Future proof

Strong management and an ability to draw on past experiences in downturns will be crucial as mutuals combat the financial crisis over the next 12 months.

By Cameron Cooper and Rachel Borchardt

As they glance at the latest banking and finance headlines, William Wolke and his management team could be excused for breaking into a cold sweat.

Financial market upheavals. Funding cost blowouts. Foreign investment bank collapses. Margin squeezes. Bad debt blues.

Yet Wolke, chief executive officer of Victoria Teachers Credit Union, seems almost to relish the challenge. He points out to Connexus that "at this stage" the downturn has not had a material effect on the credit union. Business growth to the end of November had been "exceptional" and deposits strong, coming on the back of after-tax profit of $9.9 million for the 2008 financial year, a 26 per cent rise on the previous year.

Sure, he admits, signs had started to emerge late last year of slower lending growth, and a series of interest rate cuts had led to a "margin squeeze" that is affecting profits. "But we've been travelling extremely well," Wolke says.

Far from being deterred, the board of the Camberwell-based mutual is viewing the crisis as a chance to expand the business on the back

Playing to your strengths is important element in withstanding the credit crunch.

of a strong balance sheet and robust liquidity. With more than 77,000 members and about $1 billion in assets, it has a strong base from which to prosper.

It's an opportunity for market growth, says Wolke, because non-ADI lenders are "in a very different position to what they were a year ago".

Perhaps experienced CEOs such as Wolke draw their strength from the past. After all, they have been around to witness the market crash of 1987, the 1993 recession, the Asian financial crisis of the late 1990s and fallout from events such as the September 11 terrorist attacks in 2001.

Not that they are viewing the present market downturn lightly—most have been shocked at the speed and the depth of the fall. But there is underlying hope.

Business forecaster BIS Shrapnel, in its latest outlook, argues the Australian economy will sidestep a recession in 2009 despite the deterioration in world financial conditions. It tips interest rates to dip to 4 per cent in March as the Reserve Bank keeps cutting rates in an attempt to restore market confidence. BIS Shrapnel also predicts GDP growth over 2008-09 to fall from 3.66 per cent to 1.42 per cent and it maintains that "restoring confidence is both a domestic and a global challenge".

The question on everyone's lips is: how long will the crisis last?

Chris Caton, chief economist at BT Financial Group, says the outlook depends on the focal point.

"How long before the financial sector operates with the efficiency that we used to think it should operate with? Maybe two years," he says. "How long before it has had its peak effect on the economy… maybe six months."

Caton has no doubt the Australian banking system is in better shape than its equivalent in the United States where the subprime loans fiasco started the dominos falling. He believes, too, that the central bank—after initial hiccups—has responded correctly to the crisis.

In brief

- Health check reveals strong diagnosis for mutual financial institutions.
- Focus on prudent lending continues to pay dividends.
- Growth prospects exist that may fill gaps left by second-tier bank mergers.

“The saving grace for [mutuals] is that a very high proportion of their lending is secured by residential mortgage assets...”

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“They didn’t do the right thing earlier (in 2008) when they tightened up monetary policies too much but they’ve realised that and they’re cutting as fast as they can now—and that’s the correct response,” Caton says.

The latest health check of mutuals justifies confidence. Despite the financial turmoil gripping markets, KPMG’s Building Societies and Credit Unions Survey 2008 reveals that credit unions’ profit rose 6.2 per cent while building societies’ profit fell by just 2.9 per cent from record levels in 2007. Contrast this with a 22.5 per cent fall in profit after tax for the major banks in 2007-08.

While the survey did not cover the September-October period when some market fallout started to hit home, the figures do point to ongoing strength in the mutual sector, particularly for credit unions.

“To have grown their profit is a really good result in the environment,” says Martin McGrath, financial services partner at KPMG.

The KPMG survey identifies key strategies—prudent lending practices and limited or no exposure to overseas funding risk—that continue to benefit building societies and credit unions.

“They’ve been sheltered from a lot of the fallout because they generally don’t fund overseas,” McGrath says.

An eye also has to be kept on bad debts. KPMG reports that bad debts rose 29.5 per cent for building societies and by 21.5 per cent for credit unions, although the major banks have a bigger problem to consider with a 182 per cent increase.

McGrath says it is inevitable that bad debts will rise in 2009.

“It’s a question of how much higher it will go. The saving grace for this sector is that a very high proportion of their lending is secured by residential mortgage assets—homes—so, while those organisations will bend over backwards to help their customers, at the end of the day they do have that security to protect them.”

Other positive signs exist. The annual Deloitte Australian Mortgage Report reveals that the mortgage lending sector continues to grow. Total outstanding mortgage lending across the nation increased about 10 per cent per annum to September 2008, although the rate of new loans being taken up dropped more than 20 per cent from about $25 billion in September 2007 to just under $18 billion in September 2008.

Friendly society IOOF is one of a number of mutuals that remain upbeat on the back of an “introspective approach” over the past 12 months that has seen it assess its processes and capabilities, a process that will hold it in good stead when markets do turn.

“We see a lot of opportunities in this downturn,” says general manager of investor solutions Renato Mota, who is helping oversee a merger between IOOF and Australian Wealth Management (see Friendly changes, page 25).

He credits the regulator for helping to strengthen the sector, noting that the Australian Prudential Regulation Authority’s dialogue with institutions has increased markedly.

“That says a lot about their willingness… they are really looking to understand our products and the underlying investments.”

Despite such positive results and sentiment, 2009 shapes as a critical year for all financial institutions as the economy comes under pressure. In the Federal Government’s Mid-Year Economic and Fiscal Outlook released late last year, Treasury has forecast 2 per cent annual growth for the rest of the financial year, outstripping equivalent predictions from the International Monetary Fund (1.8 per cent) and Reserve Bank (1.5 per cent). A projected surplus of $21.7 billion in 2008-09 has been sharply revised downwards, with an underlying cash surplus of $5.4 billion now tipped.

Business research group IBISWorld claims the crisis will get worse before it gets better and it foresees an especially tough year for the banking sector.

“This is mainly because there’s going to be lower demand for mortgage origination,” says Toon van Beeck, an industry analyst at IBISWorld.

The elephant in the room is unemployment. IBISWorld expects national unemployment levels to rise from 4.2 per cent in 2008 to 5.2 per cent in 2009.

“This is going to put a lot of pressure on those people wanting to take out loans, not only

through mortgages but also car loans and other big-ticket items," van Beeck says.

At Community CPS in Adelaide, the credit union is already witnessing a decline in the volume of lending as members tighten their belts, while there has been an increase in deposits as they switch from riskier equities to the "safe haven" of term deposits.

"On the positive side I guess we see our members are still being able to pay their loans and lower interest rates are certainly helping them," says CEO Kevin Benger.

However, he concedes that looming job losses may have an impact on loan repayments.

"I guess that job loss prediction is a factor so I think it's either the calm before the storm or it may not eventuate."

At BT Financial Group, Caton agrees unemployment figures will be crucial.

"One thing that you can be sure on is that the unemployment rate will go up and if it goes up to 5 per cent we can thank our lucky stars," he says. "If it goes up to 6 per cent we won't have done too badly but it's dangerous once it goes past six because as experience suggests once the unemployment rate goes up it either goes up a little or it goes up a lot."

In such testing times, a firm hand on the tiller has never been more important. At Community CPS, Benger has no doubt that more mature operators will be better placed to withstand the crisis.

"It might be called fortunate or unfortunate but we've been in an industry where we've seen a credit crisis before and, in those recessions we've had to have, market downturns."

History lessons have already paid off, with Community CPS resisting the temptation in recent years to originate loans through brokers or gain funding through overseas channels.

•• Stats

- Building society numbers, as of June 2008, had fallen from 13 to 11.
- Credit union numbers have dropped from 144 to 133 over the past 12 months.
- Credit union assets jumped 11.1 per cent to $42 billion in 2008 and building society assets increased 5.9 per cent to $27 billion.
- Cost control is an area to watch, with building societies registering an increase in costs of 7 per cent against asset growth of 5.9 per cent in 2008.

Source: KPMG

Q&A

John Minz, CEO, Heritage Building Society

What strategies are you employing to help members or the business itself?

Heritage continues to live up to its "mutuality" by providing a better deal to members. We primarily do this by providing pricing to our members more advantageous than our banking competitors. It is one element of our people-first mutual culture. This has involved passing on interest rate cuts to our members and we have also conducted periodic stress tests of the loan portfolios to assess and prepare for the potential effects of a recession on loan delinquencies.

What's the best way to operate in a downturn?

During difficult times, any financial institution needs to continuously review strategies. There has been intense focus on strategic risk management. The output of this process is a heightened focus on diversification in both deposit-taking and lending activities. It is important as a mutual to consider long-term strategies in creating a recession-proof organisation. Many of the listed ADIs have applied knee-jerk reactions as they watch their share prices plummet.

What is your forecast for the next 12 months?

The actions of the Rudd Government and the Reserve Bank have been about working to prevent any recessionary trend. Despite this, all ADIs should consider the potential effect on employment, delinquencies, housing prices, equity protection and a slowdown in demand and spending. The first home-owner grant changes and the significant cash rate reductions may well stimulate the economy in the New Year. Credit policies and funding plans should be reviewed so as to be responsive to changes in the marketplace.

"Something had to give sooner or later, so our growth was managed growth rather than huge growth," Benger says. "But that has come back to be a good thing for us and it just reinforces for us the fundamentals have always got to be right."

He suggests mutuals can do a better job of highlighting such financial prudence and good management.

"I think credit unions are really good at hiding all the good stories."

At Victoria Teachers Credit Union, a decision was also made not to generate business through brokers.

> "We are confident of being able to sail through this next 18 to 24 months... We're in a good position... because we were managing the deposit side, we weren't securitising, we weren't using brokers..."
>
> William Wolke, CEO, Victoria Teachers Credit Union

"We have consciously and strategically chosen not to use them and we're now very grateful," Wolke says. "Our credit quality is good."

Other strategies are delivering, too.

"Three or four years ago we were deliberately working our deposits as well as our assets while others might have only been managing one side of the balance sheet." Wolke says. "We were consciously making sure that we were retaining both sides because there could always be a downturn."

With such strong fundamentals and a loyal member base, some mutuals believe growth is a realistic goal, the financial crisis notwithstanding.

With second-tier banks such as St George and BankWest being swallowed up by the Big Four, KPMG's McGrath says opportunities will emerge for smaller players.

"There's sure to be a number of disaffected customers who don't want to be banking with the Big Four," he says. "There's certainly an opportunity there. And it's a question of who picks those people up. Clearly the building societies and credit unions are in a good place to access those customers."

With fewer lender options, Wolke is confident more people will turn to mutuals.

"I think they will but it is particular to each organisation and each market because I think we're all different. Each building society and credit union has its own niche and those niches can be community based, they can be geographical or they can be professional groups. So there are gaps."

IBISWorld is also confident there will be opportunities for smaller players to zero in on regional markets. However, van Beeck says such opportunities "are going to be hard to come by" and he advocates continuing industry consolidation to allow mutuals to compete in a banking space where the bigger banks are getting bigger.

"They are going to get so many cost synergies out of this that the credit unions and building societies are going to fall short if they don't seek mergers and acquisitions themselves."

What should not change is mutuals' commitment to their members. IOOF is typical of friendly societies in this regard. Among other programs, it has allocated a proportion of funds from its demutualisation to the Choir of Hard Knocks, a non-profit choir that gives disadvantaged people a creative outlet.

"It's a key component of our philosophy as an organisation," says Renato Mota. "In these times that really comes to the fore. And that is a benefit of the mutual philosophy."

At Victoria Teachers Credit Union, Wolke says it is important to remember that, while some financial institutions may be doing it tough, so are the general public.

"We've helped members when there have been droughts or bushfires or floods so we do help our members and it comes back to trust and the long-term relationship."

As the financial crisis plays out, Wolke says good management rather than good luck will win the day.

"We are confident of being able to sail through this next 18 to 24 months and again I think it's because we're in a good position. And it was because we were managing the deposit side, we weren't securitising, we weren't using brokers, so we are in a resilient position." ✦

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Friendly changes

Friendly societies are looking for new ways to grow, while playing to their strengths.

By Cameron Cooper

A name change, a rebranding and a launch featuring the work of a body artist—they are not the typical actions of a supposedly conservative friendly society with 130 years in the business.

However, the management of South Australian mutual KeyInvest is determined to look to the future while drawing from the strengths of its history. Formerly known as IOOF SA, the friendly society changed its name in May 2007 to avoid confusion with other entities operating under the IOOF label.

General manager business services James McGill admits it was a big decision to abandon a trading name with more than a century of credibility.

"But if you're going to grow your business, you want to make sure the business you grow and the brand you grow is something that's unique and you can talk about," he says.

KeyInvest is implementing its 2006-11 strategic plan, which draws on a strong balance sheet to pursue opportunities in niche investment areas such as retirement living and investment bonds.

McGill believes the present economic turmoil presents further growth prospects.

"We're at the more niche end, so, as some of the larger companies exit markets or slow down, it does create opportunities for us."

The blueprint is to be cautious but positive.

"We're a long-term player. We've been around for 130 years and we plan to be around for a lot longer. We are not an opportunistic, short-term type trading organisation."

Friendly societies have a proud history in Australia, acting as grass-root providers of financial products, insurances and other related services since the earliest days of Australia's colonisation. Peak industry body Friendly Societies of Australia lists its members' core values as financial prudence, co-operation, moral integrity, trust, empathy and social responsibility.

Another friendly society that is looking at significant change is IOOF, which is merging with Australian Wealth Management to increase its scale and service options. IOOF brings product strengths to the table, while AWM provides a core competency around distribution.

"So it's really a meeting of the minds," says Renato Mota, general manager of investor solutions at IOOF.

He believes consolidation will be an increasing trait within friendly societies.

"Financial services is becoming a scale game—be it scale in distribution or scale in administration, and I think we are seeing the same dynamic, albeit on a different scale by friendly societies and credit unions."

Mota believes the friendlies are faring well in the current environment and show no signs following the collapses that have beset the mortgage-broking sector. "So that says a lot about our level of prudence," he says.

At KeyInvest, good financial management and strong niche areas such as retirement villages represent the future. It has run one successful retirement village at McLaren Vale, south of Adelaide, for two decades, but a couple of years ago management decided to target the sector as a growth strategy.

"It became clear that there are a lot of good opportunities, again as a long-term player. As a small player, it's very easy to get burnt if you go into an area you don't know. You can come undone very quickly."

KeyInvest is constructing a new retirement village at Woodside, and has acquired four other sites.

McGill says the concept matches the friendly society's caring ethos and business needs.

"It's good for our business, but it's also good for the local community."

Cameron Cooper is a freelance writer