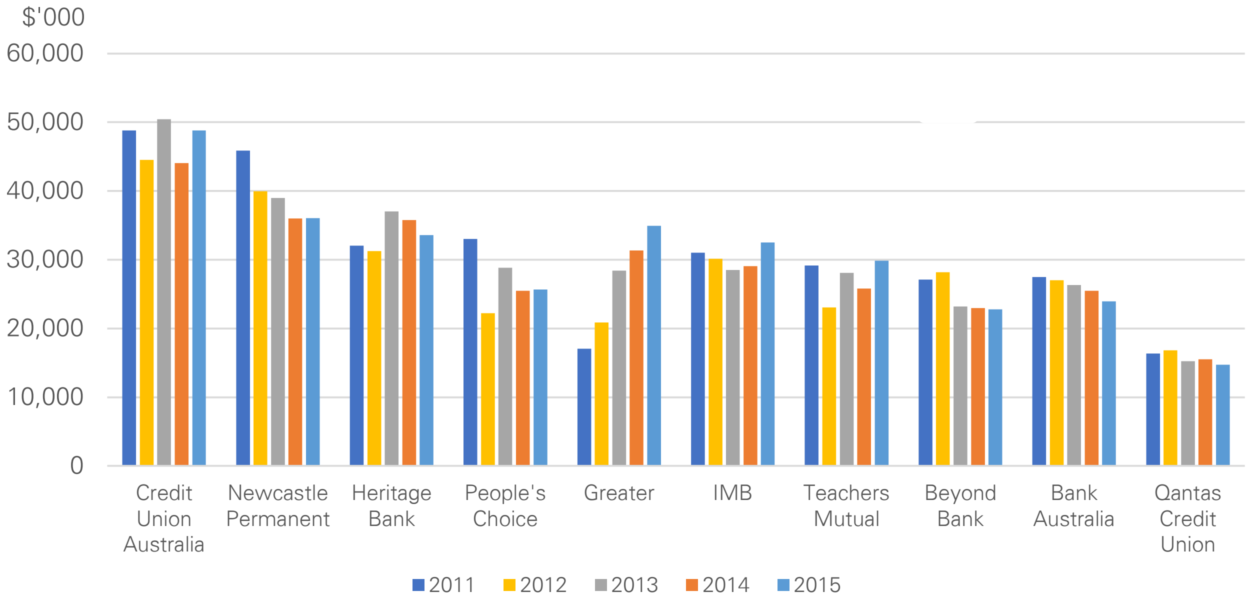
The Top 10:

Total Assets



Operating Profit after Tax



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2 Mutual banks

"The name change to G&C Mutual Bank has been enthusiastically supported by members, who together have helped drive strong business growth for your member-owned bank."

G&C Mutual Bank, Annual Report 2015

Growth in total assets for mutual banks was 6.2 percent in 2015 (2014: 4.0 percent). Two conversions occurred in the financial year ended 30 June 2015.

Since 2010 Mutuals with Tier 1 capital of at least $50 million have been able to apply to present themselves as a bank. In the 12 months to June 2015, the following mutuals converted to bank status:

SGE Credit Union → G&C Mutual Bank

Hume Building Society → Hume Bank

MyState and Auswide also converted to bank status. IMB Building Society converted to a mutual bank (IMB Bank) on 1 August 2015. Australian Defence Credit Union is in the process of converting to Australian Military Bank.

The move to mutual bank status has now been exercised by thirteen institutions. As part of this conversion, many entities have taken advantage of the perceived security, strength and positive associations of the work 'bank', by incorporating it in their new name.

"We provide the same products and services as a bank; and we meet the same financial standards as a bank. This does not mean we will be like the big 4 banks. Hume will remain customer owned and focused while delivering exceptional value to its customers."

Source: Hume Bank website

"The term 'credit union' is not readily understood by younger generations. Thus becoming a mutual bank helps to promote the long term future of the organisation."

Source: Australian Military Bank website

In October 2015, Qantas Credit Union announced a proposed name change to 'Qudos Bank', following findings that 90 percent of people believed that eligibility to the credit union required employment with Qantas Airways.

Greater Building Society has also announced a proposed name change to Greater Bank if approved by their AGM.

Some of the key objectives of our name change and rebranding were to:

- entice and promote open access
- adopt a modern and contemporary look and feel
- boost our attractiveness to the younger generation and other markets.

Source: G&C Mutual Bank Annual Report

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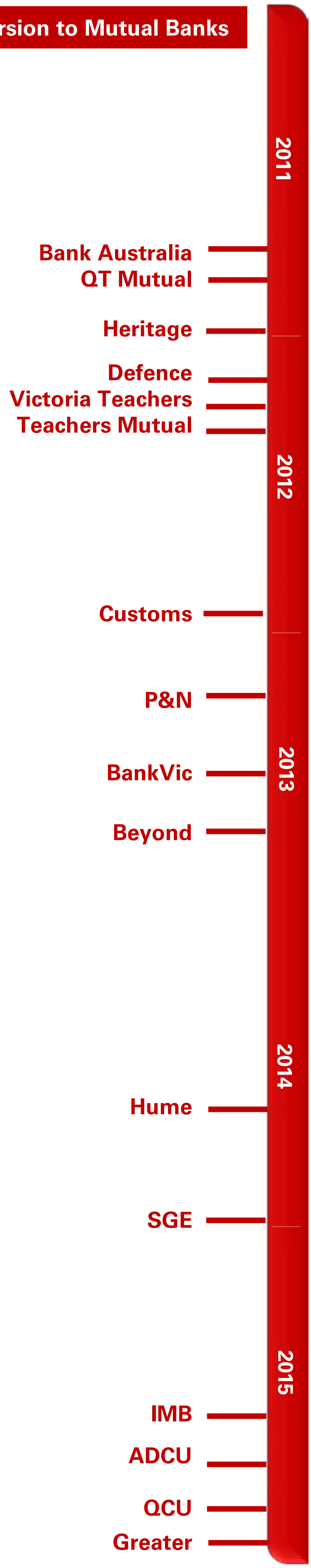
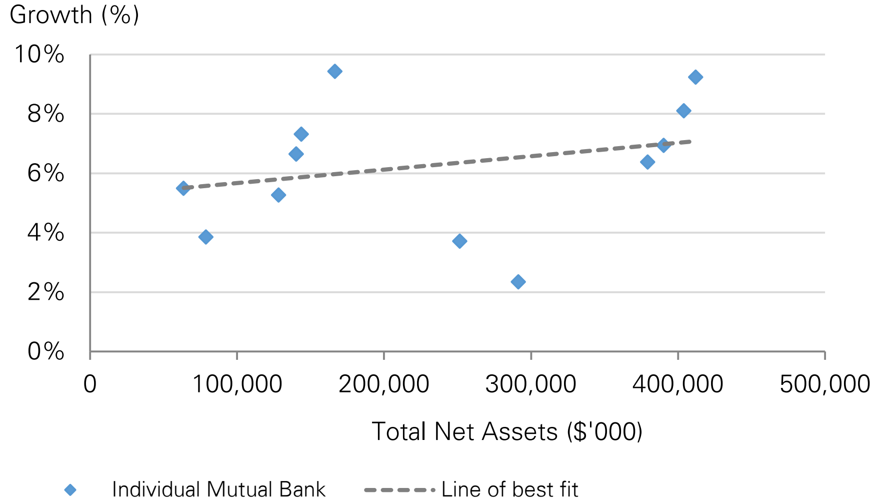
Conversion to Mutual Banks



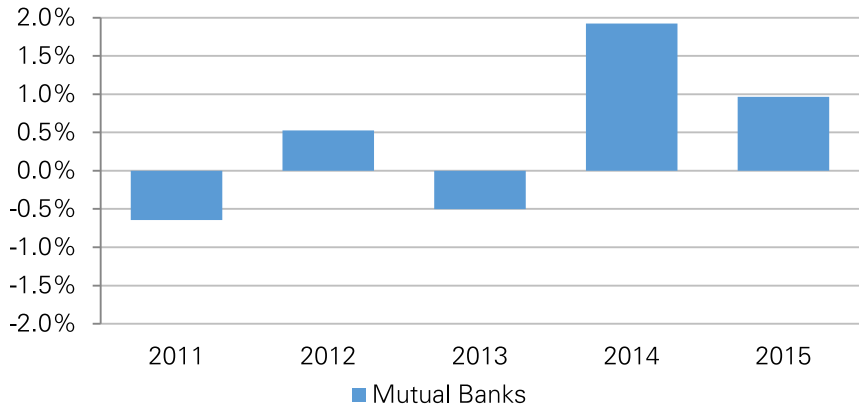
This survey includes all 13 mutual banks ('mutual banks'), which represent 32 percent of total assets in the sector.

Net Assets: Size vs Growth in Net Assets (2015)



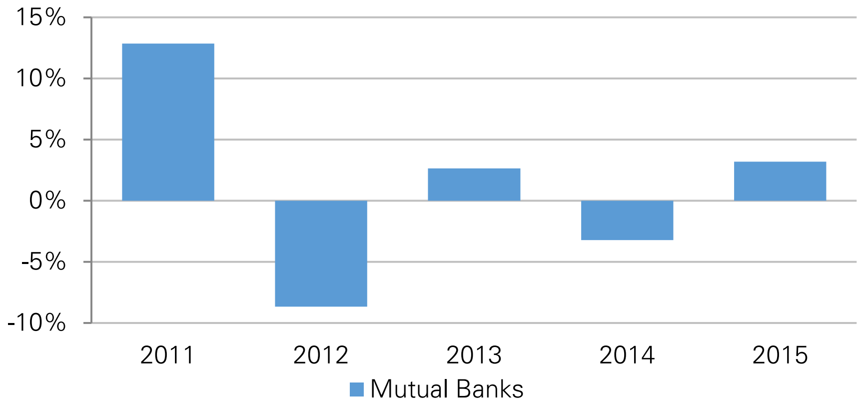
Mutual banks have increased members by 0.96 percent since 2014. Beyond Bank Australia and Teachers Mutual Bank experienced the largest percentage increase in members, with 4.5 percent and 2.6 percent increases respectively.

Growth in Membership



Profit after tax grew at 3 percent in 2015, against percent negative growth in 2014.

Growth in Profit after Tax



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3 Consolidation

The proposed merger will result in a new entity with approximately 75,000 members across the Sydney, Central Coast and Northern Beaches markets with assets under management of approximately $910 million.

Community First Credit Union, Annual Report 2015

Mutuals continue to look for merger opportunities. In the current year, three mergers were completed and four are in progress.

Completed mergers

Maritime, Mining & Power	Collie Miners and Newcom Colliery Employees Credit Union
Teachers Mutual Bank	The University Credit Society (Unicredit)

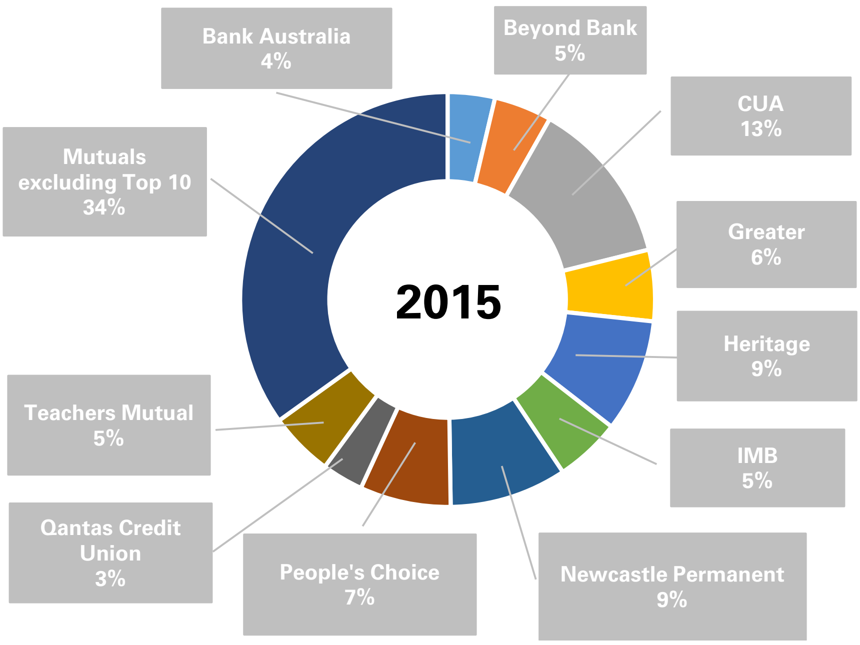
In Progress

#1: Community First and Northern Beaches
#2: Select and Encompass
#3: Country First and Beyond Bank
#4: Maritime Mining & Power and Shell Employees

Mutuals consider member experience to be a key differentiator of their service offering. A successful merger can heighten this experience by bringing together organisations with similar values, to create greater support and service quality to members and their communities. Mergers also lead to economies of scale and provide additional capital to invest in new technologies.

The top 10 have marginally increased their market share, holding 66 percent of the mutuals sector (2014: 65 percent).

Mutuals Sector: Market Share by Total Assets



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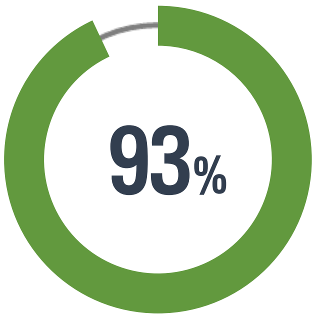
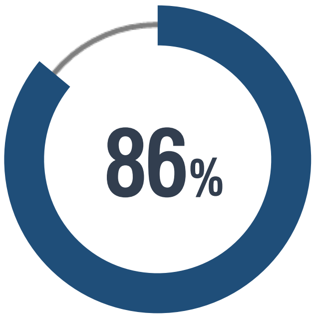
WHAT SURVEY PARTICIPANTS TOLD US



believe there will be less than 80 mutuals in 5 years



consider the Big 4 Banks to be their biggest competitor

48%
believe that competition and margin contraction will force smaller players to aggregate and collaborate

15%
consider regulation will remain an impediment causing the product and service offering to be less relevant

35%
find the pace of innovation makes it difficult for older business models to stay competitive

2%
think traditional Banks may be overtaken by alternatives such as PayPal in the future

Maintaining competitiveness…

Key strategic focuses in the year ahead

38% voted to upgrade IT systems and adopt new technologies/invest in existing or new channels such as social media and mobile banking

13% will look for merger or aggregation partners to increase economies of scale

Your plans to merge:

21% **anticipate** that they will be involved in merger activity

19% are **considering** the possibility of merger activity

60% are **not expecting** any merger activity

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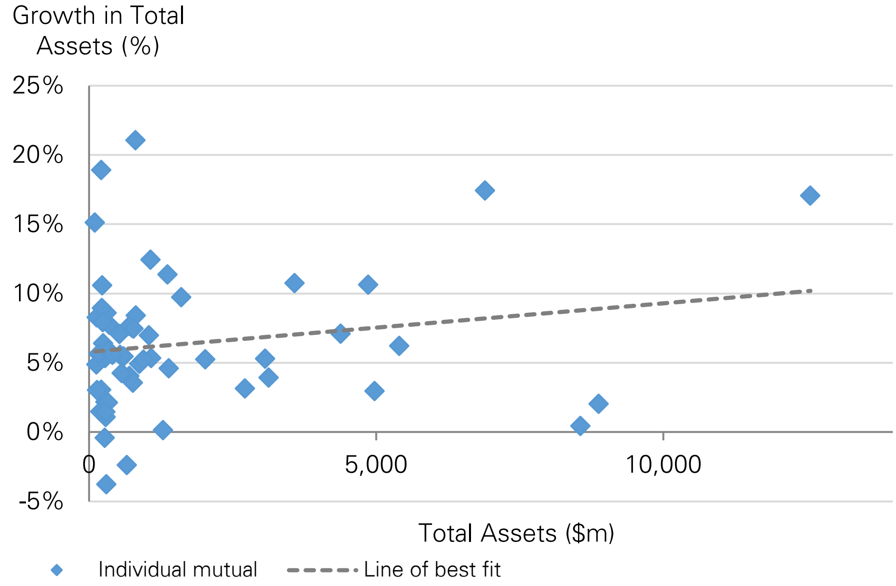
4 Assets and asset quality

> **Our home loans are some of the best value products available on the market and recent enhancements have been a key driver in lending growth which started to pick up strongly towards the end of the financial year – putting us in great shape as we move into 2016.**
>
> *Qantas Credit Union, Annual Report 2015*

Growth in total assets has increased to 7.4 percent (2014: 3.8 percent) on the back of growth in loans and advances, whilst the major banks grew at 9.7 percent (2014: 8.4 percent).

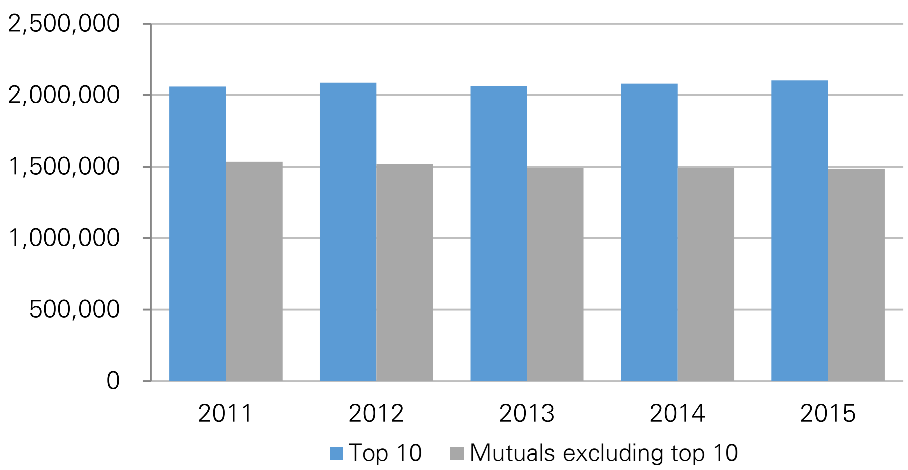
Asset growth in 2015 has been driven strongly by growth in the Australian housing market.

Mutuals Sector: Size vs Growth in Total Assets (2015)



Total members increased by 0.5 percent in 2015 (2014: 0.4 percent). The mutuals are looking at new initiatives to reach beyond their current membership base, and position themselves as a strong and relevant player in the eyes of the younger demographic.

Number of Members



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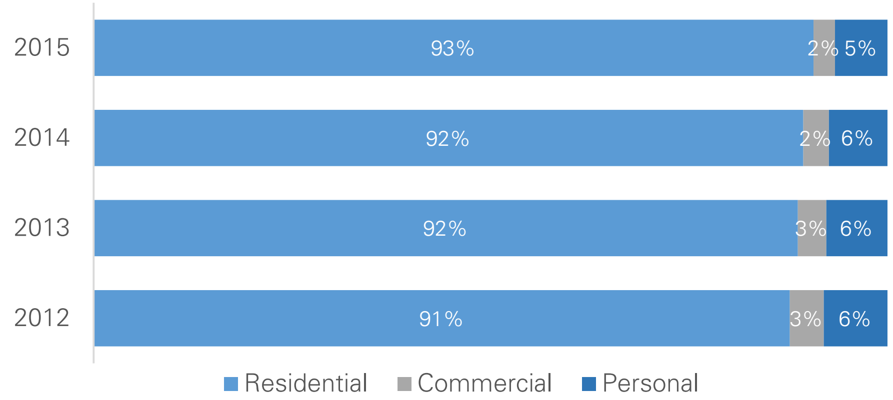
To reiterate my advice at the EGM, 'Modern mutual' means that your company would be owned by its active members and freed to compete for business in the digital age. The specific changes which lay the foundations for CUA to continue its growth but in no way weaken your board's commitment to maintain CUA as a mutual.

CUA,
Year in Review 2015

Loan Composition

The loan portfolio concentration remained focused on residential mortgages in 2015, with 93 percent of total lending secured by residential loans.

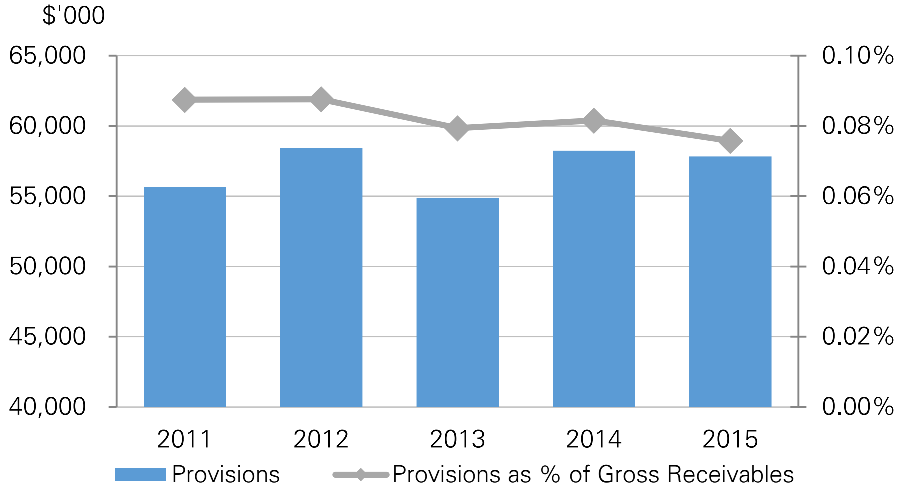
Mutuals sector: Loan Portfolio



Asset Quality

Impairment provisions across the sector fell to $57.8 million in 2015 from $58.2 million in 2014.

Impairment Provisions



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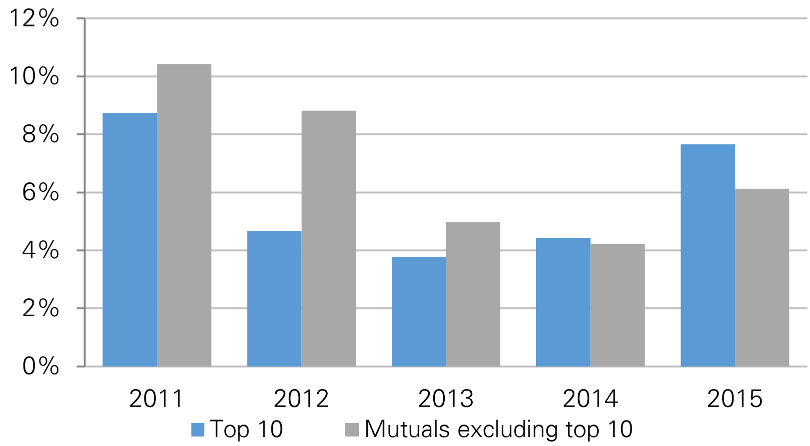
5 Deposits

> **Like all financial institutions, we must retain and cherish our loyal long-standing member base, while also attracting and engaging a younger demographic. This begins with our Tiny Monsters Bank accounts and Mighty Saver teens accounts.**
>
> *Teachers Mutual Bank, Annual report 2015*

Deposits grew by 7.1 percent (2014: 4.4 percent). Mutuals continue to rely on retail deposits as their primary source of funding.

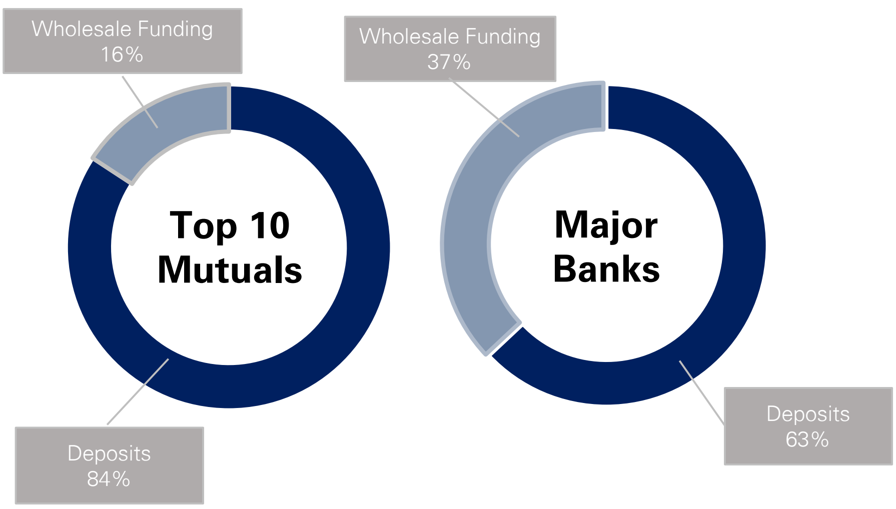
Mutuals continue to face strong competition for deposits. The low interest rate environment has made raising funds from deposits more difficult, as consumers pursue higher return investments. However, the mutuals have continued to increase their household deposits, despite this competitive landscape.

Growth in Total Deposits



Mutuals continue to have limited access to other funding options, such as wholesale funding and institutional deposits. The composition of their funding remains heavily skewed towards retail deposits.

Composition of Funding



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6 Capital

Last year began with a deliberate decision to invest across the business in a host of initiatives aimed at driving enhanced performance. Our internal theme 'earning the right to grow' saw the leadership team focus on improving the core business, our capability, our systems and our processes.

P&N Bank, Annual Report 2015

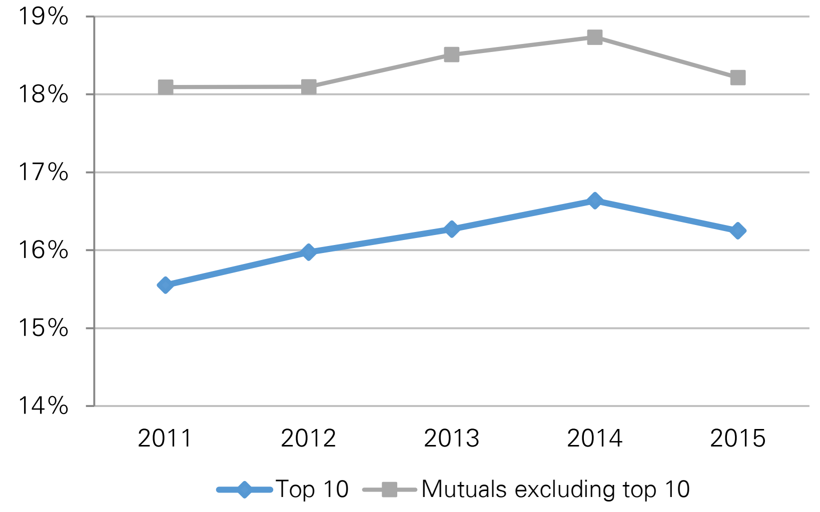
Average capital adequacy ratio has decreased to 17.8 percent from 18.3 percent for the sector.

Average capital adequacy remains higher in comparison to APRA's minimum requirements in 2015. The top 10 have continued to maintain a lower average capital adequacy ratio of 16.2 percent (2014: 16.6 percent) versus 18.2 percent (2014: 18.7 percent) for the rest of the sector.

The slight falls show the mutuals are starting to work their balance sheets a bit harder from a capital perspective. We expect to see further reductions in future years as mutuals seek growth opportunities and optimise capital usage.

The increased capital requirements imposed by APRA that come into effect on 1 July 2016 will not negatively impact mutuals as they already operate at or above these amounts.

Average Capital Adequacy Ratio



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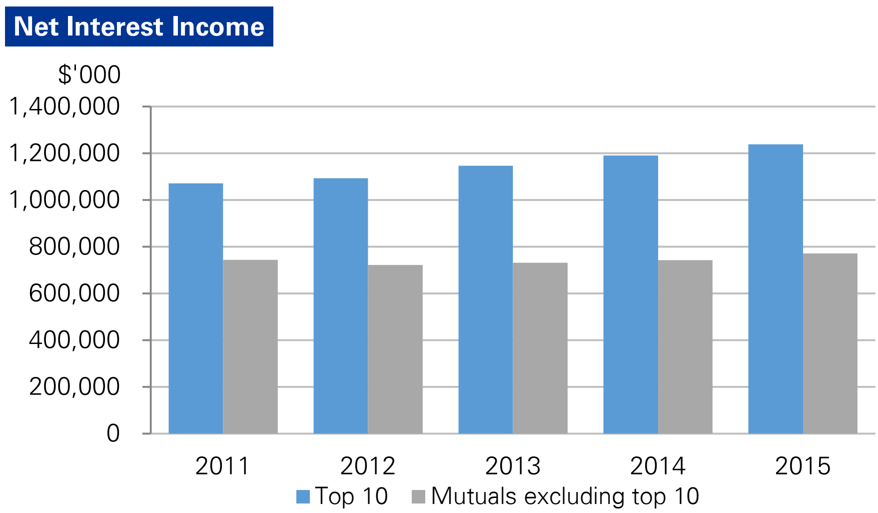
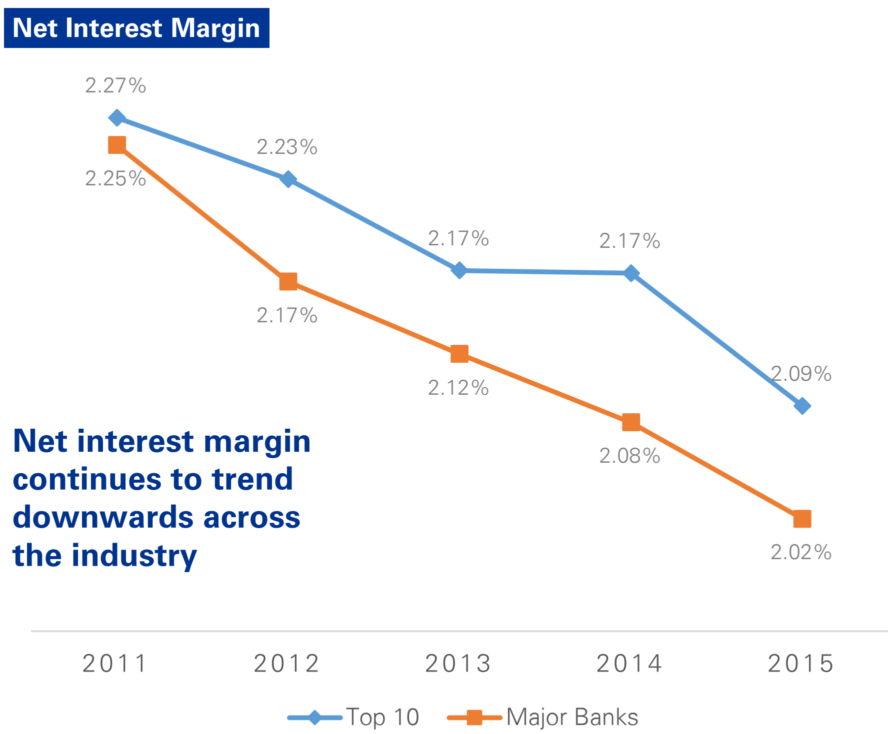
7 Net interest income

> **We face the year ahead with great optimism, recognising that it will be a challenging time as interest margins remain under pressure and competition increases.**
>
> *Gateway Credit Union, Annual Report 2015*

The top 10 mutuals recorded net interest income of $1,239 million in 2015 (2014: $1,190 million). The rest of the sector achieved $772 million (2014: $743 million).



Net interest income for the mutuals has grown by 4.0 percent, with the top 10 mutuals experiencing a growth of 4.1 percent in net interest income. The remaining other mutuals experienced a smaller increase of 3.9 percent.



Net interest margin continues to trend downwards across the industry

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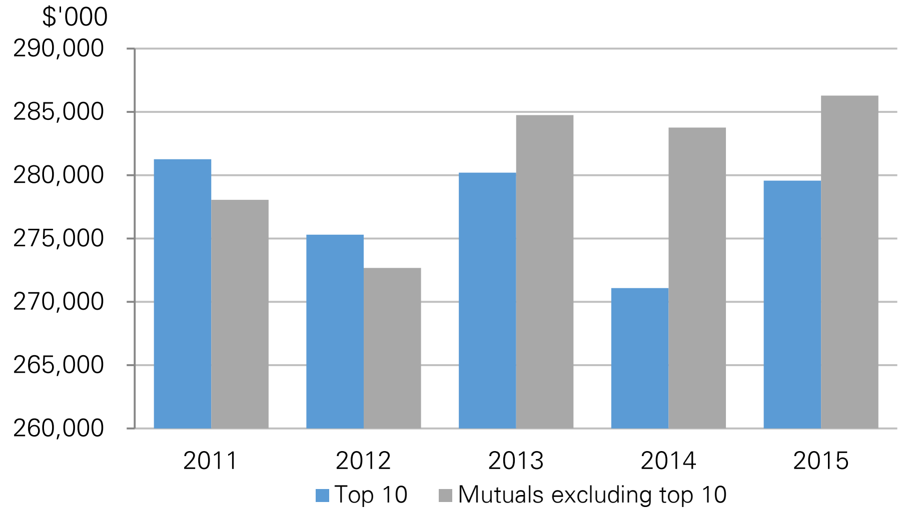
8 Non-interest income

> **The Credit Union has commenced implementation of Phase Three of its Strategic Plan, which primarily focuses upon improved member offerings, greater access options for members, a fairer and simpler transaction fees program, and additional products and services.**
>
> *My Credit Union, Annual Report 2015*

Total non-interest income generated during the year was $566 million, which represents a 2.0 percent increase since 2014.

2015 saw the top 10 mutuals record non-interest income of $280 million, which represented a 3.1 percent increase (2014: $271 million). 49 percent of the total non-interest income generated was attributed to the top 10. Non-interest income for the rest of the sector increased by 0.9 percent to $286 million.

Non Interest Income*



**Figures have been adjusted for significant non-recurring transactions.*

Improving and expanding the sources of non-interest income is becoming increasingly important. In recent times, regulatory pressures on fees have challenged mutuals to set up alternate sources of income in order to sustain or increase profitability. These alternate income sources may include expanding product offerings to include insurance or expanding services to include brokerage, as well as entering new markets.

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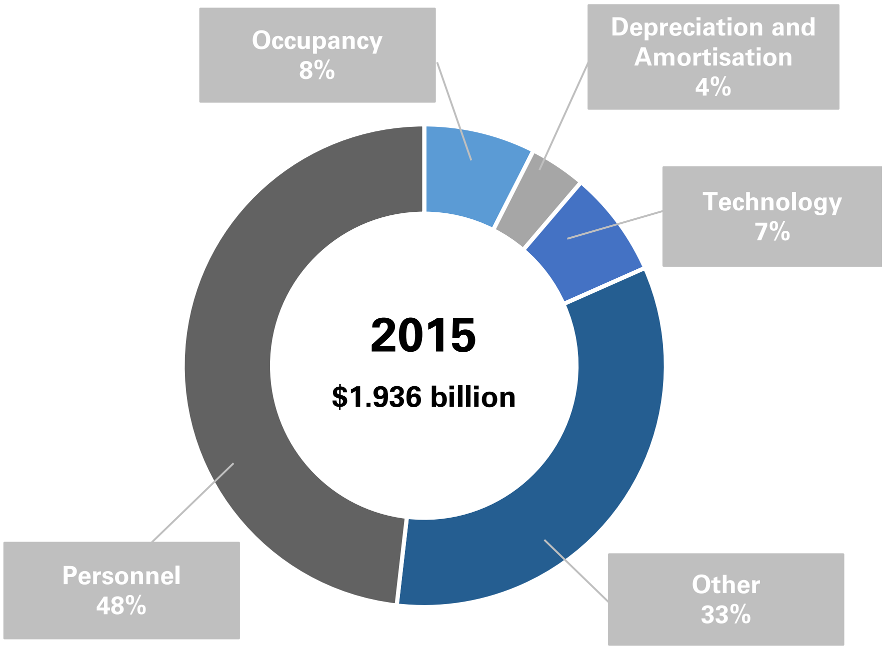
9 Costs

> The Bank remains committed to providing excellent service to its members through the largest network of branches in the Australian Defence Force (ADF).
>
> *Defence Bank, Annual Report 2015*

Mutuals average cost to income ratio has increased marginally to 80 percent (2014: 79 percent). Mutuals continue to look towards collaboration and new technologies to achieve economies of scale.

Mutuals Sector: Composition of Costs



For mutuals, growth and profitability are closely aligned with member satisfaction. Therefore, it is unsurprising that personnel costs remain the largest proportion of total costs as mutuals rely on their staff to deliver a high quality of service to their members.

In 2015, personnel costs increased by 2.9 percent for the top 10, and 4.4 percent for the rest of the sector.

Technology investment continues to rise, to keep up with the unlimited smorgasbord of tools being developed to re-engineer the banking process.

In 2015, technology expenses increased by 1.9 percent for the top 10, and 2.7 percent for the rest of the sector.

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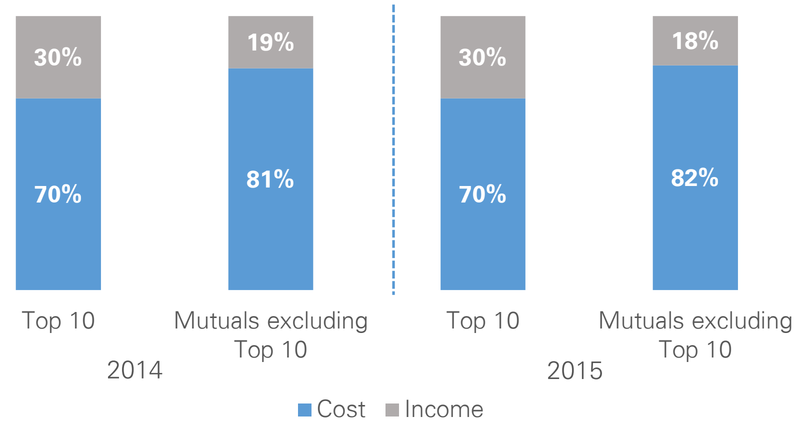
Technology improvements and efficiency in product delivery to members will change the way people bank. In the long run, this will reduce branch related personnel costs as the relevance of bricks-and-mortar changes. The low cost of start-up companies in recent years has meant that partnering with these smaller, emerging players (such as fintech companies) is enabling mutuals to take advantage of advanced technologies at cost-effective prices.

Larger mutuals, are consistent year-on-year while smaller mutuals have shown a small increase.

Cost to Income Ratio



Collaboration within the sector represents a golden opportunity to access cost efficiencies afforded to larger firms that cannot be gained alone.

Source: People's Choice Credit Union

The recent collaboration between People's Choice Credit Union and P&N bank with the digital agency Fusion to co-share their web-platform is a key example of mutuals collaborating to achieve a common goal.

Source: P&N Bank

WHAT SURVEY PARTICIPANTS TOLD US

Biggest opportunities to improve performance in 2016:

40% **Efficiency** – doing more with less

19% **Alliance** partners

15% **Collaboration**

Source: KPMG Mutuals Survey 2015

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10 Senate Inquiry – Raising the issue of tax neutrality

The recent Senate Inquiry has provided an opportunity for the mutuals to escalate the long standing issue of competitive tax neutrality at a time which nicely coincides with the government's tax reform agenda.

KPMG

The current Senate Inquiry into the role, importance and overall performance of co-operative, mutual and member-owned firms has provided an opportunity for mutuals to elevate long standing concerns around tax neutrality and provide recommendations for tax reform.

With tax reform squarely on the government agenda, the Senate Inquiry couldn't have come at a more opportune time. On this point, the main concern raised across the various submissions into the Inquiry was the inability of mutual ADIs to flow through franking credits to members, which inherently places them at a competitive disadvantage to their listed competitors.

The taxation of mutual ADIs at corporate rates, coupled with their inability to distribute franking credits, does provide reasonable grounds for the argument that the ultimate tax burden carried by the mutuals sector is relatively higher than their non-mutual counterparts. This argument is supported by two key principles, one being that the effect of the dividend imputation system is to enable corporate tax to be ultimately levied on the profits distributed to shareholders at their individual tax rate. With the dominance of superannuation fund investors (taxed at 15 percent), the net overall tax rate applied to the earnings of the non-mutuals sector is consequently lower than that of the mutuals. In absence of a franking credit flow through mechanism, the corporate tax burden is borne by the mutual ADI at the headline rate of 30 percent and franking credit balances continue to grow indefinitely. Currently, it is standing in excess of $1.5 billion across the sector, based on data provided by the Customer Owned Banking Association.

Further, the inability of mutuals to pay dividends to members means that they inherently retain earnings which form part of their prudential capital base. However, unlike their listed competitors, increases in the capital base are not able to be returned to members in the form of capital gains.

To resolve the issue of inequity, some industry members have called for a reduced corporate tax rate comparable to the net overall effective tax rate of their listed competitors after taking into account the impact of franking credits across a typical investor base. Whilst this would offer a prospective solution, it does not address the issue of the current balance of accumulated franking credits and is laden with economic subjectivity around the appropriate headline tax rate.

Some of the more innovative solutions focus on the creation of instruments that allow mutual ADIs to release franking credits to their members – ranging from a frankable retail deposit product to a Common Equity Tier 1 (CET1) non-voting capital instrument paying franked coupons.

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In terms of the CET1 solution, the government and APRA have made good headway in this space since the release in April 2014 of a revised Prudential Standard APS 111 Capital Adequacy: Measurement of Capital and an accompanying letter to mutual ADIs. The revised standard allows mutual ADIs to issue Additional Tier 1 (AT1) Capital or Tier 2 (T2) Capital instruments that convert to 'mutual equity interests' where the relevant conversion provisions relating to loss absorption or non-viability are triggered. On conversion, the mutual equity interests are recognised as CET1 Capital for the purposes of APS 111. These changes are a welcome step towards providing mutual ADIs with more diversified funding options and thus, reducing the reliance on retail deposits as the primary source of funding and retained earnings to meet the regulatory capital requirements.

However, further refinements to the prudential standards which allow mutual ADIs to directly issue CET1 instruments (other than in the event of conversion) would be a transformational reform to the industry, serving a dual purpose of boosting the regulatory capital base with the added certainty of the flow through of franking credits to members.

The issue of funding diversification has started to gain real traction across mutuals, and we recommend that all mutuals evaluate their funding and capital requirements and look to take advantage of the recent prudential and tax developments in this space.

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

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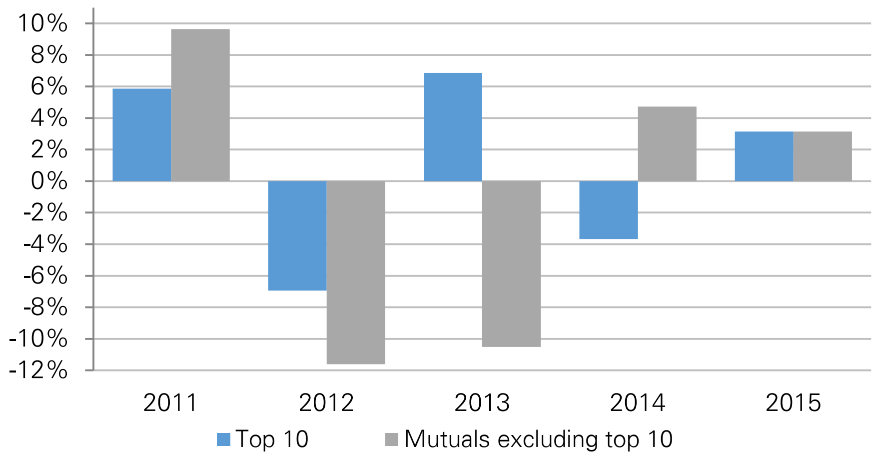
11 Profits

> **One of Newcastle Permanent's key objectives is to provide meaningful support to the regional communities in which we operate. We do this in a number of ways, including community sponsorships and through staff community assistance programs.**
>
> *Newcastle Permanent, Annual Report 2015*

Overall profit before tax of $624 million is a 3.1 percent increase. This compares to the major banks which experienced 6.9 percent growth in profits.

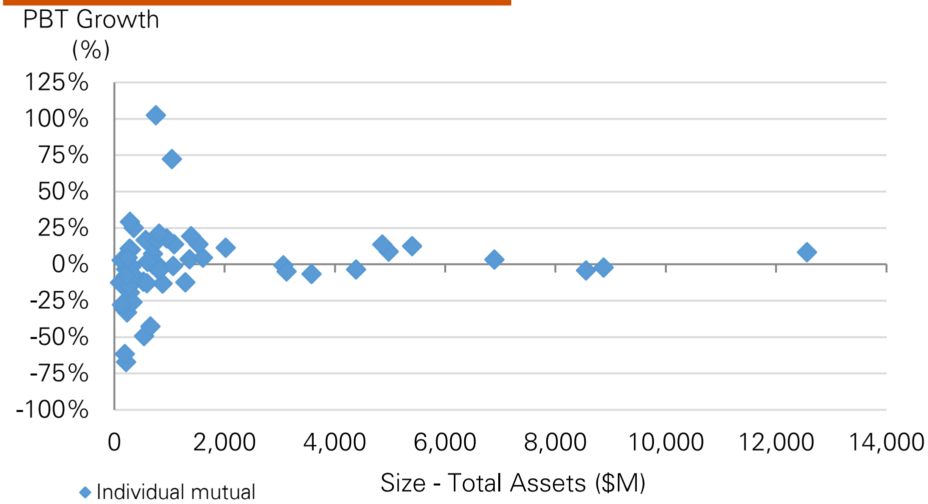
The sector saw a growth in profits in 2015. This is a positive result despite two interest rate cuts by the RBA during the year, which kept interest rates at historical lows. Profit was led by increases in loans and advances and net interest income.

Growth in Profit Before Tax



Whilst profit is a key indicator of financial performance, mutuals are ultimately member-owned and community-focused organisations. For this reason, profits are pursued for the purpose of reinvesting back to their members – through improving products and services, and helping members and communities achieve their financial goals. The positive results today will help lay the foundations for kick-starting the chase of growth opportunities tomorrow.

Mutuals Sector: Size vs Growth in PBT



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12 Presence

> **Investment in infrastructure – both physical and digital, development of staff, and strengthening the economic and social wellbeing of members and the community remained top priorities for People's Choice throughout the year.**
>
> *People's Choice, Annual Report 2015*

Mutuals continue to maintain a strong presence within the communities in which they operate, and giving back remains a key focus.

Community Involvement

Mutuals contribute to the community in numerous ways, generally through involvement in community events and generous donations to not-for-profit and community organisations.

#1: Community Partnerships

Beyond Bank has community partnerships with not-for-profit and community organisations that they believe are helping to make a difference. Beyond Bank provides their partners with banking products, sponsorship, fundraising, and volunteering.

Source: Beyond Bank

Queensland Country Credit Union's Community Partnership Program works with not-for-profit organisations to provide cost effective banking.

Source: Queensland Country Credit Union

Illawarra Credit Union has profit-sharing partnerships with a number of organisations in their area. Illawarra Credit Union will pay 0.2 percent of loan balances and 0.05 percent of deposit balances of members who are referred to the credit union by a club. This provides organisations with ongoing financial support.

Source: Illawarra Credit Union

Community First Credit Union's McGrath Pink Visa credit and debit cards donate half the annual fee to the McGrath Foundation to support the placement of McGrath Breast Care Nurses in communities across Australia.

Source: Community First Credit Union

51% of survey participants said that **community involvement is a key differentiator** for their competitive advantage

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#2: Scholarships

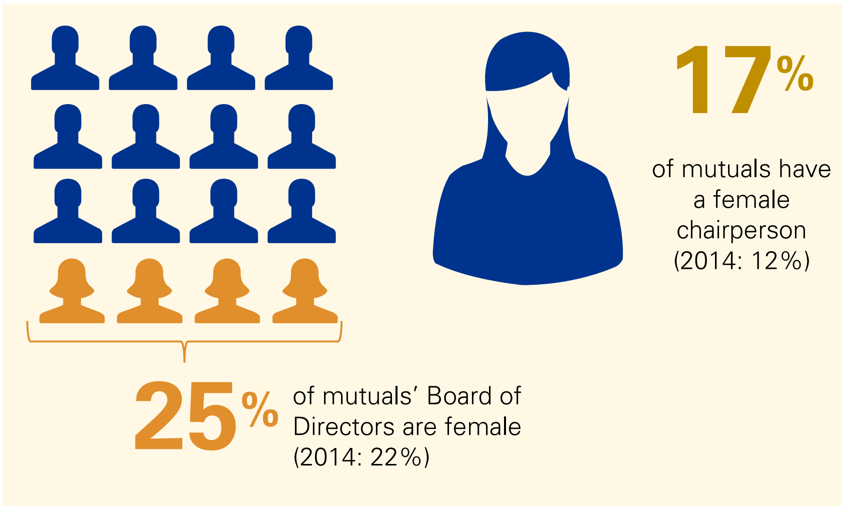
Teachers Mutual Bank collaborates with educational partners and provides financial support through scholarships including: Future Teacher, NSW's Premier's New and Emerging Technologies and Harvard Club of Australia. Teachers Mutual Bank believes in professional development for improving the skills and training for all teachers, principals, deputy principals and administration staff.

#3: Charity Foundations

Greater Building Society has established the Greater Charitable Foundation, which provides support to communities and aims to improve the lives of people within these communities. The Foundation receives funding from Greater Building Society's own profits. An initial $1 million allocation was made to the foundation. Charity partners of the Foundation include Camp Quality, Autism Spectrum Australia (Aspect) and Father Chris Riley's Youth off the Streets.

Gender Diversity

The mutuals continue to promote gender equality.



Relevance of branches

The number of branches continues to fall with a 3.3 percent reduction from last year. This reduction been driven by a shift in focus on the way customers bank and turning attention to the changing and innovative digital environment. Mutuals are pursuing an expansion of their network and building their profile and brand visibility through new online platforms.

New technology and mobile banking are questioning the relevance of bricks and mortar branches

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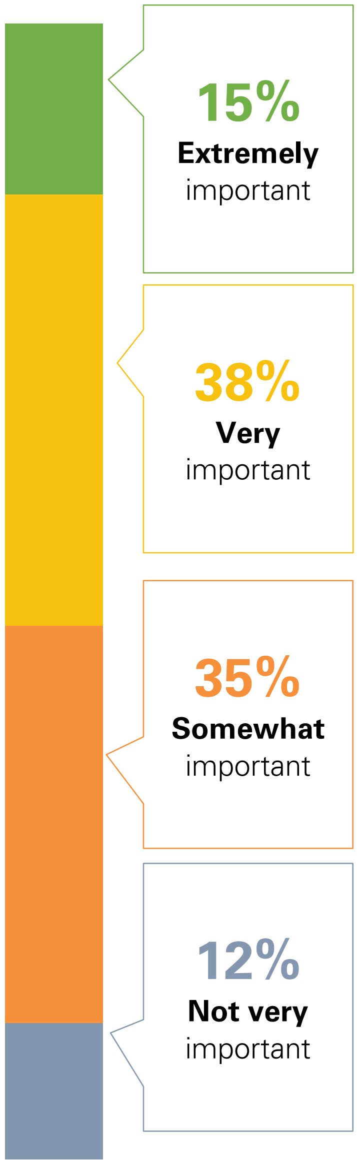
HOW MUTUALS ARE ENGAGING…

Importance of social media to your strategy

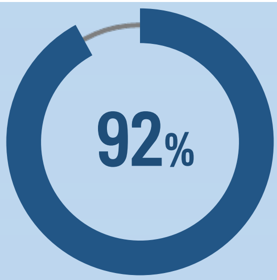


Social Media Insights

Mutuals continued to invest in social media strategies in 2015. However, the results of our questionnaire told us that only 52 percent of survey participants have a clear picture of what people are saying about their organisation on social media platforms, with 19 percent using automated social media monitoring tools. Understanding what people are saying is important for mutuals, not only from a brand and reputation point of view, but also as a means to gain insight into the thoughts of members and to respond directly to their needs.

In an age where thumb tapping on electronic devices is a daily ritual, a strong social media presence presents a gateway for mutuals to always stay in touch with their members. It also provides an opportunity to reach beyond their existing member base and connect with potential customers and, in particular, the youth market. To gain traction with this group, the mutuals must position themselves as a relevant organisation by aligning themselves with the way this target demographic communicates and manages their finances.

Mutuals need to recognise that the cost of social media is low and the potential gains are high. They need to implement a purposeful social media strategy – one that involves actively engaging with users and posting interesting content that will resonate with the audience. This will bring greater value to their customer relationships and demonstrate how well they integrate with their members' lives.



of survey participants have one or more social media accounts

Survey participants considered social media to be the second most important advertising channel for 2016 (No. 1: TV advertising)

Survey participants are sharing through…

83% FACEBOOK	54% TWITTER	59% YOUTUBE	62% LINKEDIN	17% INSTAGRAM

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14 Technology and innovation

We continued our investment in the digital environment with a focused online strategy increasing IMB's footprint beyond the traditional branch network. The digital strategy also supports IMB's desire to continue to grow younger members and allow current members to transact and interact with IMB across a variety of channels.

IMB, Annual Report 2015

The pace of digital transformation is rapid and continues to challenge the traditional ways of banking. Running parallel are the ever-changing needs of customers – processes need to be faster, simpler and better. In order to remain relevant and competitive, mutuals are investing in technology and innovation to keep up with the big players in the industry.

Digital Developments

Investment in mobile capabilities and web-based platforms continued in 2015. This is in response to the changing landscape as advances in technology continue to evolve rapidly. 92 percent of mutuals now have mobile apps and/or mobile-app friendly websites; however, this is quickly becoming an expectation rather than an option. The focus is now turning to the features and functionalities available on these applications. The mutuals have made progress in this area as they continue to invest in new technologies. Another criterion that is greatly valued by customers is accessibility. Customers want multi-channel movement between branch, broker, mobile and other digital devices to be synced and seamless. Going forward, 79 percent of participants plan to increase their investment in mobile in the coming year, with 42 percent including it in their top five projects.

Developments in the Digital Space

Tap-and-Pay

CUA introduced redi2PAY, a secure app that uses host card emulation (HCE) technology to turn Android phones into an instant 'tap and go' payments device.

Source: CUA website

Biometric Authentication

People's Choice introduced TouchID to their mobile apps, allowing members to access their accounts by fingertip touch rather than by PIN, in a move towards greater security for members.

Source: PCCU website

Customer Engagement Tool

Bank Australia reinvigorated an online forum enabling customer interaction and conversations on their website. This was one of the features that led to Bank Australia's achievement of the Canstar award.

Source: Bank Australia website

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Innovation will be the key technology challenge for survey participants in 2016.

Source: KPMG Mutuals Survey 2015

Fintech Collaboration

Emerging start-ups are putting pressure on established organisations with powerful, advanced and cost-effective alternatives to traditional banking. Mutuals have an opportunity to partner with new players to expand market offerings and extend their service capabilities. This will help innovation and competitiveness.

#1: Boost operational and technology efficiency

The digital ecosystem is growing every day and capabilities that were once considered impossible, are now coming to fruition. Ignoring the changing environment will mean falling behind. Therefore, to survive, mutuals are innovating and adapting to the new world. This involves actively investing in tools and technologies that improve business and IT efficiency. Opportunities to become operationally agile in these areas include, but are not limited to:

- A greater online presence and brand awareness through a bigger digital footprint
- Greater service to customers by moving to paperless loan applications
- Reduction of bricks-and-mortar branches through digital improvements
- Reaching new customers through real time pricing, credit score calculation and loan valuation platforms
- Synergies achieved across business units through a single data warehouse

#2: Engage with a younger demographic

The younger generation today will become the main customer demographic for mutuals in the years to come. It is therefore vital to tap into this group by responding to their digital habits and needs. Gen Y professionals have instigated the drive towards convenience and accessibility; and in this technology-focused age, simplicity and frictionless processes are undoubtedly a must.

#3: Value-add to customers

A key focus for mutuals is, and always will be, its members. Mutuals can leverage their deep and systematic understanding of their members to invest in the right tools for members. This involves thinking beyond traditional servicing and capabilities and gearing efforts towards developing valued solutions tailored to their personal wants.

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> **The financial marketplace is continually changing around us and we must respond to these changes. The future lays in technology and our ability to meet our members' future needs, such as mobile banking apps, new payment methods and delivery of loans in a more efficient manner.**
>
> *Encompass, Annual Report 2015*

#4: Cut through the complexity of choice

The evolving speed of the Internet and growing library of information has meant that, more than ever, consumers are faced with an overwhelming array of choices and complexity when making decisions. This has increased the tendency for customers to shop around for the best deals. With greater digital capabilities, mutuals now have an opportunity to switch the direction of choice – reach out to customers directly with quick, accessible and competitive prices rather than wait for customers to approach them.

Mutuals are in a perfect paradigm – they are agile and have flexible business models, allowing them to implement changes at a lower cost and with lower implementation risk than larger and more established banking institutions. Their business architecture allows for rapid yet manageable innovation.

WHAT SURVEY PARTICIPANTS TOLD US...

62% are **flexible** and willing to invest in new technologies whilst retaining more traditional business models

34% are **agile** and are seeking new business models

4% are **sticking to traditional ways** and seeing what happens

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WHAT START-UPS TOLD US…

MoneyBrilliant aims to support the financial well-being of all Australians by empowering them with technology to run their everyday finances, really simply. Mutuals are an important part of the financial mix with a heritage in putting the customer first yet it's hard for them to compete with the technological developments and marketing budgets of some competitors. Our service helps level the playing field for mutuals by providing an innovative money experience that is fast becoming the way customers want to interact with their finances. This deepens the value mutuals offer to their customers, with the potential to elevate mutuals to 'main financial relationship' status.

Jenna Enright, CEO
MoneyBrilliant

Moroku: There are an increasing number of banks and regulators around the world who are turning their attention to a new business model for banking, one based on liquidity, sustainably and growing the overall size of the revenue pool based on customer success. As we do this, turning to game design is a very useful approach.

Game play focuses on the core set of skills and capabilities the customer needs to acquire in order to get to the next level and win. This serves us very well as we turn our attention to customers, how they win, and how banks support their customers' financial journey through a digital experience. This is very relevant for mutuals who compete on purpose, by connecting their offerings to their core values around communities and helping people win financially.

Colin Weir, CEO
Moroku

MOROKU

Avoka: Mutuals have a great opportunity to differentiate their financial services offering on customer service however the modern consumer expects to engage their finance provider through the digital channel. That's where Avoka is working with mutuals like Beyond Bank, ADCU and G&C Mutual – they're leveraging our technology to acquire new members and issue cards/loans online and on mobile. They're using our technology to put a branch in the pocket of every smartphone owner.

Derek Corcoran, CXO

Avoka

AVOKA

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Macrovue is an online platform that makes it easy for investors to manage and grow their wealth. Users can buy and track customisable portfolios of global stocks or exchange-traded funds with the click of a button via a secure, easily-navigable platform. To invest in long-term ideas like food security or the internet of things, buy one of our research-based, diversified, global portfolios. Or invest `socially' by buying portfolios constructed by friends and investment experts. Our brokerage commissions, even for international stocks, are among the lowest in Australia. Macrovue is based in Sydney, backed by AMP, and founded by two former Bank of America analysts.

Sid Sahgal, Managing Director

Macrovue

Proviso: Mutuals are operating in a hyper-competitive environment. Not only is the presence of the big banks increasing, but a wave of non-bank lenders is rolling into the Australian market. With digital innovation and technology as a core competence and without the burden of legacy systems non-bank lenders are creating new markets and taking market share from existing players.

Partnering with Fintech companies is one of the ways the mutuals can keep moving at the pace their customers and the market are demanding. Many Fintech companies – like ours – are innovators, not disruptors and can be used to great benefit by mutuals. Our technology is used to speed up the lending process, reduce application abandonment and significantly improve the customer experience.

If you really care about providing the optimal customer experience and improving your business efficiency then it's not a project that can wait. As an Australian Fintech company, we'd love to help you get there.

Luke Howes, CEO
Proviso

Piggy: Financial issues are the #1 cause of stress and anxiety amongst Australians. Changing that pattern requires new approaches to financial education, user experience and brand communication that the startup model is uniquely suited for. Mutuals have a unique, momentary opportunity to deliver this change through their own startup partnerships, or risk being left behind.

Mario Hasanakos and Alex Badran, Founders

Piggy

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SocietyOne

SocietyOne: At a time when the sector is looking to develop innovative partnerships to help build relevant customer experiences, the online marketplace lending model offers an interesting and cost-effective proposition to grow and attract a younger, more digitally savvy generation. Access to an open architecture, cloud-based market-leading technology platform can help mutuals boost their competitiveness and agility, while allowing for greater product diversification and geographic reach.SocietyOne's variably-costed platform is becoming a very efficient way for mutuals to deploy capital and generate attractive returns.

Matt Symons, CEO and Co-founder

SocietyOne

RISKflo™ synthesises technology and social processes to enable boards and senior executives to rapidly and regularly have:

- a clearer view of their risks
- stronger prevention of those risks
- teams who are more engaged (creating a strongly risk aware culture).

At the heart of the RISKflo innovation is a flexible cloud based collaboration platform – Discovery™. This gives every risk stakeholder a voice, enabling the efficient capture and sharing of expertise amongst colleagues so that diverse expertise informs the organisations view on risk behaviour and how best to manage it.

"RISKflo has removed administrative complexity and cost helping us gather and present meaningful risk insights in our end of year risk assessments and declarations." - GM Operational Risk & Compliance, ME Bank.

"RISKflo's collaboration platform has tremendous potential for the industry to enable calibration of mortgage risk assessment systems" - Executive Chairman Graham Andersen, Morgij Analytics

Martin Kelly, Managing Director

Riskflo

RISKflo

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15 Outlook and challenges

We know the financial service environment is challenging and we don't see this changing in the foreseeable future. It's influenced by ever-changing technology, a competitive marketplace and a more cautious consumer.

Beyond Bank, Annual Report 2015

What will a mutual of the future look like? How will customers manage their money in 20 or even 40 years' time? In this age of imminent change, is it even possible to guess?

Certainly the industry is struggling to decide where their business should be placed only 12 months from now. The impact of digital technology will be vast and swift and entirely transformational.

While mutuals will try to keep up, in the short to medium-term through the latest technological advances and innovative plays they must also carve out a long term road map but a flexible one to allow for fast changes as new disruptive technologies and approaches emerge. It is about readying your business for who your customer will be in the future – whether that is next week or next decade.

Generations X and Y will dominate the financial space over the next couple of decades. Their share of financial assets, which sat at just 36 percent in 2010 is set to jump to 70 percent in 2030.

It is only the beginning of what may prove to be a 40 or 50 year experience for Gen Y-ers as workers, consumers, savers, borrowers and investors.

Today's technology supports a more nuanced approach to the diverse needs of Gen Y-ers. Unlike traditional distribution mechanisms, digital allows you to be a lot more precise in how you deal with the diverse behavioural groups of this cohort.

There is a capacity to personalise and tailor offerings to an extent we have not seen before.

Yet there is another issue to consider here. Any response at a tactical level – through the provision of tools, mechanisms, services, and so forth – can risk missing the essential point moving forward, which is: how can mutuals best position themselves as this generation grows up and their needs evolve? How do the mutuals ensure they are this generation's trusted partner in that long-term economic journey?

When it comes to Gen Y, online and mobile banking are the preferred channels for almost all core banking transactions and services. With such an overwhelming focus on all things digital, it is clear mutuals should be embracing the very latest advances in technology to distinguish their online and mobile channels.

In this fintech enabled age, there are many options to pursue. There are also many providers with whom mutuals can integrate to help deliver cutting edge solutions.

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The notable exception with regard to online banking is obtaining a home loan. Traditional distribution channels will remain critical for the acquisition of home loans. To improve digital adoption for home loans it may be a matter of considering how mutuals can simplify complex transactions to better enable digital customer experiences. It may also be a challenge of looking at how to drive adoption of new channels or technologies.

Ultimately, mutuals have still to decide whether home loans will continue to require a face to face approach as opposed to a fully digital experience. A key challenge is that online research is the prevailing way that young professionals research and choose their financial products. This means that the importance of a mutual's digital presence is more important than ever. Investing in targeted search engine optimisation, search engine marketing and social media will become more important in driving discovery.

The question is: Are mutuals doing enough of it and are they doing it well?

Independent comparison websites are very popular information sources reflecting a generation that grew up with search engines at their fingertips. KPMG research shows the proportion of Gen Y holding financial products at four or more organisations has tripled over the past 3 years. Gen Y struggle to change believing it is too much trouble to change. The challenge for mutuals is to develop the right incentives – such as cash back, waived fees and gift vouchers.

The importance of security is reducing for Gen Y. We see two factors driving this – on one hand there has been a huge increase in different payment mechanisms – on the other, there is the perception that losses are covered by mutuals so to date consumers have not publically seen their cost of risk go up. Mutuals have to weigh this more casual attitude against what they know of cyber security threats. There is no doubt that factors such as increasing third-party usage, greater uptake of digital and cloud-based solutions, and the continuing burden of legacy systems are creating greater risk exposure for mutuals. As a result mutuals need to adopt an equally sophisticated and proactive approach to cyber security.

We acknowledge there is no single route to success. Yet mutuals cannot ignore the demands of the next generation and the underlying foundations required to support this. Customers of the future priorities and preferences are distinctive – and will require careful consideration by mutuals as they shape their business models for the future.

There are four attributes that customers want in their 'Mutual of the Future':

1. Intuitive	2. Convenient
Pre-empting customers' needs and providing them with a holistic and personalised service to manage their finances and future.	Provides easy access to products, information and support along with the ability to effortlessly access and transfer funds.
3. Progressive	**4. Results oriented**
The pace of social and technological advancement will continue, and there is a strong upside awaiting those willing to embrace innovation.	Do more with less. Fulfil the primary purpose of individuals to manage and make money for them.

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We actively seek to create a shared value for all connected with our institution. It's our values based banking approach, and for the purposes of communication, our milestones are described under the 'triple bottom line' performance categories of: People, Planet and Performance.

Community Mutual Group, Annual Report 2015

Ultimately customer centricity and innovation were placed at the heart of the business.

For more information, refer to 'Banking on the future – The expectations of the Gen Y professional' (www.kpmg.com.au)

Cultural Challenge

A recent global KPMG study found that a number of financial institutions have become more focused on increasing shareholder value and rewarding their employees (through incentives), and less focused on value to customers and impact on society. A call to embed a positive culture within an organisation beckons – one that is focused to serve all their stakeholders including customers, society (including via regulators), shareholders, employees and the company itself.

In a competitive landscape, the mutuals are looking to implement strategies and changes that will lead to sustainable growth and profitability. However, in doing so, they must not stray from their core principle: to operate as a member-owned and community-based organisation. This poses a challenge to the mutuals. They must find a way to balance these, at times, competing objectives, and expend the necessary care and awareness to reach a desired end-state that is valued by all stakeholders. The outcome will be higher customer satisfaction, highly motivated employees and overall improved productivity for the organisation. The culmination of these factors will be the catalyst for market share growth and superior returns.

For more information, refer to 'Financial services cultural assessment and transformation' (www.kpmg.com.au).

Data Challenge

Organisations continue to struggle with the challenge of aggregating and managing vast amounts of data. This is magnified by the rapid technological change that has occurred over the past decade, which has radically increased the speed of business operations and the rate at which data is amassed, stored and processed. The culmination of these changes has driven financial services organisations to adopt a more data centric culture with greater emphasis on end to end data management, reporting and analysis.

Over the years, increased regulatory requirements, new corporate structures and new operating models have tested the management systems and data agility of organisations. Regulators have become increasingly concerned about how the current weakness in risk data aggregation systems may compromise financial reporting. For many organisations, the reporting architecture is a patchwork of data extraction, manual calculation and reporting components focused on individual business areas. The main risk implications of this are:

- data is missing, inconsistent, and incompatible, and thus inadequately analysed
- performing trend analysis or operational reviews across a wider business area is difficult to collate and untimely
- the need for quick and accurate data to take remedial action in time-critical situations is not met.

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The challenge ahead is to create a clear data skeleton and invest in data capabilities, not only in meeting regulatory reporting demands, but also in everyday operational analyses. Such an exercise should lead to increased data confidence, reduced potential for loss, efficiency gains and overall improved ability to respond quickly and effectively to changes in corporate strategy and the operating environment.

To do this, the data must be:

Accurate – data needs to be valid and true to increase internal and external confidence and to demonstrate robust data maintenance and controls.

Quality – data across multiple systems needs to be compatible, consistent and complete.

Flexible – data needs to be agile and reactive to market events and ad hoc regulator requests. It must also allow to be split and reorganised to enable analysis in multiple variations.

Efficient – data needs to be effectively managed across different silos and functions. To do this, systems and units need to have a unified approach to data management.

This starts with a cultural change and setting the tone from the top. The strategic approach to risk data needs to be established and the ownership of data must be communicated to achieve cohesion amongst business units with a commitment to data quality and accountability. With multiple systems and incompatible data, risk professionals are currently spending too much time and effort on data aggregation, reconciliation and analysis and too little time on applying the results to risk management and decision making. Establishing a clear data architecture and an effective data quality regime will help resolve this by bringing together the necessary integration of all functional units (i.e. finance, control and IT data sets).

Implementing this change will involve substantial planning, cost and time; however, the long-term strategic and operational benefits to be gained are significant and imperative in our changing environment.

For more information, refer to 'Managing the data challenge in banking' (www.kpmg.com.au).

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Survey scope and contributors

This survey includes 13 mutual banks, 5 building societies and 42 of the 73 credit unions regulated by APRA at 30 June 2015. Survey results represent over 95 percent of the mutuals sector by total assets and profit after 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 covering topics such as: business direction, technology, branches, social media, risks, the youth market and collaboration. The response rate was 68 percent.

In addition to the contributors listed on the Contact us page, the team below significantly contributed to this publication:

Top row: Victor Owusu, Adeel Khan, Anthony Jones, Brett Rosenberg

Bottom row: Peter Russell, Elizabeth Man, Harriet Coles, Lishan Goh, Regina Lee

Absent: Tanya Voronina

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kpmg.com.au

Contact us

Financial Services

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

Ian Pollari
National Banking and Fintech Leader
Partner
+61 2 9335 8408
ipollari@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

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

Michael O Connell
NSW Mutuals Leader
Partner
+61 2 9455 9498
moconnell1@kpmg.com.au

Darren Ball
SA and VIC Mutuals Leader
Partner
+61 8 8236 3197
darrensball@kpmg.com.au

Daniel Knoll
Management Consulting
Partner
+61 2 9455 9148
danielknoll@kpmg.com.au

Kevin Smout
WA Mutuals Leader
Partner
+61 8 9263 7105
ksmout@kpmg.com.au

Kristina Craig
Management Consulting
Associate Director
+61 2 9455 9462
kcraig1@kpmg.com.au

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