# Members Equity Bank Limited

## ABN: 56 070 887 679

# Interim Financial Statements

### For the half-year ended 31 December 2018

## Members Equity Bank Limited

## Directors' report
## for the half-year ended 31 December 2018

The directors of Members Equity Bank Limited (the Company) submit herewith the interim financial statements of the Group (being the Company and its subsidiaries) for the half-year ended 31 December 2018, and the independent auditor's review report thereon.

**Directors**

The directors of Members Equity Bank Limited at any time during or since the end of the half-year and at the date of this report are:

| | |
|---|---|
| K Hodgson | Chairman since January 2016 and Director since January 2012 |
| C Bart AO | Director since July 2016 |
| C Christian | Director since November 2012 |
| G Combet AM | Director since November 2014 |
| J Milne | Director since November 2012 (resigned on 4 October 2018) |
| J Nesbitt | Director since February 2017 |
| E Rubin | Director since October 2016 |

**Principal activities**

The principal activities of the Group comprised of:

- provision of banking services under a banking licence;
- funding, management, and servicing of residential and consumer lending portfolios; and
- carrying out associated funding activities for off balance sheet portfolios.

There were no significant changes during the period in the nature of the activities of the Group.

**Dividends**

No dividends have been paid or declared since the start of the financial half-year (2017: $nil). The directors do not recommend the payment of a dividend with respect to the half-year ended 31 December 2018.

The Group has paid $5,077,895 of fully franked dividends during the half-year with respect to the perpertual Capital Notes issued in November 2017 (2017: nil).

**Review of operations and results**

Statutory profit for the half-year ended 31 December 2018 was $41.2 million compared to $46.4 million for the half-year ended 31 December 2017.

**Subsequent events**

Aside from the events as described in Note 5 to the financial statements, there have been no matters or circumstances which have arisen since the end of the financial half-year which significantly affect the operations of the Group, the results of those operations, or the state of affairs of the Group in subsequent years.

**Significant items**

In December 2018, the Group issued $100 million of perpetual Capital Notes which are callable in December 2023. The notes form part of equity on the balance sheet.

There are a number of significant items which are included in the Group's statutory profit for the financial period but have been excluded from the Group's underlying profit for the financial period. The following table reconciles the Group's statutory profit with the Group's underlying profit. All amounts are after tax.

| | 31 Dec 2018<br>$'m | 31 Dec 2017<br>$'m |
|---|---|---|
| Underlying earnings | 55.0 | 51.0 |
| • Realised and unrealised gains / (losses) on hedging instruments (1) | (1.8) | 0.6 |
| • Impairment losses - other (2) | (5.0) | - |
| • IT system remediation and decommissioning costs (3) | (7.0) | (5.2) |
| Statutory profit for the half-year | 41.2 | 46.4 |

(1) These instruments do not qualify for hedge accounting.

(2) Changing market dynamics have resulted in the deferral of the current credt card platform development. As a result an impairment loss relating to the associated intangible asset has been recognised.

(3) Cost of IT enhancements to improve the customer experience and to decommission legacy systems.

### Rounding

The Company is a company of the kind referred to in *ASIC Corporations (Rounding in Financial/Directors' Reports) Instrument 2016/191*, dated 24 March 2016, and in accordance with that Instrument amounts in the interim financial statements are rounded off to the nearest thousand dollars, unless otherwise indicated.

### Corporate Governance

The Board has received the relevant assurances required from the Chief Executive Officer and the Chief Financial Officer in respect of the half-year financial report for the period ended 31 December 2018.

The directors of the Company have responsibility for the integrity of external reporting. Further details of the role of the Board and the Audit and Governance Committee are available in the Corporate Governance Statement on the Company's website at mebank.com.au.

### Auditor independence

The auditor's independence declaration is included on page 3 of the interim financial statements.

Signed in accordance with a resolution of the directors.

On behalf of the directors

Director
Melbourne, 6 March 2019

Deloitte.

Deloitte Touche Tohmatsu
ABN 74 490 121 060

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6 March 2019

The Members
Members Equity Bank Limited
Level 28, 360 Elizabeth Street
MELBOURNE VIC 3000

Dear Members

**Members Equity Bank Limited**

I am pleased to provide the following declaration of independence to the members of Members Equity Bank Limited (the Bank).

As lead audit partner for the review of the Interim Financial Statements of the Bank for the half-year ended 31 December 2018, I declare that to the best of my knowledge and belief, there have been no contraventions of:

(i) the auditor independence requirements of the Australian Auditing Standards in relation to the review; and

(ii) any applicable code of professional conduct in relation to the review.

Yours sincerely

Deloitte Touche Tohmatsu

DELOITTE TOUCHE TOHMATSU

M Stretton

Mark Stretton
Partner
Chartered Accountants

Deloitte.

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# Independent Auditor's Review Report to the Members of Members Equity Bank Limited

## Report on the Interim Financial Report

We have reviewed the accompanying Interim Financial Statements of Members Equity Bank Limited, which comprises the condensed consolidated statement of financial position as at 31 December 2018, and the condensed consolidated statement of profit or loss and other comprehensive income, the condensed consolidated statement of cash flows and the condensed consolidated statement of changes in equity for the half year ended on that date, notes comprising a summary of significant accounting policies and other explanatory information, and the declaration of the directors as set out on pages 7 to 20. The consolidated entity comprises the company Members Equity Bank Limited and the entities it controlled at the end of the half-year or from time to time during the half-year.

*Directors' Responsibility for the Interim Financial Statements*

The directors of the company are responsible for the preparation and fair presentation of the Interim Financial Statements in accordance with Australian Accounting Standards. The directors' responsibility also includes such internal control as the directors determine is necessary for the preparation and fair presentation of the Interim Financial Statements that is free from material misstatement, whether due to fraud or error.

*Auditor's Responsibility*

Our responsibility is to express a conclusion on the Interim Financial Statements based on our review. We conducted our review in accordance with Auditing Standard on Review Engagements ASRE 2410 *Review of a Financial Report Performed by the Independent Auditor of the Entity*, in order to state whether, on the basis of the procedures described, anything has come to our attention that causes us believe that the Interim Financial Statements are not presented fairly, in all material respects, in accordance with Australian Accounting Standards. As the auditor of Members Equity Bank Limited, ASRE 2410 requires that we comply with the ethical requirements relevant to the audit of the annual financial report.

A review of an Interim Financial Statements consists of making enquiries, primarily of persons responsible for financial and accounting matters, and applying analytical and other review procedures. A review is substantially less in scope than an audit conducted in accordance with Australian Auditing Standards and consequently does not enable us to obtain assurance that we would become aware of all significant matters that might be identified in an audit. Accordingly, we do not express an audit opinion.

*Conclusion*

Based on our review, which is not an audit, nothing has come to our attention that causes us to believe that the Interim Financial Statements of Members Equity Bank Limited do not present

**Deloitte.**

fairly, in all material respects, the consolidated entity's financial position as at 31 December 2018 and of its financial performance for the half year ended on that date in accordance with Australian Accounting Standards.

Deloitte Touche Tohmatsu

DELOITTE TOUCHE TOHMATSU

M Stretton

Mark Stretton
Partner
Chartered Accountants

Melbourne, 6 March 2019

## Directors' declaration

The directors declare that:

(a) in the directors' opinion, there are reasonable grounds to believe that the Group will be able to pay its debts as and when they become due and payable; and

(b) in the directors' opinion, the attached interim financial statements and notes thereto comply with accounting standards and present a true and fair view of the financial position and performance of the consolidated entity.

Signed in accordance with a resolution of the directors.

On behalf of the directors

Director
Melbourne, 6 March 2019

# Members Equity Bank Limited

## Condensed consolidated statement of profit or loss and other comprehensive income for the half-year ended 31 December 2018

| | Notes | Consolidated half-year ended 31 Dec 2018 $'000 | Consolidated half-year ended 31 Dec 2017 $'000 |
|---|---|---|---|
| Interest and similar income | | 648,426 | 620,177 |
| Interest and similar expense | | (444,365) | (423,388) |
| **Net interest income** | | 204,061 | 196,789 |
| Funds management fee income | | 909 | 1,575 |
| Other operating income | | 11,157 | 13,139 |
| **Total net operating income** | | 216,127 | 211,503 |
| **Expenses** | | | |
| Operating expenses | | 124,958 | 121,989 |
| Impairment losses - credit related | | 4,059 | 5,545 |
| Impairment losses - other | | 7,082 | - |
| Project expenses | | 21,017 | 17,589 |
| **Total operating expenses** | | 157,116 | 145,123 |
| **Profit before income tax** | | 59,011 | 66,380 |
| Income tax expense | 4 | 17,804 | 19,999 |
| **Profit for the period** | | 41,207 | 46,381 |
| **Other comprehensive income** | | | |
| **Items that will not be reclassified subsequently to profit or loss** | | - | - |
| **Items that may be reclassfied subsequently to profit or loss** | | | |
| Net fair value gain / (loss) on fair value through other comprehensive income financial assets, net of tax | | (1,415) | 1,402 |
| Cash flow hedges - effective portion of changes in fair values, net of tax | | (11,408) | 10,524 |
| **Total comprehensive income for the period** | | 28,384 | 58,307 |

Notes to the financial statements are included on pages 11 to 20.

## Members Equity Bank Limited

## Condensed consolidated statement of financial position as at 31 December 2018

| | Note | Consolidated 31 Dec 2018 $'000 | Consolidated 30 Jun 2018 $'000 |
|---|---|---|---|
| **Assets** | | | |
| Cash and cash equivalents | | 377,362 | 409,650 |
| Investments | 7 | 2,875,141 | 3,176,469 |
| Derivatives | | 7,573 | 11,005 |
| Trade and other receivables | | 11,244 | 5,894 |
| Loans and advances | 7 | 25,234,516 | 24,212,838 |
| Plant and equipment | | 5,119 | 5,780 |
| Intangible assets | | 93,766 | 93,228 |
| Deferred tax assets | | 19,963 | 8,802 |
| Other assets | | 13,054 | 13,083 |
| **Total assets** | | 28,637,738 | 27,936,749 |
| **Liabilities** | | | |
| Deposits and other borrowings | | 26,743,494 | 26,165,970 |
| Derivatives | | 24,831 | 11,572 |
| Trade and other payables | | 25,868 | 22,230 |
| Current tax liabilities | | - | 838 |
| Provisions | | 27,979 | 29,235 |
| Subordinated debt | | 300,985 | 300,734 |
| **Total liabilities** | | 27,123,157 | 26,530,579 |
| **Net assets** | | 1,514,581 | 1,406,170 |
| **Equity** | | | |
| Issued capital | | 1,105,473 | 1,006,282 |
| Reserves | | 8,955 | 22,759 |
| Retained earnings | | 400,153 | 377,129 |
| **Total equity** | | 1,514,581 | 1,406,170 |
| Book value per share | | $ 137.12 | $ 127.30 |

Notes to the financial statements are included on pages 11 to 20.

## Members Equity Bank Limited

## Condensed consolidated statement of changes in equity
## for the half-year ended 31 December 2018

| | | Consolidated | | | | | |
|---|---|---|---|---|---|---|---|
| | Notes | Issued capital $'000 | Retained earnings $'000 | General reserve for credit losses $'000 | Investment revaluation reserve $'000 | Cash flow hedge reserve $'000 | Total $'000 |
| **Balance as at 1 July 2017** | | 807,921 | 297,942 | 17,457 | 2,722 | (13,387) | 1,112,655 |
| Issue of share capital | | - | - | - | - | - | - |
| Issue of capital notes* | | 198,362 | - | - | - | - | 198,362 |
| Dividends paid | | - | - | - | - | - | - |
| Transfer to/(from) general reserve for credit losses | | - | (1,505) | 1,505 | - | - | - |
| Other comprehensive income for the period | | - | - | - | 1,402 | 10,524 | 11,926 |
| Profit for the period | | - | 46,381 | - | - | - | 46,381 |
| **Balance as at 31 December 2017** | | 1,006,283 | 342,818 | 18,962 | 4,124 | (2,863) | 1,369,324 |
| | | | | | | | |
| **Balance as at 1 July 2018** | | 1,006,282 | 377,129 | 22,461 | 1,619 | (1,321) | 1,406,170 |
| Adjustment due to change in accounting policy - net of tax | 3 | - | (14,086) | - | - | - | (14,086) |
| **Balance as at 1 July 2018 (adjusted)** | | 1,006,282 | 363,043 | 22,461 | 1,619 | (1,321) | 1,392,084 |
| Issue of share capital | | - | - | - | - | - | - |
| Issue of capital notes** | | 99,191 | - | - | - | - | 99,191 |
| Dividends paid | | - | (5,078) | - | - | - | (5,078) |
| Transfer to/(from) general reserve for credit losses | | - | 981 | (981) | - | - | - |
| Other comprehensive income for the period | | - | - | - | (1,415) | (11,408) | (12,823) |
| Profit for the period | | - | 41,207 | - | - | - | 41,207 |
| **Balance as at 31 December 2018** | | 1,105,473 | 400,153 | 21,480 | 204 | (12,729) | 1,514,581 |

*$200 million net of transaction costs
**$100 million net of transaction costs

Notes to the financial statements are included on pages 11 to 20.

## Members Equity Bank Limited

## Condensed consolidated statement of cash flows for the half-year ended 31 December 2018

| | Consolidated | |
|---|---|---|
| | 31 Dec 2018 $'000 | 31 Dec 2017 $'000 |
| **Cash flows from operating activities** | | |
| Profit before tax | 59,011 | 66,380 |
| Adjustments for: | | |
| Change in operating assets | (744,663) | (1,031,113) |
| Change in operating liabilities | 573,707 | 932,671 |
| Non-cash items included in profit before tax | 23,122 | 28,155 |
| Income tax payments | (24,146) | (15,915) |
| Net cash (used in) / from operating activities | (112,969) | (19,822) |
| **Cash flows from investing activities** | | |
| Purchase of plant and equipment | (461) | (903) |
| Purchase of intangible assets | (13,780) | (14,252) |
| Net cash used in investing activities | (14,241) | (15,155) |
| **Cash flows from financing activities** | | |
| Redemption of subordinated debt | - | (33,000) |
| Proceeds from issue of capital notes | 100,000 | 200,000 |
| Dividends paid on capital notes issued | (5,078) | - |
| Net cash provided by financing activities | 94,922 | 167,000 |
| **Net (decrease) / increase in cash** | (32,288) | 132,023 |
| **Cash and cash equivalents at the beginning of the period** | 409,650 | 312,646 |
| **Cash and cash equivalents at the end of the period** | 377,362 | 444,669 |

Notes to the financial statements are included on pages 11 to 20.

## 1 General information

The interim financial statements of Members Equity Bank Limited (the Company) and its subsidiaries (collectively, the Group) for the half- year ended 31 December 2018 were authorised for issue in accordance with a resolution of the directors made on 6 March 2019.

The Company is a limited company, incorporated and domiciled in Australia. The Group's principal activities are:
- provision of banking services under a banking licence;
- funding, management, and servicing of residential and consumer lending portfolios; and
- carrying out associated funding activities for off balance sheet portfolios.

## 2 Basis of preparation

The interim financial statements are general purpose financial reports prepared in accordance with *AASB 134 'Interim Financial Reporting'*. Compliance with AASB 134 ensures compliance with International Financial Reporting Standard *IAS 34 'Interim Financial Reporting'*. The interim financial statements do not include notes of the type normally included in an annual financial report and should be read in conjunction with the most recent annual financial report.

The interim financial statements have been prepared on the basis of historical cost, unless the application of fair value measurement is required by relevant accounting standards. Cost is based on the fair values of the consideration given in exchange for assets. All amounts are presented in Australian dollars, unless otherwise stated.

The Company is a company of the kind referred to in *ASIC Corporations (Rounding in Financial/Directors' Reports) Instrument 2016/191,* dated 24 March 2016, and in accordance with that Instrument amounts in the interim financial statements are rounded off to the nearest thousand dollars, unless otherwise indicated.

The accounting policies and methods of computation adopted in the preparation of the half-year financial report are consistent with those adopted and disclosed in the Company's 2018 annual financial report for the financial year ended 30 June 2018, except for the impact of the Standards and Interpretations described in Note 3. These accounting policies are consistent with Australian Accounting Standards and with International Financial Reporting Standards.

## 3 Significant accounting policies

Critical accounting estimates and significant judgements

The preparation of the Group's interim financial statements in conformity with Australian Accounting Standards requires the use of certain critical accounting estimates. It also requires management to exercise judgement in the process of applying the accounting policies. The basis of which key judgements and estimation uncertainty applied by management in preparing the interim financial statements are consistent with those that were applied and disclosed in the annual financial report for the year ended 30 June 2018, except for the impact of the Standards and Interpretations as described below.

Application of new and revised accounting standards
The Group has adopted the following new and revised accounting standards that became effective 1 July 2018 and are relevant to its operations for the half-year.

### (i) AASB 9 Financial Instruments and related amendments

AASB 9 Financial Instruments (AASB 9) replaced AASB 139 Financial Instruments: Recognition and Measurement (AASB 139) from 1 July 2018. This has resulted in changes to accounting policies for the classification and measurement of financial assets and financial liabilities, and the manner in which credit impairments are required to be determined.

The Group has applied AASB 9 in the current financial year beginning 1 July 2018 with respect to the classification and measurement of financial assets, and impairment of financial assets, for which a transition adjustment has been recognised in its retained earnings as at 1 July 2018. AASB 9 provides concessional relief to the effect that prior year comparatives are not required to be restated.

The key changes in significant accounting policies and impacts from the transition are summarised below:

**3 Significant accounting policies (continued)**

Classification and subsequent measurement:

*Financial assets*

AASB 9 has three classification catergories for financial assets; amortised cost, fair value through other comprehensive income (FVTOCI) and fair value through profit or loss (FVTPL). The classification is based on the business model under which the financial asset is managed and its contractual cash flows.

In comparison to AASB 139, the FVTOCI and amortised cost categories have been added; and the held-to-maturity, loans and receivables and available-for-sale classification categories have been removed.

The Group applies the following principal policies for new financial assets' classifications in terms of AASB 9.

(a) Amortised cost
A financial asset is measured at amortised cost if both of the following conditions are met:
- the financial asset is held within a business model whose objective is to hold financial assets in order to collect contractual cash flows; and
- the contractual terms of the financial asset give rise on specified dates to cash flows that meet the the sole payment of principal and interest (SPPI) requirements.

(b) Fair value through other comprehensive income (FVTOCI)
A financial asset is measured at FVTOCI if both of the following conditions are met:
- the financial asset is held within a business model whose objective is achieved by both collecting contractual cash flows and selling financial assets; and
- the contractual terms of the financial asset give rise on specified dates to cash flows that meet the SPPI requirements.

Changes in the fair value of debt financial assets that are classified as FVTOCI are recognised in other comprehensive income (OCI), except for the recognition of expected credit losses, interest revenue and foreign exchange gains and losses which are recognised in the income statement.

When debt financial assets at FVTOCI are derecognised, the cumulative gain or loss previously recognised in OCI is reclassified from OCI to 'Other operating income' in the income statement. Interest income from these financial assets is included in 'Interest and similar income' using the effective interest rate (EIR) method.

(c) Fair value through profit or loss (FVTPL)
Financial assets that are not measured at amortised cost or FVTOCI are measured at FVTPL. Equity financial assets are measured at FVTPL unless the Group irrevocably elects to present subsequent changes in the fair value in OCI. This election is made on an individual instrument basis and upon realisation of the equity instrument, the fair value gain or loss is transferred from a reserve account directly to retained earnings. The Group has not made this election for its equity instruments.

The Group may also irrevocably elect to classify a financial asset as FVTPL if doing so eliminates or significanly reduces an accounting mismatch. Interest income from these financial assets is included in 'Interest and similar income'.

**Business model assessment**

The Group determines the business model at the level that reflects how groups of financial assets are managed. In determining the business model, all relevant evidence that is available at the date of assessment is used including:
- how the performance of the financial assets held within that business model are evaluated and reported to the Group's key management personnel;
- the risks that affect the performance of the business model (and the financial assets held within that business model) and, in particular, the way in which those risks are managed; and
- how managers of the business are compensated (for example, whether compensation is based on the fair value of the assets managed or on the contractual cash flows collected).

The Group exercises judgement to determine the appropriate level at which to assess its business models and its business objectives with respect to financial assets. This has not materially changed from the business model impact assessment and considerations as disclosed in the Group's 30 June 2018 annual financial report.

### 3 Significant accounting policies (continued)

*Financial liabilities*

The Group's classification for financial liabilities have not changed significantly under AASB 9. The Group's financial liabilities are measured at amortised cost or FVTPL in accordance with AASB 9.

Impairment

AASB 9 replaces the AASB 139's incurred loss model with an expected loss model. The impairment requirements apply to financial assets measured at amortised cost and FVTOCI, and amounts receivable from contracts with customers as defined in AASB 15.

The Group applies a three-stage approach to measuring the expected credit loss (ECL) based on changes in the financial asset's underlying credit risk and includes forward-looking or macroeconomic information. Where ECL is modelled collectively for portfolios of exposures, it is modelled as the product of the probability of default (PD), the loss given default (LGD), and the exposure at default (EAD). The calculation of ECL requires judgement and the choice of inputs, estimates, and assumptions used involve uncertainty at the time that they are made. Outcomes within the next financial period that are different from management's assumptions and estimates could result in changes to the timing and amount of ECL to be recognised.

The determination of the ECL, which is unbiased and probability weighted, and incorporates all available information relevant to the assessment, including information about past events, current conditions, and reasonable and supportable information about future events, time value of money and economic conditions at the reporting date.

The ECL is determined with reference to the following stages:

(a) *Stage 1: 12 month ECL*
At initial recognition, and for financial assets for which there has not been a significant increase in credit risk (SICR) or for those financial assets for which there has been an increase in credit risk but for which the credit risk is considered to be low, ECL is determined based on PD over the next 12 months, adjusted for forward looking estimates (FLE).

Interest income is determined with reference to the financial asset's gross carrying amount.

(b) *Stage 2: Lifetime ECL not credit impaired*
Where there has been a SICR, the ECL is determined with reference to the financial asset's lifetime PD and the lifetime losses associated with that PD, adjusted for FLE. The Group assesses whether there has been a SICR since initial recognition based on qualitative, quantitative, and reasonable and supportable FLE that includes significant management judgement. Use of more alternative criteria could result in significant changes to the timing and amount of ECL to be recognised. Lifetime ECL is generally determined based on the average maturity of the financial asset.

Interest income is determined with reference to the financial asset's gross carrying amount.

(c) *Stage 3: Lifetime ECL credit impaired*
Financial assets are classified as stage 3 where they are determined to be credit impaired, which generally matches the Australian Prudential Regulatory Authority (APRA) definition of default which includes exposures that are at least 90 days past due, and where the obligor is unlikelty to pay without recourse against available collateral.

The ECL for credit impaired financial assets is generally measured as the difference between the discounted contractual and discounted expected cash flows from the individual exposure. For credit impaired exposures that are modelled collectively, ECL is measured as the product of the lifetime PD, LGD, and EAD, adjusted for FLE. Interest income is determined with reference to the financial asset's amortised cost carrying value, being the financial asset's net carrying value after the ECL provision.

**3 Significant accounting policies (continued)**

Expected credit loss model

*Model inputs*

The Group models the ECL for on balance sheet financial assets measured at amortised cost. The key inputs used in measuring ECL include:

(a) Exposure at default: the EAD represents the estimated exposure in the event of a default.
(b) Probability of default: the PD is the likelihood of default, applied to each underlying exposure.
(c) Loss given default: the LGD is the magnitude of the expected credit loss in the event of default.

*Methods of determining SICR*

SICR thresholds, which require judgement, are used to determine whether an exposure's credit risk has increased significantly.

The delinquency of any given exposure is the primary mechanism used to monitor credit risk at ME, hence a days past due (DPD) threshold is used to determine the SICR of an exposure. It is then used to determine when an account migrates to Stage 2 ECL. Stage 2 ECL consists of exposures that have deteriorated significantly in credit quality since origination. Any exposure that is more than 30 DPD is generally deemed to have a SICR, unless there are product specific characteristics that indicate that this threshold should be rebutted.

*Definition of default*

Default is defined as the point when the borrower is unlikely to pay its credit obligations in full, without recourse by the Group to the realisation of the collateral; or the borrower is more than 90 DPD.

*Forward looking estimates*

The Group has considered a number of key indicators to determine forward looking estimates applied in the ECL model. The key indicators used are house price index and unemployment data. These key indicators are reviewed and determined by the Group's Treasury and Risk teams, with references to public information and third party sources.

Modified financial assets and financial liabilities at amortised cost

A financial instrument is modified when its original contractual cash flows are renegotiated or modified. A financial instrument that is renegotiated is derecognised if the existing agreement is cancelled and a new agreement is made on substantially different terms or if the existing terms are modified such that the renegotiated loan is substantially different from the existing financial instrument. When the modification does not result in derecognition, a gain or loss is recognised in the income statement as the difference between the financial instrument's original contractual cash flows and the modified cash flows discounted at the original EIR. Where the modification results in derecognition, a newly recognised financial asset is assessed to determine whether it is required to be classified as purchased or originated credit-impaired (POCI) financial assets.

Hedge accounting

The Group has put in place a macro cash flow hedge by entering into interest rate swap contracts to hedge its portfolio of liabilities. The International Accounting Standards Board (IASB) has a separate project to confirm the accounting for macro hedging. Whilst the macro hedge accounting project is on-going, adopters of AASB 9 may, as an accounting policy choice, continue to apply the macro fair value hedge accounting model for interest rate risk in AASB 139. The Group has elected to continue its macro cash flow hedge accounting under AASB 139. Hence there will be no impact on hedge accounting upon the application and adoption of AASB 9 on 1 July 2018.

**3 Significant accounting policies (continued)**

Transition

As permitted by AASB 9, the Group has not restated its comparative financial statements and has recorded a transition adjustment to its opening balance sheet, retained earnings and OCI as at 1 July 2018 to account for the impact of the adoption of AASB 9's classification and measurement, and impairment requirements.

The transitional adjustment to the opening retained earnings balance on 1 July 2018 has reduced the Group's retained earnings by $14.1 million (net of tax), and does not have a material impact on the Group's minimum regulatory capital requirements.

The table below shows the classification of each class of financial asset and liability under AASB 139 and AASB 9 as at 1 July 2018.

| | Original classification under AASB 139 | New classification under AASB 9 | Original carrying amount under AASB 139 $'000 | New carrying amount under AASB 9 $'000 | Remeasurement as at 1 July 2018 $'000 |
|---|---|---|---|---|---|
| **Financial assets** | | | | | |
| Cash and cash equivalents | Amortised cost | Amortised cost | 409,650 | 409,650 | - |
| Investments | | | | | |
| Treasury notes and semi-government securities | Available-for-sale | FVTOCI | 775,657 | 775,657 | - |
| Bank bills | Available-for-sale | FVTOCI | 293,886 | 293,886 | - |
| Corporate floating rate notes | Available-for-sale | FVTOCI | 1,030,662 | 1,030,662 | - |
| Mortgage backed securities | Available-for-sale | FVTOCI | 171,017 | 171,017 | - |
| Government securities | FVTPL | FVTPL | 905,247 | 905,247 | - |
| Derivatives | | | | | |
| Basis swaps | FVTPL | FVTPL | 2,487 | 2,487 | - |
| Trade and other receivables | Loans and receivables | Amortised cost | 3,804 | 3,804 | - |
| Loans and advances | Loans and receivables | Amortised cost | 24,212,838 | 24,192,715 | (20,123) |
| **Financial liabilities** | | | | | |
| Deposits and other borrowings | Amortised cost | Amortised cost | 26,165,970 | 26,165,970 | - |
| Derivatives | | | | | - |
| Futures | FVTPL | FVTPL | 3,874 | 3,874 | - |
| Trade and other payables | Amortised cost | Amortised cost | 22,230 | 22,230 | - |
| Subordinated debt | Amortised cost | Amortised cost | 300,734 | 300,734 | - |
| Tax impact | | | | | 6,037 |
| Total adjustment to retained earnings (net of tax) | | | | | 14,086 |

The table below shows the gross exposure and related ECL allowance for each class of asset subject to the impairment requirements of AASB 9.

| | 30 June 2018 | | | 1 July 2018 | | |
|---|---|---|---|---|---|---|
| | Gross $'000 | ECL allowance $'000 | Net $'000 | Gross $'000 | ECL allowance $'000 | Net $'000 |
| **Financial assets** | | | | | | |
| Cash and cash equivalents | 409,650 | - | 409,650 | 409,650 | - | 409,650 |
| Investments | | | | | | |
| Treasury notes and semi-government securities | 775,657 | - | 775,657 | 775,657 | - | 775,657 |
| Bank bills | 293,886 | - | 293,886 | 293,886 | - | 293,886 |
| Corporate floating rate notes | 1,030,662 | - | 1,030,662 | 1,030,662 | - | 1,030,662 |
| Mortgage backed securities | 171,017 | - | 171,017 | 171,017 | - | 171,017 |
| Trade and other receivables | 5,894 | - | 5,894 | 5,894 | - | 5,894 |
| Loans and advances | 24,233,482 | 20,644 | 24,212,838 | 24,233,482 | 40,767 | 24,192,715 |

### 3 Significant accounting policies (continued)

The table below shows the reconciliation from the opening balance to the closing balance of ECL allowance and transfers during the period

| | Collective provision 12 month ECL $'000 | Collective provision Lifetime ECL Not credit impaired $'000 | Collective provision Lifetime ECL Credit impaired $'000 | Collective provision for credit losses $'000 | Specific provision Lifetime ECL credit impaired $'000 | Total $'000 |
|---|---|---|---|---|---|---|
| Balance as at 30 June 2018 | - | - | - | 13,698 | 6,946 | 20,644 |
| Change on initial application of AASB 9 | 11,673 | 15,882 | 10,080 | (13,698) | (3,814) | 20,123 |
| Balance as at 1 July 2018 | 11,673 | 15,882 | 10,080 | - | 3,132 | 40,767 |

**(ii) AASB 15 Revenue from contracts with customers**

AASB 15 replaces all the previous guidance on revenue recognition from contracts with customers. It requires the identification of discrete performance obligations within a customer contract and an associated transaction price that is allocated to these obligations. Revenue is recognised upon satisfaction of these performance obligations, which occur when control of the goods or services is transferred to the customer.

The Group adopted AASB 15 on 1 July 2018. On conclusion of the transition project, no material adjustment to opening retained earnings was recognised as the amendments to accounting policies did not result in significant changes to the timing or amount of revenue recognised at 30 June 2018.

The key judgements in applying AASB 15 include the timing and amount of variable consideration to be recognised in relation to performance fees; determining whether multiple services provided in a single contract are distinct; and determining when certain expenses can be presented net of any associated revenue.

The Group's revenue from contracts with customers is primarily in the nature of fees and other operating income as presented in the income statement.

*Funds management fee income*
The Group has assessed that the performance obligations are satisfied over time, and that the method currently used to recognise income will continue to be appropriate under AASB 15.

*Other operating income - interchange fee income*
The Group has assessed that the performance obligations are satisfied at a point in time, and that the method currently used to recognise income will continue to be appropriate under AASB 15.

*Other operating income - income from certain exclusivity contracts*
The Group has assessed that the performance obligations are satisfied either over time or at a point in time. Hence, revenue can only be recognised when the performance obligations are met, including any variable considerations, from 1 July 2018.

*Other operating income - account transaction and service fee*
The Group has assessed that this income is recognised on a range of banking products when services are delivered and not related to any contracts.

As permitted by AASB 15, the Group has not restated its comparative financial statements and has assessed that there will be no material adjustments to the opening balance sheet, retained earnings as at 1 July 2018.

## 3 Significant accounting policies (continued)

At the date of approval of the financial statements, the Standards and Interpretations listed below were in issue but not yet effective. The Group is currently assessing the impact of the following Standards and Interpretations.

| Standard/Interpretation | Effective for annual reporting periods beginning on or after | Expected to be initially applied in the financial year ending |
|---|---|---|
| AASB 16 Leases | 1 January 2019 | 30 June 2020 |
| Interpretation 23 Uncertainty over Income Tax Treatments | 1 January 2019 | 30 June 2020 |
| Revised IFRS Conceptual Framework | 1 January 2020 | 30 June 2021 |

## 4 Income tax

The Group calculates the period income tax expense using the tax rate that would be applicable to the expected total annual earnings. The major components of income tax expense in the interim statement of profit or loss are:

| | Consolidated half-year ended | |
|---|---|---|
| | 31 Dec 2018 $'000 | 31 Dec 2017 $'000 |
| **Income taxes** | | |
| Current income tax expense | 21,256 | 19,228 |
| Adjustment recognised in the current year in relation to the current tax of prior years | - | - |
| Deferred income tax expense/(income) related to origination and reversal of deferred taxes | (3,452) | 771 |
| **Income tax expense recognised in statement of profit or loss** | 17,804 | 19,999 |

## 5 Investment in controlled entities

During the half-year ended 31 December 2018 and up until the approval of the financial statements, SMHL Series Securitisation Fund 2011-2 and SMHL Series 2008-1 closed on 15 August 2018 and 21 January 2019 respectively.

In addition, the Group formed two additional trusts, SMHL Series Securitisation Fund 2018-2 and SMHL Series 2018-1 Fund as part of its securitisation program, which settled on 16 August 2018 and 20 September 2018 respectively. The trusts were formed in Australia, and the Group holds 100% of the residual income units of the trusts.

## 6 Regulatory capital

**Issued capital**

On 5 December 2018, the Group issued $100 million of perpetual Capital Notes. With prior written approval from APRA, the Group has the right but not an obligation to redeem the Capital Notes. Unless a Tax Event or a Regulatory Event occurs, the Group will only have a right to redeem the Capital Notes on or after 5 December 2023. The Capital Notes contain a provision for write-off in the event of non-viability. A non-viability trigger event will occur if APRA provides a written notice to the Group that the write-off is necessary or a determination by APRA that without a public sector injection of capital, the Group would become non-viable. This issuance supported the Group's Tier 1 capital position as an eligible Additional Tier 1 capital instrument.

## 7 Financial instruments

### (i) Categories of financial instruments

| | Consolidated | |
|---|---|---|
| | 31 Dec 2018 $'000 | 30 Jun 2018 $'000 |
| **Financial assets** | | |
| Cash and cash equivalents | 377,362 | 409,650 |
| Investments | | |
| Amortised cost financial asset | 501 | - |
| FVTOCI financial assets | 2,059,212 | 2,271,222 |
| FVTPL financial assets | 815,428 | 905,247 |
| Derivatives | | |
| Designated hedge accounting relationship | 5,124 | 8,518 |
| FVTPL derivatives | 2,449 | 2,487 |
| Trade and other receivables | 11,244 | 5,894 |
| Loans and advances | 25,234,516 | 24,212,838 |
| **Financial liabilities** | | |
| Derivatives | | |
| Designated hedge accounting relationship | 22,575 | 7,698 |
| FVTPL derivatives | 2,256 | 3,874 |
| Deposits and other borrowings | 26,743,494 | 26,165,970 |
| Trade and other payables | 25,868 | 22,230 |
| Subordinated debt | 300,985 | 300,734 |

### (ii) Fair value of financial instruments

All assets and liabilities for which fair value is measured or disclosed in the financial statements are categorised within the fair value hierarchy, described as follows, based on the lowest level input that is significant to the fair value measurement as a whole:

(a) Level 1 — Quoted (unadjusted) market prices in active markets for identical assets or liabilities;

(b) Level 2 — Valuation techniques for which the lowest level input that is significant to the fair value measurement is directly or indirectly observable; and

(c) Level 3 — Valuation techniques for which the lowest level input that is significant to the fair value measurement is unobservable.

**7 Financial instruments (continued)**

The following table shows an analysis of financial instruments recorded at fair value by level of the fair value hierarchy:

| | Consolidated | | | |
|---|---|---|---|---|
| | Level 1 | Level 2 | Level 3 | Total |
| | $'000 | $'000 | $'000 | $'000 |
| **31 December 2018** | | | | |
| ***Financial assets*** | | | | |
| Investments | | | | |
| Amostised cost financial assets: | | | | |
| Mortgage backed securities | - | - | 501 | 501 |
| FVTOCI financial assets: | | | | |
| Treasury notes and semi-government securities | - | 773,290 | - | 773,290 |
| Bank bills | - | 277,545 | - | 277,545 |
| Corporate floating rate notes | - | 859,199 | - | 859,199 |
| Mortgage backed securities | - | 149,178 | - | 149,178 |
| FVTPL financial assets: | | | | |
| Government securities | - | 812,428 | - | 812,428 |
| Unlisted equity | - | - | 3,000 | 3,000 |
| | - | 2,871,640 | 3,501 | 2,875,141 |
| Derivatives | | | | |
| Designated hedge accounting relationship | - | 5,124 | - | 5,124 |
| FVTPL derivatives | - | 2,449 | - | 2,449 |
| | - | 7,573 | - | 7,573 |
| ***Financial liabilities*** | | | | |
| Derivatives | | | | |
| Designated hedge accounting relationship | - | 22,575 | - | 22,575 |
| FVTPL derivatives | - | 2,256 | - | 2,256 |
| | - | 24,831 | - | 24,831 |
| **30 June 2018** | | | | |
| ***Financial assets*** | | | | |
| Investments | | | | |
| Amostised cost financial assets: | | | | |
| Mortgage backed securities | - | - | - | - |
| FVTOCI financial assets: | | | | |
| Treasury notes and semi-government securities | - | 775,657 | - | 775,657 |
| Bank bills | - | 293,886 | - | 293,886 |
| Corporate floating rate notes | - | 1,030,662 | - | 1,030,662 |
| Mortgage backed securities | - | 171,017 | - | 171,017 |
| FVTPL financial assets: | | | | |
| Government securities | - | 905,247 | - | 905,247 |
| Unlisted equity | - | - | - | - |
| | - | 3,176,469 | - | 3,176,469 |
| Derivatives | | | | |
| Designated hedge accounting relationship | - | 8,518 | - | 8,518 |
| FVTPL derivatives | - | 2,487 | - | 2,487 |
| | - | 11,005 | - | 11,005 |
| ***Financial liabilities*** | | | | |
| Derivatives | | | | |
| Designated hedge accounting relationship | - | 7,698 | - | 7,698 |
| FVTPL derivatives | - | 3,874 | - | 3,874 |
| | - | 11,572 | - | 11,572 |

There were no transfers of financial instruments between levels 1, 2, and 3 during the half-year.

Unlisted equity is currently measured at cost on the basis the transaction settled on 14 December 2018 at a price deemed to be fair value.

## 7 Financial instruments (continued)

Except as detailed in the following table, the carrying amounts of financial assets and financial liabilities in the financial statements approximate their fair values:

| | Book Value | Consolidated | | | |
|---|---|---|---|---|---|
| | | Level 1 | Level 2 | Level 3 | Total |
| | $'000 | $'000 | $'000 | $'000 | $'000 |
| **31 December 2018** | | | | | |
| ***Financial assets*** | | | | | |
| Loans and advances (i) | 25,234,516 | - | - | 25,262,123 | 25,262,123 |
| ***Financial liabilities*** | | | | | |
| Deposits and other borrowings: | | | | | |
| - Medium term notes (ii) | 1,105,965 | - | 1,108,775 | - | 1,108,775 |
| Subordinated debt (ii) | 300,985 | - | 302,605 | - | 302,605 |
| **30 June 2018** | | | | | |
| ***Financial assets*** | | | | | |
| Loans and advances (i) | 24,212,838 | - | - | 24,181,631 | 24,181,631 |
| ***Financial assets*** | | | | | |
| Deposits and other borrowings: | | | | | |
| - Medium term notes (ii) | 1,105,824 | - | 1,108,633 | - | 1,108,633 |
| Subordinated debt (ii) | 300,734 | - | 304,439 | - | 304,439 |

Methodologies and assumptions used to determine the fair value of financial assets and liabilities not carried at fair value

(i) The fair value of fixed rate loans is estimated by reference to current market rates offered on similar loans. The Group has reviewed the disclosure in relation to the classification of the fair value hierarchy for loans and advances, and has determined that it should be classified as level 3 fair value. The inputs used to determine the fair value of loans and advances are unobservable.

(ii) The fair values of medium term notes and subordinated debt are determined in accordance with generally accepted pricing models based on discounted cash flow analysis using prices from observable current market transactions and dealer quotes for similar instruments.

## 8 Segment information

The Group operates as one segment and therefore no separate segment reporting is provided.

## 9 Intangible Assets

The Group assessed the recoverable amount of the Intangible asset associated with the new card platform. As a result of changing market dynamics, strategic priorities have been re-assessed resulting in a deferral of the current card platform development. The recoverable amount was estimated based on its value in use, assuming the project will commence in 2020. As a result of the assessment an impairment loss has been recognised for $7.1m ($5.0m net of tax).

## 10 Subsequent events

Aside from the events as disclosed in Note 5 above, there have been no matters or circumstances which have arisen since the end of the financial half-year which significantly affect the operations of the Group, the results of those operations, or the state of affairs of the Group in subsequent periods.