HD **Moody's: Competition remains a key challenge for Australian mutuals**

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Moody's Investors Service says that moderate credit growth and rising competition will continue to pressure the growth and profitability of Australia's mutual financial institutions.

"The main credit issue facing the sector in 2014 will be increased competition on both loans and deposits, which will in turn threaten margins and may pressure certain institutions to increase their credit risk appetite," says Daniel Yu, a Moody's Associate Vice President and Analyst.

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"Combined with rising regulatory and compliance costs, this will also maintain consolidation pressure in the sector," adds Yu.

"Nevertheless, the overall credit standing of the mutual sector is likely to remain sound, supported by often solid niche franchises and strong balance sheets," Yu concludes.

COMPETITIVE PRESSURE SPURRED BY LOW GROWTH ENVIRONMENT

Yu was speaking on the release of a new outlook entitled "Australia's Mutual Financial Institutions: Competition Remains a Key Challenge".

As the report highlights, the overall credit growth outlook will likely remain subdued in 2014 on the back of Australia's subsiding resources investment cycle. As a result, competitive pressure will continue in 2014.

"The mutuals face competition in their core franchise of home lending from Australia's four major banks, which look to compensate for weak credit growth in corporate lending," adds Yu.

At the same time, deposit competition is also set to remain a factors as the listed banks want to boost their stable funding ahead of the introduction of the Basel III Liquidity Coverage Ratio requirement in 2015. This competition in both lending and deposits will continue to pressure the mutuals' net interest margins.

In response to the growth and margin pressure, some mutuals have broadened their geographic coverage, or have begun to relax their underwriting standards, albeit from a conservative starting point.

For example, during 2013, many of the sector's larger institutions increased their proportion of loans that are interest-only, and loans with loan-to-value ratios greater than 90%. Additionally, most mutuals now accept, and even target, customers outside their traditional home regions or employer groups.

The sector has also seen credit unions and building societies transition to mutual bank status. Although this trend may broaden their appeal to customers unfamiliar with the mutual sector, this extension of business beyond their core franchises can also introduce new risks.

NICHE FRANCHISES AND STRONG BALANCE SHEETS

Nevertheless, the report points out that, overall, the mutual sector's credit standing is likely to remain sound and resilient, supported by its often solid niche franchises and strong balance sheets, as well as the inherent conservatism of the mutual business model.

As mutuals tend to deemphasize profit-maximisation in favour of providing value to their members, this strategy should alleviate the risk these institutions could assume excessively high risks to generate higher returns.

"For example, Australian mutuals have not expanded into higher-risk, higher-return lending, such as **commercial property** loans, which led to significant losses among peers in other markets like Spain, the UK and the US," says Yu.

Additionally, the mutuals' healthy credit profiles are supported by strong asset quality and healthy capital buffers. Moreover, despite their shrinking share of loans and deposits, many institutions enjoy an above-average degree of customer loyalty in certain niche markets, providing key support to their franchises.

Thus, despite their shrinking role in the broad system, the mutuals' traditional focus on particular communities or employer groups is key to their ability to successfully compete against much larger banks.

Subscribers can access the report at: https://www.moodys.com/research/Australias-Mutual-Financial-Institutions-Competition-Remains-a-Key-Challenge--PBC_163068.

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