



FINANCIAL SERVICES

Building societies and credit unions: 2008

Financial Institutions Performance Survey

BANKING

FINANCIAL SERVICES

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AUDIT ■ TAX ■ ADVISORY

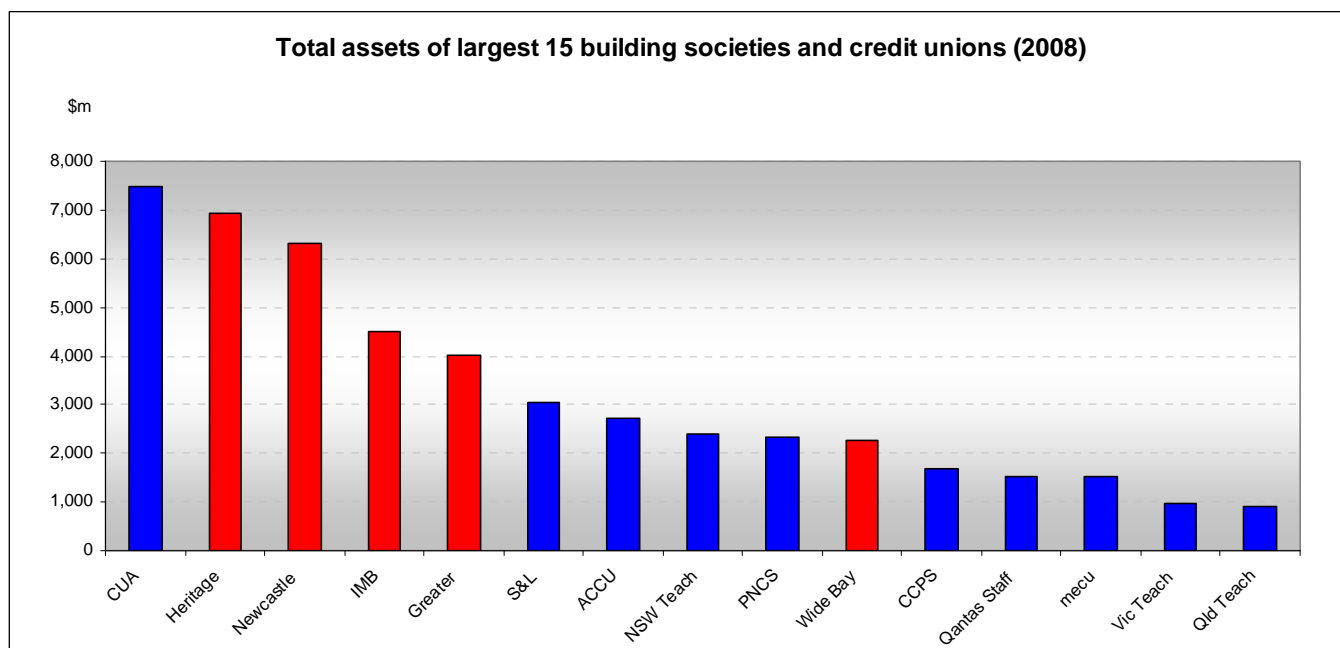
Introduction

Amid the turmoil in financial markets, building societies and credit unions have reported another good set of results in the 2007-08 financial year. Profits increased by 6.2 percent¹ for credit unions and decreased by a small 2.9 percent for building societies. This solid result was built on a foundation of asset growth and continued low bad debts (albeit bad debts increased from the record low levels of recent years).

Building societies have seen their total assets increase 5.9 percent from \$25.5 billion to \$27.0 billion. Credit unions' total assets have increased 11.1 percent from \$37.9 billion to \$42.0 billion. Importantly, funding from customer deposits has largely matched asset growth, with growth of approximately 10 percent for both building societies and credit unions.

In summary it has been a year in which the mutual sector has again performed well, largely by operating conservatively in the markets they know well. They have little or no exposure to overseas markets or large corporates. Whilst no organisation operating in financial services can say that they are completely immune to the recent extraordinary volatility of the markets, the credit unions and building societies results show that their performance is much more closely aligned to the financial situation of their members than to the performance of financial markets.

For the second consecutive year, Credit Union Australia Limited (CUA) is the largest building society or credit union.



¹Movement adjusted for merger gains.

Consolidation

Consolidation accelerated during 2008 with the number of building societies decreasing by two to 11 and the number of credit unions decreasing by ten to 133 at 30 June 2008². For building societies, consolidation occurred through two publicly listed building societies (Home and Mackay Permanent) being acquired by other financial institutions (Bank of Queensland and Wide Bay Australia respectively). In contrast, credit union merger activity continues to be driven by friendly mergers amongst mutuals.

Some of the recent activity is summarised in the table below, which shows that significant merger activity has continued into 2008/2009. The pressure to merge continues, particularly for smaller institutions. In previous surveys we have pointed to increasing regulatory costs and related systems costs as drivers for mergers, with a view to achieving economies of scale. To this we can now add the scarcity of funding in markets traditionally accessed by banks, leading to intense competition for customer deposits. Greater size can assist mutuals in this regard by creating a stronger balance sheet and greater distribution capacity. We expect the pace of consolidation to continue in 2009.

Acquirer ³	Target	Status
Connect Financial	Islandstate	Completed July 2007
Bank of Queensland	Home Building Society	Completed November 2007
The Summerland Credit Union	First Pacific Credit Union	Completed December 2007
Wide Bay Australia	Mackay Permanent Building Society	Completed January 2008
Community First Credit Union	Hibernian Credit Union	Completed May 2008
Maritime Workers of Australia Credit Union	Power Credit Union	Completed July 2008
mecu Limited	Uni Credit Union	Completed August 2008
Savings and Loans	Austral Credit Union	Approved September 2008
New England Credit Union	Orana Credit Union	Completed September 2008
Community CPS Australia	United Credit Union	Approved September 2008
Gateway Credit Union Limited	Broadway Credit Union Limited	Approved September 2008
NSW Teachers Credit Union	TAFE and Community Credit Union	Subject to approval in November 2008

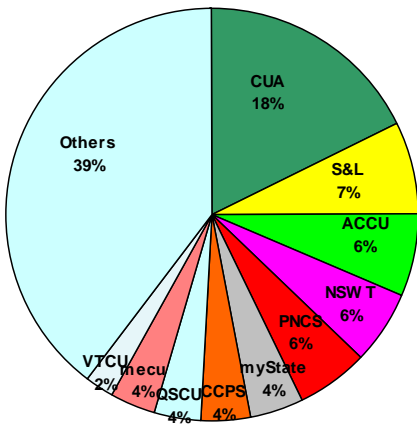
In addition to friendly mergers, building societies and credit unions continue to perform well and accordingly remain attractive potential takeover targets for larger listed financial institutions. However, the global credit and liquidity crises have reduced the appetite of potential acquirers (in addition to reducing the price they are prepared to pay), at least for the short term.

² Source: APRA Quarterly statistics

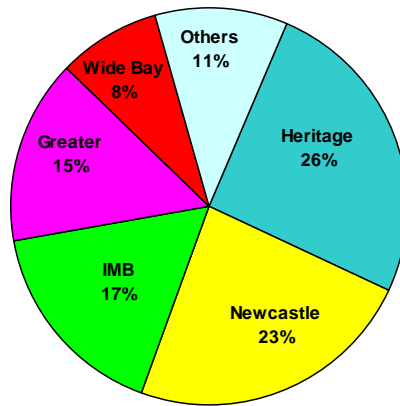
³ There have also been a number of other mergers between smaller credit unions, not listed above. Typically these mergers involve a common interest such as similar industry backgrounds.

Market share of the major mutuals is shown the diagrams below:

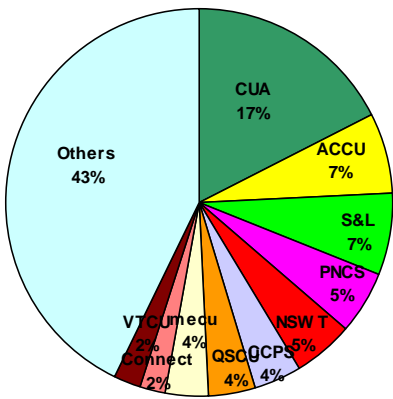
**2008 Credit Unions
Market share by total assets**



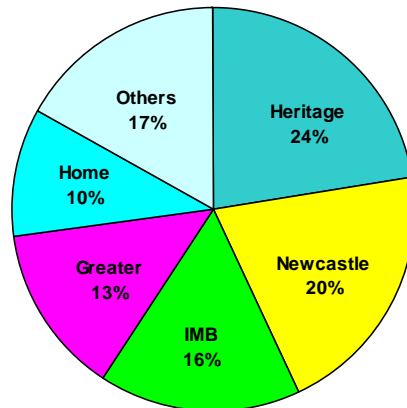
**2008 Building Societies
Market share by total assets**



**2007 Credit Unions
Market share by total assets**



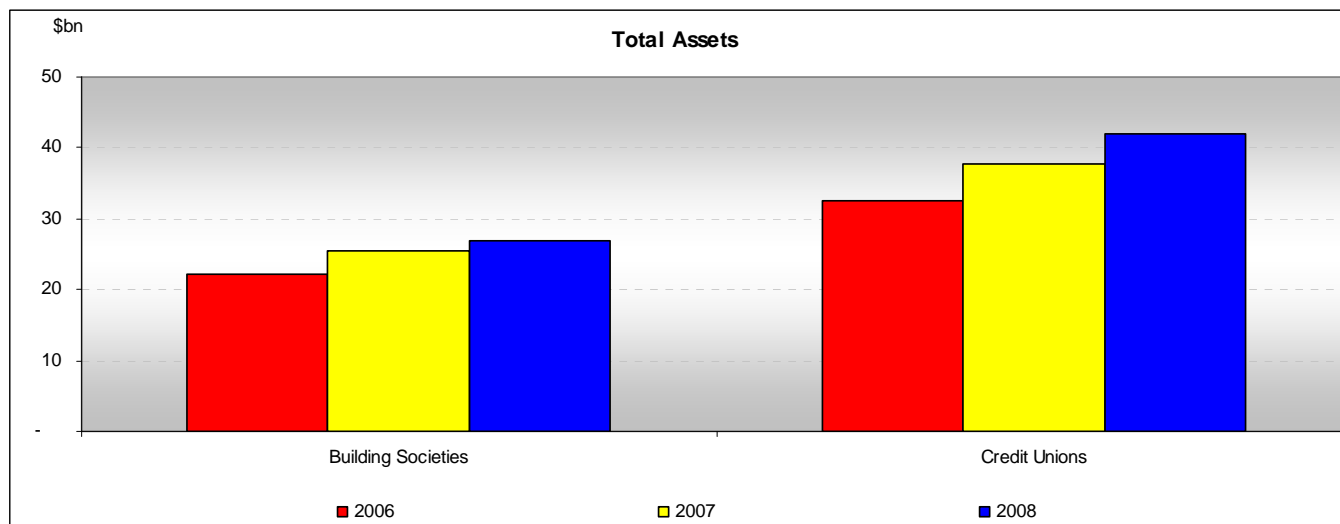
**2007 Building Societies
Market share by total assets**



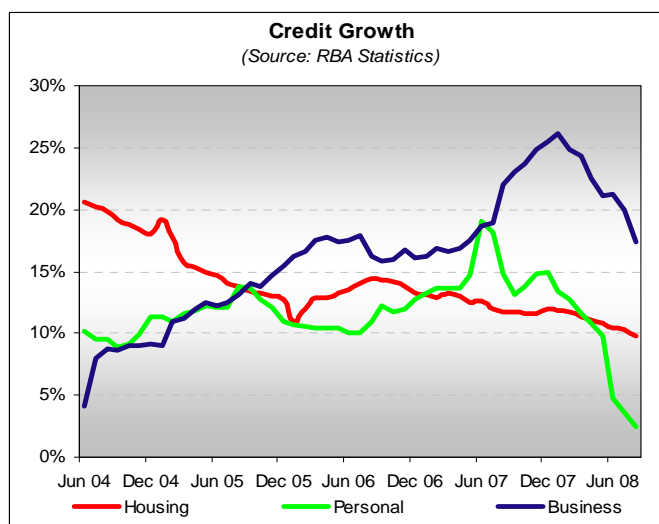
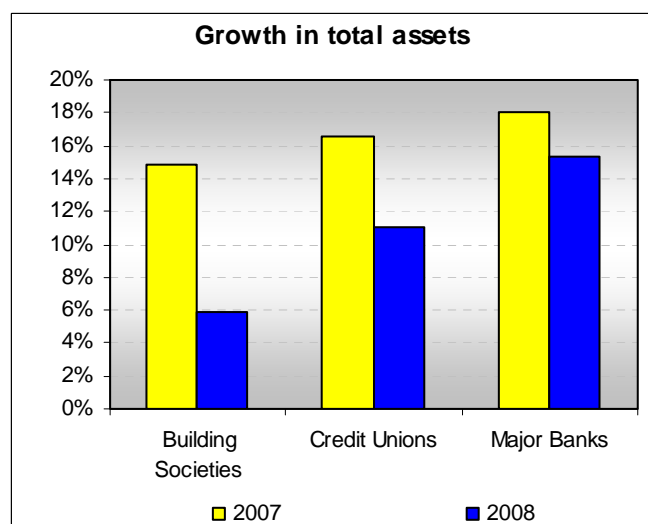
Market share is based on those entities included in our survey – not the sector as a whole. Accordingly “Others” comprise 55 credit unions and 5 building societies in 2008 and 58 credit unions and 6 building societies in 2007.

Assets

The building societies in the survey recorded reduced total asset growth of 5.9 percent in 2008 whereas credit unions achieved growth of 11.1 percent, which is broadly consistent with the growth rate achieved by credit unions in 2007.



According to the RBA⁴, growth in housing lending for the 2008 financial year was 10.4 percent, compared to 12.6 percent growth at June 2007. Business lending has also experienced an increase in growth from 18.7 percent at June 2007 to 21.3 percent at June 2008, after peaking at 26.1 percent in January 2008. Growth in personal lending has however decreased significantly from 19.1 percent at June 2007 to just 4.8 percent at June 2008.

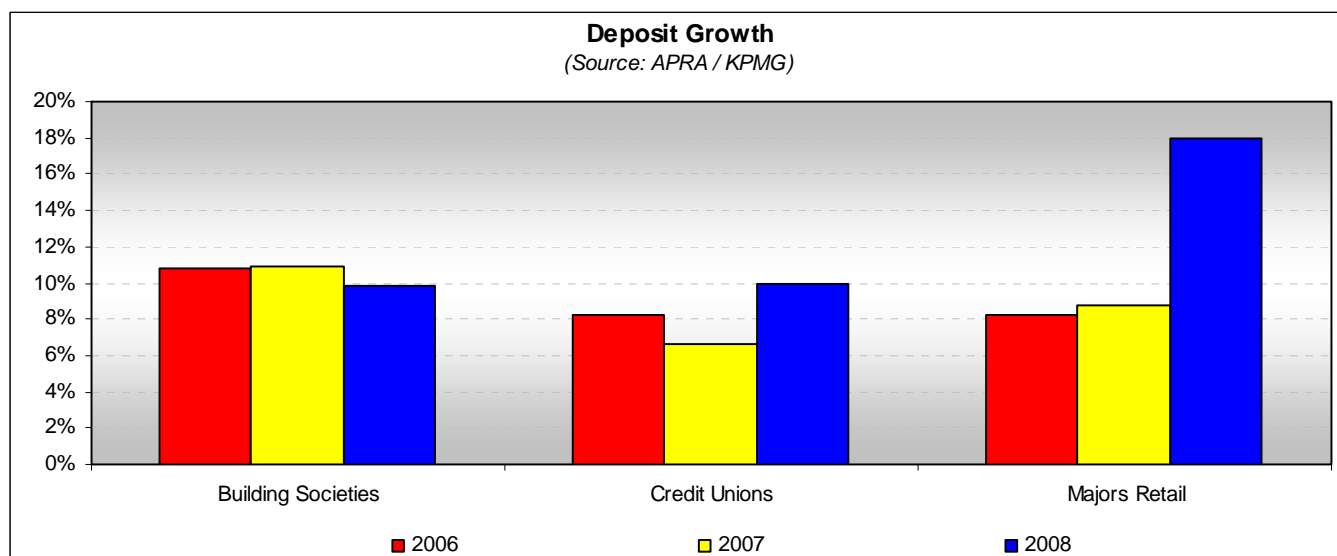


The growth rates achieved by the building societies and credit unions reflects the make up of their portfolios, with a predominance of home lending and some personal lending. The strong business lending growth experienced in the broader market does not have much, if any, direct impact on building societies and credit unions. The data suggests that credit unions maintained, and may have slightly increased, their share of their chosen asset classes, whereas building societies, may have suffered a decline in market share.

⁴ Source: RBA Lending and Credit Aggregates – Current and Historical – D2

Deposits

Both building societies and credit unions achieved deposit growth of 9.8 percent and 11.4 percent respectively in 2008. This compares to asset growth of 5.9 percent and 11.1 percent respectively. We note that the mutuals deposit growth is well below retail deposit growth achieved by the major banks of 18.6 percent and overall system growth in retail deposits in 2008 of 17.9 percent⁵. This reflects the strong focus the banks have given to raising customer deposits following the significant decline in the availability of wholesale funding. To some extent the growth in market share of the banks may also reflect a “flight to quality” prior to the introduction of the government guarantee of deposits.

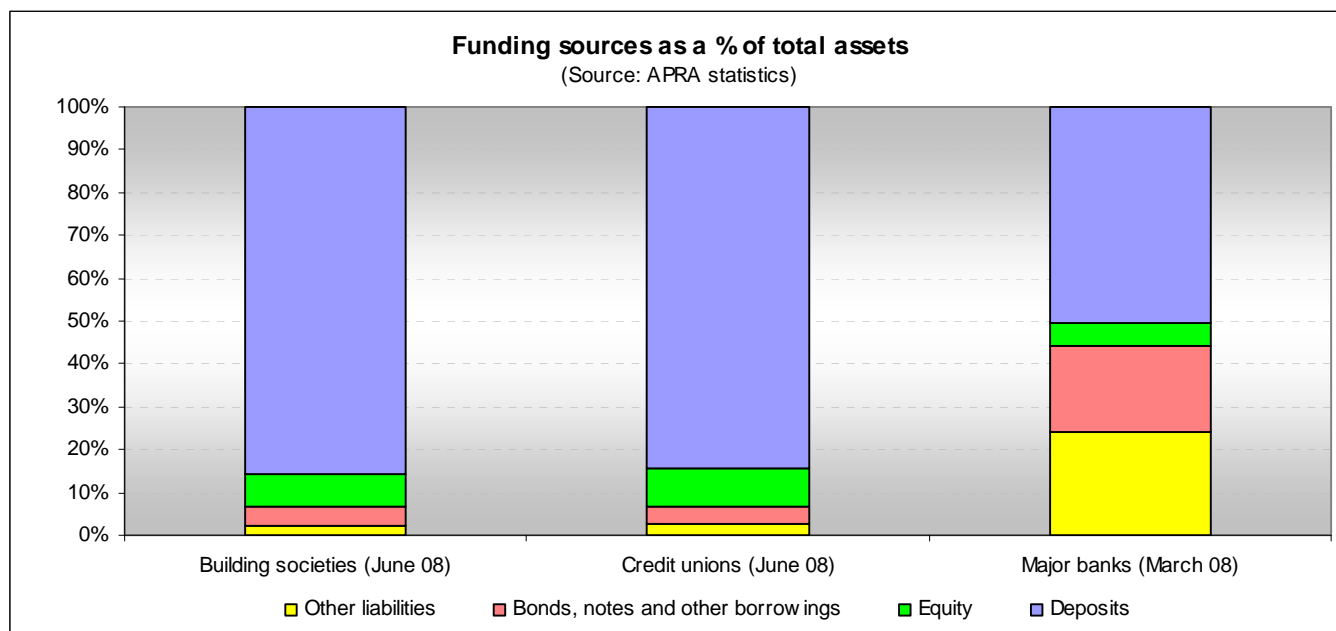


All financial institutions, including building societies and credit unions, have experienced strong asset growth over the prior few years. Easy access to relatively inexpensive wholesale funding, particularly securitisation, made it possible for financial institutions to increase lending without undue concern about their ability to fund that growth. As a result, for an extended period asset growth outstripped growth in retail deposits.

This situation has changed dramatically. With the recent troubles in wholesale funding markets, retail deposits became a key funding focus for all financial institutions during 2008. This is nothing new for the 70 percent of building societies and credit unions in this survey who fund more than 90% of their assets from capital and retail deposits. However, the environment became more challenging for the few mutuals who have been significant users of wholesale markets, typically by way of securitisation of home loans. These building societies and credit unions have experienced a mixture of lower lending volumes to match the availability of funds and erosion of interest margins due to the increased cost of wholesale funding (where available).

The contrast between the funding of the mutuals and the banks is apparent in the graph below. The traditional focus of the mutuals on customer deposits has placed them in a strong position to weather the global credit crisis and is reflected in the strong results for the sector overall.

⁵ Source: APRA Monthly Banking Statistics



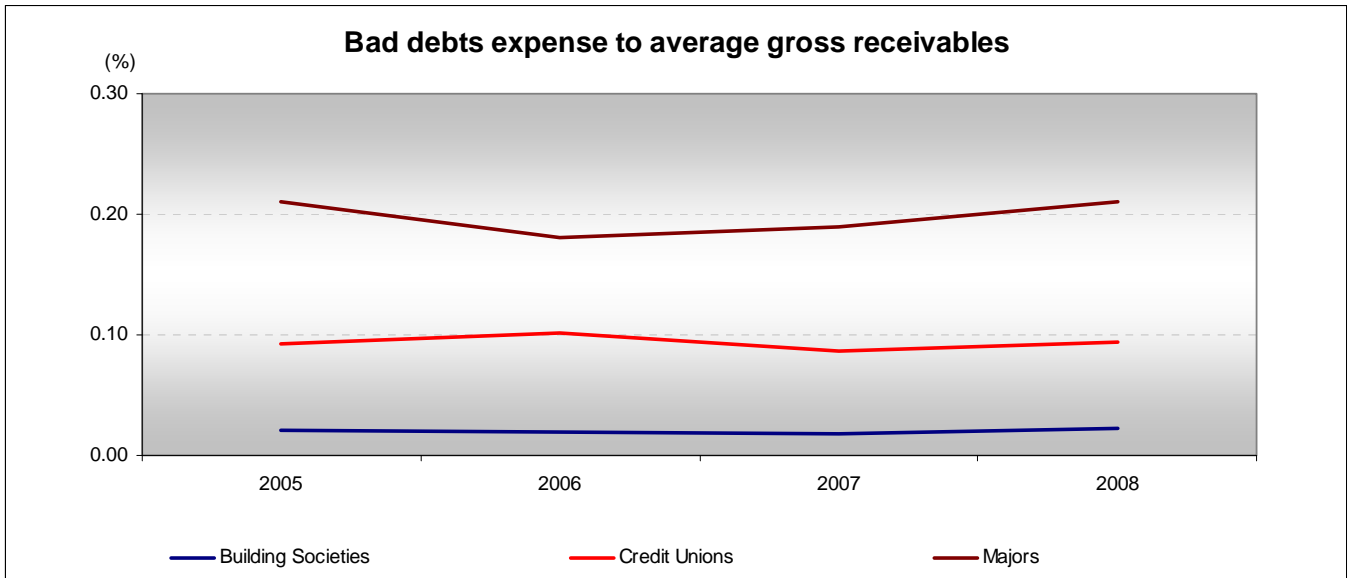
Looking beyond the period covered by the survey, the Federal government deposit guarantee announced in October 2008 will have a significant impact on the retail deposits and wholesale funding of all financial institutions during 2008/2009. The immediate impact has been a flow of funds from other investment classes into deposits with APRA approved deposit taking institutions (banks, building societies and credit unions) as investors react to the new risk and reward dynamic created by the government guarantee. Building societies and credit unions have benefited from the flow of funds to deposits however we expect that most will not experience the same level of deposit inflows as the major banks due to differences in their customer base.

The guarantee scheme fees, which come into effect from 28 November 2008 and impact deposits over \$1 million, will create a competitive disadvantage for building societies and credit unions relative to larger AA and A rated banks. For instance the fee non-rated building societies and credit unions pay to guarantee deposits over \$1 million will be 80 basis points higher than that paid by the AA rated major banks. Further, the fee threshold of \$1 million minimum deposit may distort pricing such that deposits just below \$1 million receive more attractive terms than those above \$1 million. Building societies and credit unions will need to adapt their deposit strategies proactively to maximise retention of existing large deposits.

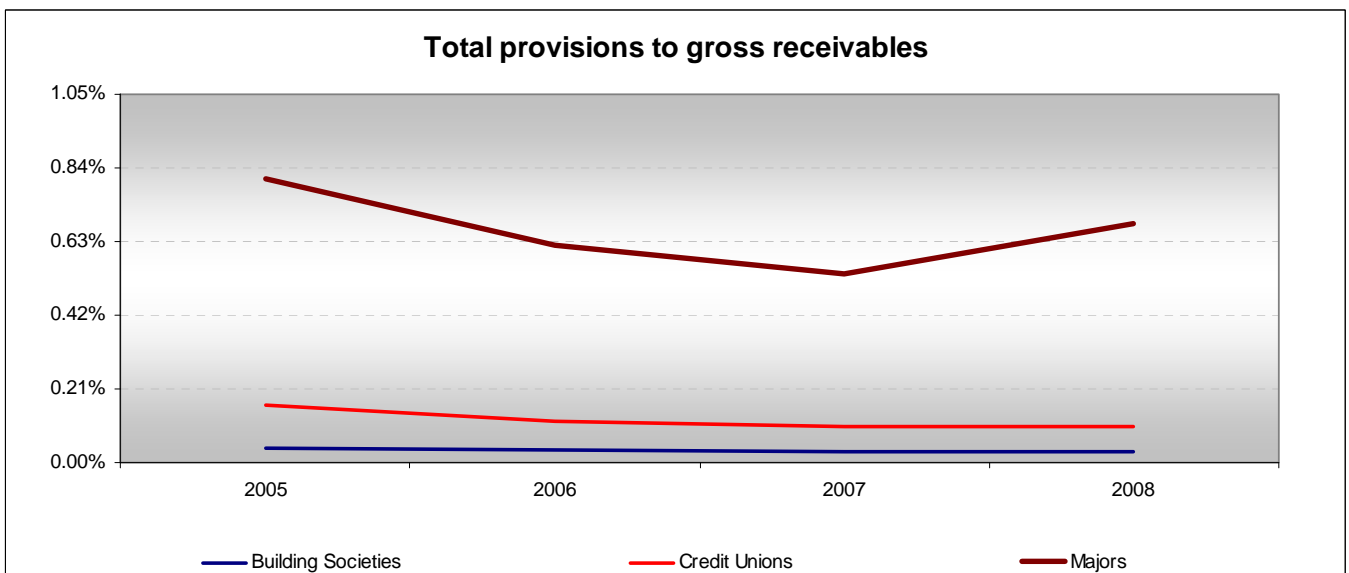
In contrast to the 15 percent increase in securitised assets recorded by survey participants during 2007, securitised assets remained stable at around \$12 billion in 2008. This reflects run off of existing securitised assets combined with a decrease in new securitisation due to lower investor demand for and increased cost of funding via residential mortgage backed securities. Given the elevated financial market turmoil experienced in September and October 2008, we expect the volume of securitised assets to decrease in 2009.

Asset quality

Bad debt expense for building societies increased 31.7 percent in 2008 and bad debts expense for credit unions increased by 21.5 percent. Although these increases sound high, they compare favourably with the 182 percent increase recorded by the major banks. Further the ratio of bad debts expense to average gross receivables remained stable at a very low 0.02 percent for building societies and 0.09 percent for credit unions.



The ratio of provisions to gross receivables for building societies and credit union has remained relatively stable due to the little or no exposure that these entities have to the financial problems in overseas markets or to the recent problems at notable Australian corporates such as MFS, Allco and ABC Learning. This is in contrast to the situation for the majors who have significantly increased their level of provisioning, both against specific problem accounts and also increases in their “collective” provision against the impact of the general downturn.



Capital

The volatile economic environment has forced bankers to increase their focus on their capital position. Consistent with this, the Capital Adequacy Ratio (CAR) for the building societies and credit unions surveyed increased from 16.7 percent in 2007 to 16.8 percent in 2008. The increase in CAR is a result of continued profit growth combined with lower growth in risk-weighted assets relative to the previous year. It reflects the sector's cautious approach to capital adequacy in response to general economic uncertainty. This places them in a strong position to deal with the continuing volatility in financial markets and the increasing likelihood of a decline in asset quality.

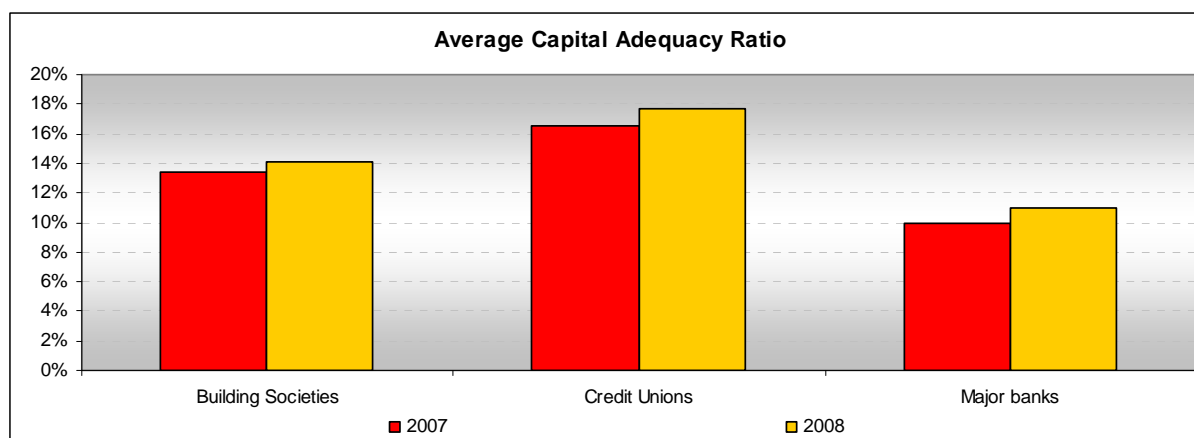
Another factor impacting the CAR during 2008 was the adoption of the Basel II approach to measuring capital adequacy from 1 January 2008. Basel II is a global framework for assessing the capital adequacy of deposit-taking institutions which was implemented locally by APRA. The Basel II rules allow several alternative approaches to the measurement of capital, however all building societies and credit unions have adopted the least complex "standardised" approach. The impact on capital of adopting the standardised approach was:

- A decrease in the capital required in regards to home loans, particularly full documentation home loans with loan mortgage insurance and low loan to value ratios. This has been a significant benefit for building societies and credit unions, as home loans represent over 80 percent of their total loans and advances⁶.
- An increase in capital due to a new requirement to hold capital in regards to operational risk. The operational risk charge is calculated using prescribed percentages of lending assets and other income.

The net impact for most building societies and credit unions has been an increase in the CAR, however the result for individual institutions depends on the type of lending and other business that they conduct.

The major banks have adopted more complex "advanced" approaches to measuring capital adequacy under Basel II. Prior to the introduction of Basel II there was significant concern that the advanced methodology would provide the major banks with a competitive advantage over small financial institutions, by allowing them to hold less capital against the same loans. Whilst the major banks continue to enjoy advantages provided by scale and their AA credit ratings, APRA has closely monitored the impact of Basel II on capital to ensure that there is not a significant decrease in capital held by any deposit-taking institutions. In addition, the advanced models used by the major banks are sensitive to recent loss experience and therefore the decline in asset quality experienced by major banks during 2008 is likely to increase the amount of capital they are required to hold. In contrast, the capital requirement for building societies and credit unions is not directly impacted by actual loss experience.

The CAR of both building societies at 14.1 percent⁷ and credit unions at 17.6 percent⁷ compares favourably to that of the major banks at 11 percent⁸. This reflects a range of factors, including the fact that mutuals are less focussed on return metrics, such as return on equity, than publicly listed banks. In addition, APRA generally requires higher CARs for smaller financial institutions.



⁶ Source: APRA Monthly Banking Statistics – June 2008

⁷ Represents a simple average of the CAR for survey participants

⁸ Source: KPMG Major Banks Survey Year End 2008

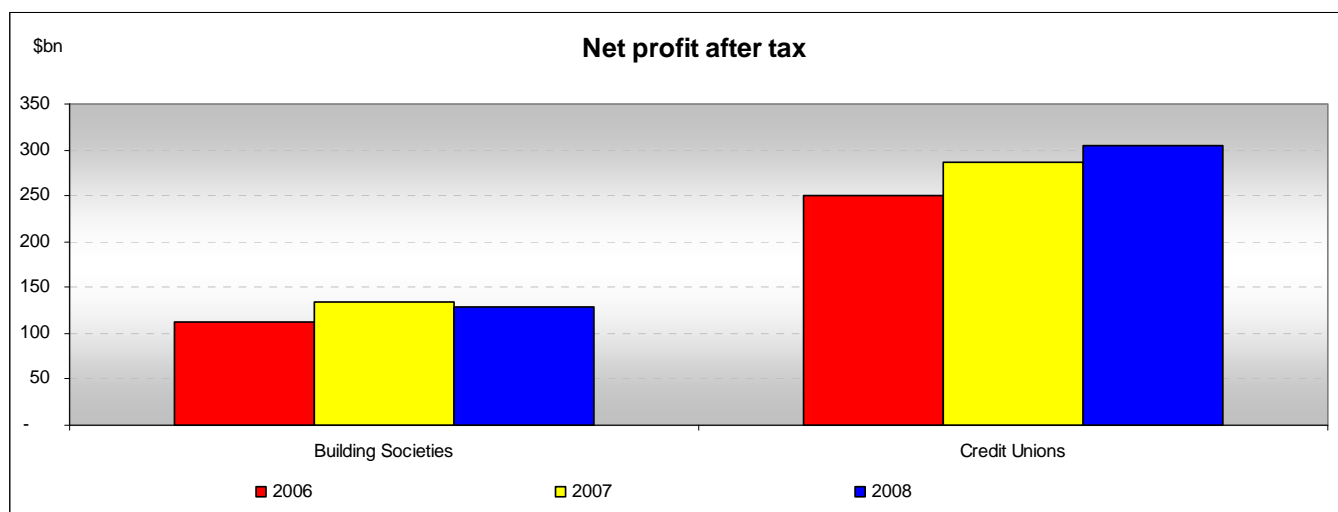
Profits

Despite all the turmoil in financial markets, building societies and credit unions produced similar levels of profits to the prior year. This is an excellent result when you consider that last year was a record profit year.

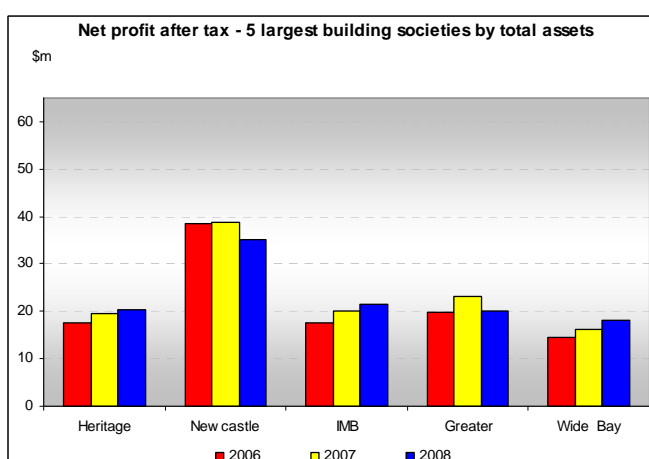
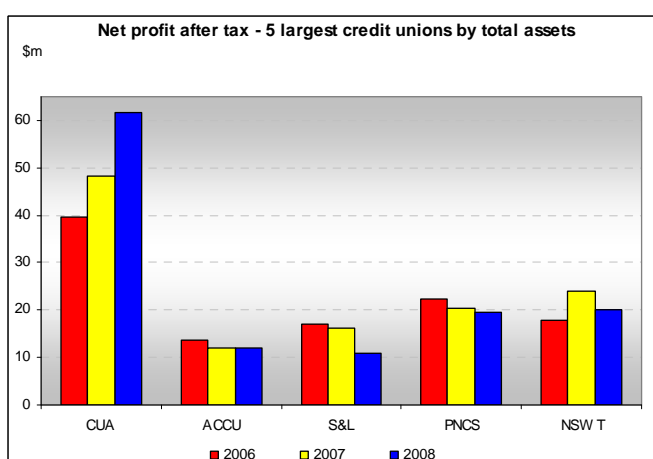
Profit after tax for building societies decreased by 2.9 percent whilst credit unions profit after tax increased by 6.2 percent⁹. Profits were underpinned by asset growth which flowed through to higher interest and non-interest income, albeit offset by margin contraction. Whilst this level of profit growth is modest relative to the strong growth of recent years, it is a very sound result considering the impact of the global financial crisis on the Australian banking sector generally. Consider, for example, the 22.5 percent decrease in profit after tax experienced by the major banks in 2007 - 2008¹⁰.

The components of this result are analysed in the following sections. Broadly it reflects the nature of the business of the building society and credit union sector:

- they are not reliant on funding from overseas markets (although some of the larger mutuals were users of securitisation).
- they are generally not exposed to the corporate market and hence large corporate failures.
- they have “stuck to their knitting” amid an Australian economy that continued to grow, albeit at slower rates.



The results for the 10 largest building societies and credit unions have all been solid. However, there is diversity when comparisons are made to last year with some increasing profits and others recording declines in profit after tax.



⁹ Adjusted to exclude the impact of merger gains.

¹⁰ Source: KPMG Major Banks Survey Year End 2008.

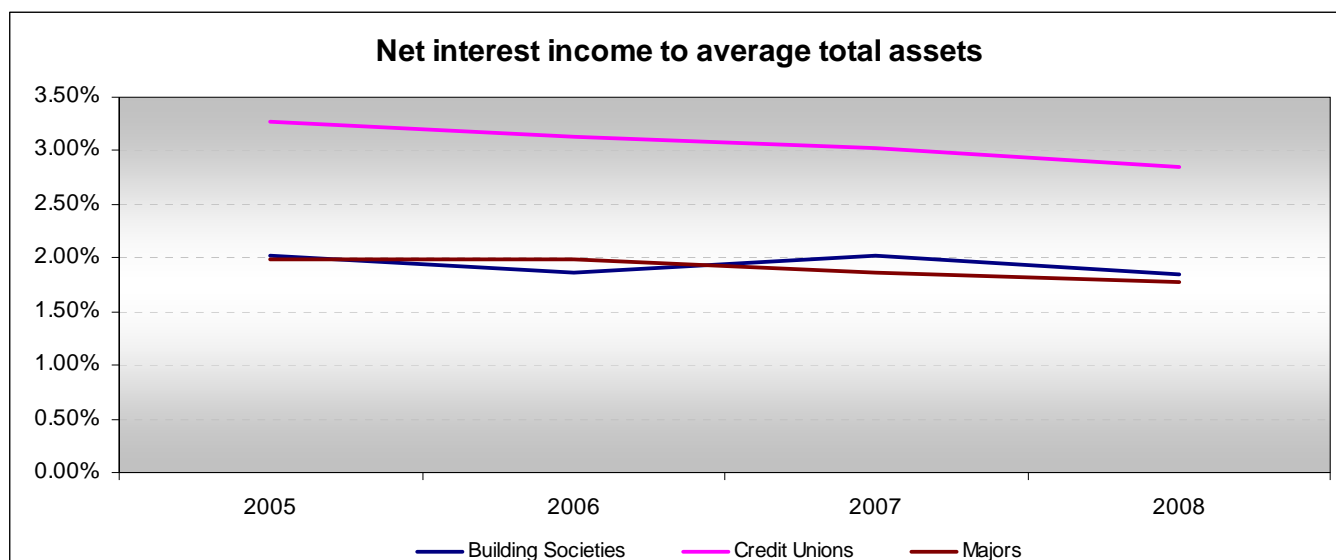
Net interest income

Both building societies and credit unions continued to experience interest margin contraction during 2008. The ratio of interest income to average total assets:

- Decreased 16 basis points to 1.84 percent for building societies.
- Decreased 20 basis points to 2.86 percent for credit unions.

This is a significantly greater decline than the 9 basis points decline to 1.78 percent experienced by the major banks¹¹. However, it should be noted that the major banks' results are for the year to September 2008 (compared to June 2008 for the building societies and credit unions) and therefore includes around nine months since lending interest rates were increased by amounts greater than the increase in the RBA's cash rate.

The main factor impacting interest margins in 2008 was a dramatic increase in funding costs in wholesale markets. However, most building societies and credit unions were sheltered from this by their very low reliance on wholesale funding. For instance, 46 of the 65 credit unions in this survey funded over 90% of their assets from deposits and capital. The ratio of net interest income to average assets for these credit unions was stable in 2008 compared to 2007. In contrast, the ratio of net interest income to average total assets for the other 19 credit unions, which are to some extent reliant on wholesale markets, largely via securitisation, fell by around 24 basis points.



¹¹ Source: KPMG Major Banks Survey Year End 2008.

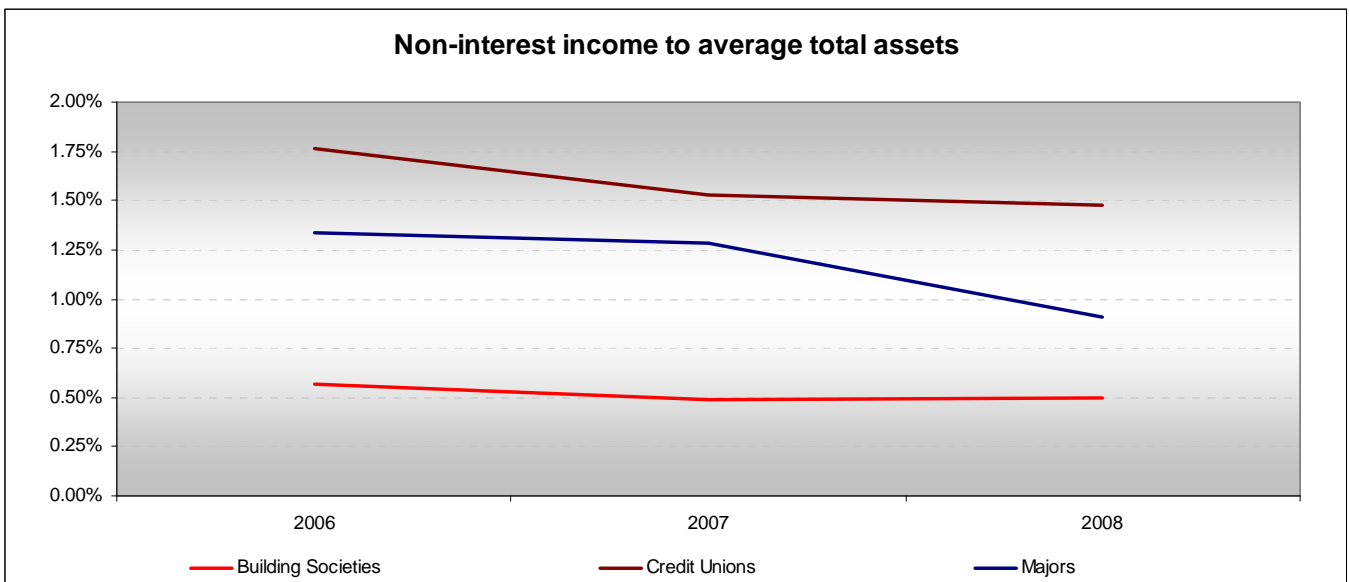
Non-interest income

Non-interest income in the sector includes commissions from selling wealth management and insurance products to members, loan fees and profits from wealth management operations (for those institutions that provide in-house wealth management operations). Typically account fees are very low or zero in this sector, reflecting the focus on providing benefits to members.

Credit unions increased their non-interest income by 8.9 percent in 2008. However, non-interest income includes significant gains by CUA on the sale of property and the revaluation of financial instruments recorded at fair value. Excluding CUA, the remaining credit unions in this survey increased their non-interest income by a modest 1 percent. One of the factors negatively impacting non-interest income for these credit unions was a decrease in property related profits relative to the previous year.

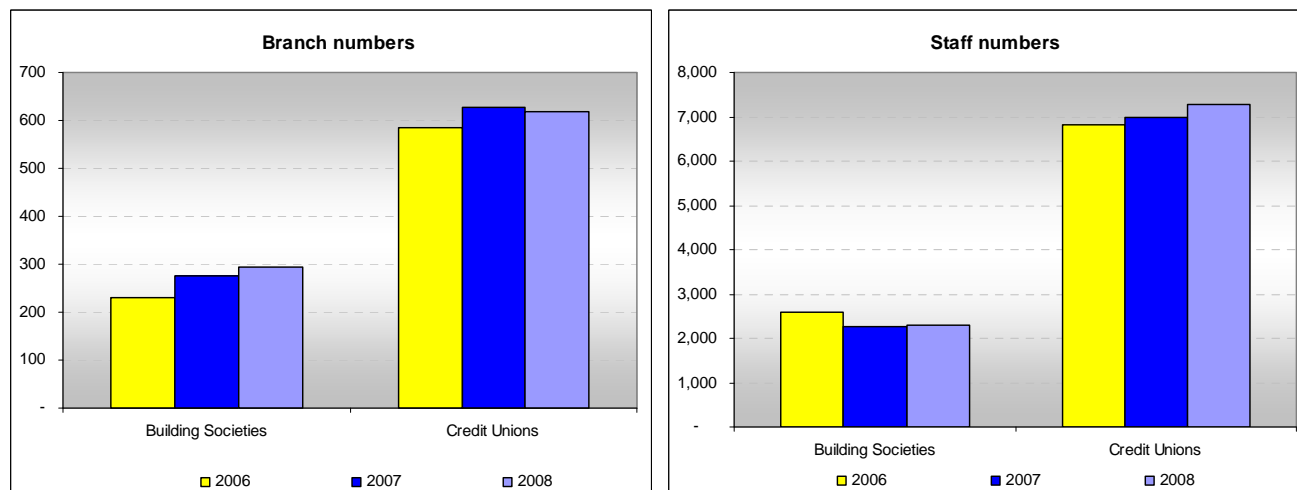
Building societies increased their non-interest income by 11 percent relative to 2008. Similar to the credit unions, this result includes some significant items including a gain on sale of Visa shares, property and other investments. We estimate underlying non-interest income growth was around 2 percent for building societies.

The ratio of non-interest income to average total assets for credit unions decreased from 1.53 percent in 2007 to 1.48 percent in 2008, but remained relatively stable for building societies at close to 0.50 percent in 2007 and 2008. In contrast, the major banks experienced a significant decrease in non-interest income, primarily due to a decrease in funds under management, and therefore profits, from their wealth management operations.

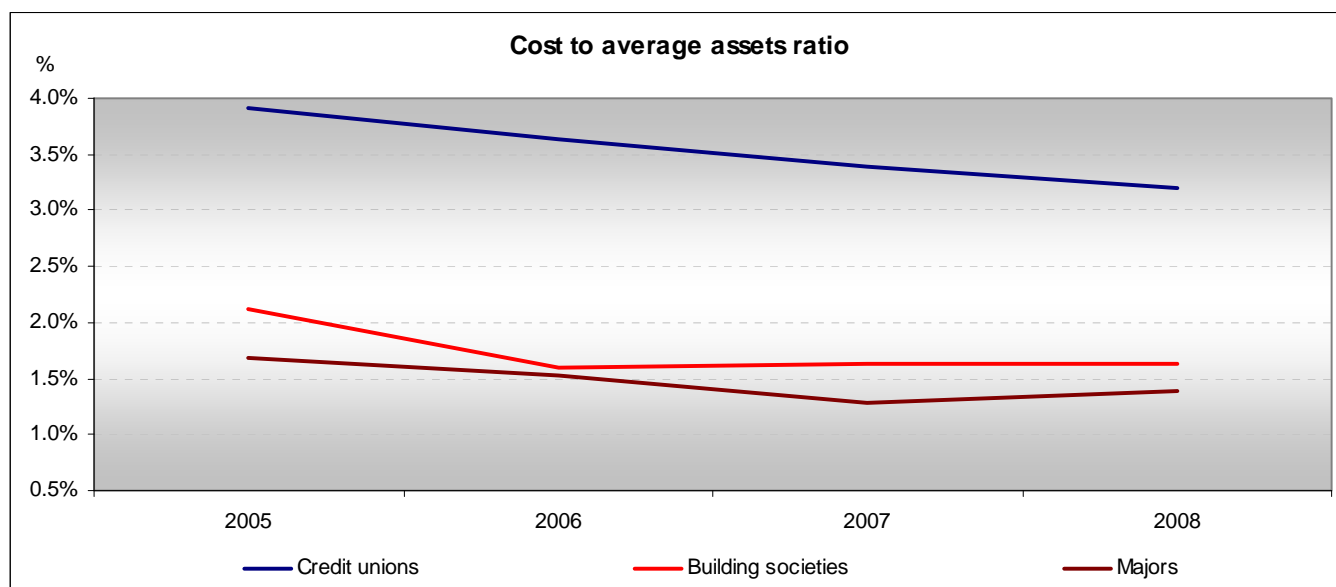


Costs

Building societies operating costs increased by 7 percent, which may be considered to be a little disappointing in the context of asset growth of 5.9 percent. Credit unions' operating costs have increased by 5.3 percent in 2008, which is a good result when viewed in the light of asset growth of 11.1 percent.



It is generally accepted that a cost to assets ratio is a more appropriate ratio for measuring efficiency of building societies and credit unions than cost to income ratios (given building societies and credit unions focus on maximising benefits for members, rather than profitability for shareholders). Building societies achieved a cost to average assets ratio of 1.63 percent in 2008 (stable from 2007). Credit unions reduced their ratio from 3.4 percent in 2007 to 3.2 percent. The increase in the number of mergers of credit unions to some extent reflects the anticipated benefit of economies of scale to costs.



The level of cost increases for building societies and credit unions compares favourably to the 9.3 percent increase recorded by the major banks¹² (albeit the banks achieved asset growth of 15.3 percent). In the current economic environment, with subdued asset growth, competition for deposits squeezing margins and potential for increased bad debts, cost management will be of increasing importance. In this scenario the banks, with their greater scale, may have more scope to reduce costs than the mutual sector.

¹² Source: KPMG Major Banks Survey Year End 2008

Outlook

As we look to the 2008/09 year for building societies and credit unions, we believe that the following issues will influence performance:

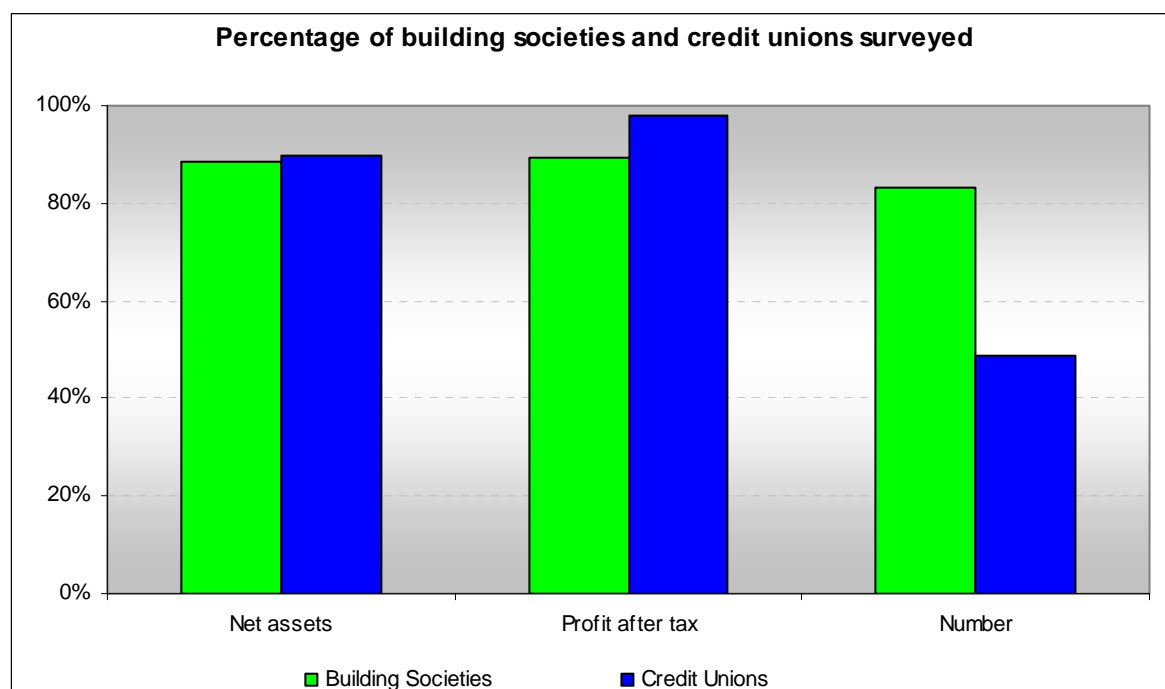
- The Federal Government guarantee will provide a significant funding benefit to building societies and credit unions, particularly those who require access to wholesale funding markets. However, the higher guarantee fee paid by building societies and credit unions will make it more difficult for these institutions to be price competitive with larger banks for deposits over \$1 million. In this context there is potential for financial institutions to offer better terms for deposits just less than \$1 million as these are guaranteed for no fee.
- Overall system lending growth will continue to slow, particularly personal and business lending. Banks, building societies and credit unions will have the opportunity to continue to grow market share in home loans from non-bank lenders, whose funding difficulties are likely to continue, restricting their ability to grow their loan books.
- The significant changes to the second tier of banking in Australia, with the impending merger of St. George with Westpac, the acquisition of Bankwest by CBA and speculation about the potential sale of Suncorp's banking operations, provide an opportunity for the mutuals to increase their customer base. Whether they are able to convert this opportunity in to new customers will depend upon how successful the mutuals are in targeting customers of those organisations who may be inclined not to bank with a "major". In particular, the mutuals will need to be able to convince these potential customers that they can provide the full breadth of services they are accustomed to receiving from their bank.
- Whilst larger lenders are experiencing declining asset quality, bad debts expense for building societies and credit unions has remained comparatively low, due primarily to differences in their asset mix. We expect the economic slow down to increasingly impact the customer base of building societies and credit unions, in 2009. However, given the predominance of mortgage loans in their portfolios, we do not expect the increase in bad debts expense to be dramatic.
- Recent financial market turmoil, combined with the desire to improve member services and reduce costs, provides greater impetus for mergers amongst mutuals. Therefore we expect the significant consolidation activity seen in 2008 to continue throughout 2009.
- With the Australian economy heading for more subdued growth, cost control will be a continued focus area for all Australian businesses including building societies and credit unions.
- Liquidity and funding plans of all deposit taking institutions will remain under heavy scrutiny from APRA. In turn, we expect liquidity and funding to be primary focus areas for management and boards of building societies and credit unions in 2009. The availability of potential securitisation arrangements with the RBA provides a potential alternative source of funding to supplement the traditional reliance on customer deposits.

Appendix 1: Survey scope

This survey includes 10 of the 11 independent building societies and 65 of the 133 credit unions authorised by APRA as of 30 June 2008¹³.

Based on aggregate building society and credit union statistics reported by APRA:

- Building society survey participants represent 89 percent by net assets and 90 percent by profit after tax.
- Credit union survey participants represent 90 percent of credit unions by net assets and 98 percent by profit after tax.



¹³ Source: APRA Quarterly statistics

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