M&A Outlook: Australian Financial Services

Towards 2030

minterellison.com

MinterEllison

Introduction

Welcome to the second edition of the MinterEllison M&A outlook series.

The financial services sector is one of Australia's most dynamic and innovative industries, and continues to undergo transformational change. Set against the backdrop of uncertain economic conditions and the wide-ranging, continuing ramifications of the Financial Services Royal Commission (FSRC), significant changes in the financial services industry will continue over the short to medium term as it addresses a myriad of issues. These include a need to restructure, address shortcomings in culture and respond to competition from traditional and non-traditional players.

M&A activity will be one mechanism open to institutions in the sector to address the collective impact of these issues on the organisation, its business and its reputation.

The recommendations of the FSRC are a catalyst for simplification, long term change and an opportunity to re-establish community trust. The Federal Budget provided more funding to ASIC and APRA to increase their enforcement activities, and for an increased role for regulators across the spectrum of financial services businesses.

Additional drivers are bringing transformational change to the financial services sector. These drivers include changes to prudential standards, shifting customer expectations, increased stakeholder management, technological advancements and new competitive and commercial threats.

However, many of these drivers are moving the sector in different directions and there will be important trade-offs to be made by market participants over time. This report explores how M&A may be one of the key responses to some of these underlying drivers in the next few years. We explore how financial services companies might best position themselves for the longer-term challenges that lie ahead.

We have asked members of our cross-disciplinary team to share their key insights on the future direction of the industry. We would welcome the opportunity to discuss its content with you in more detail.

Victoria Allen
Partner

victoria.allen@minterellison.com

Rahoul Chowdry
Partner, Financial Services Industry Lead

rahoul.chowdry@minterellison.com

Contents

Industry Climate: Financial Services at the cross roads 4
Summary of key drivers of M&A 5

Part A Short term M&A context and outlook 6
Short term M&A context and outlook 7
Recent M&A developments in financial services 11
Short term predictions 12
Divestment of wealth management 17
Recent international trends 18

Part B Long term drivers 21
Long term drivers 22
Economic and commercial issues 24
Funds management and investment platforms 32

Part C Governance & culture, and regulatory issues 33
Governance & culture, and regulatory issues 34
The FSRC implementation roadmap 37
The BEAR case on potential talent gaps 40
Regulation and compliance costs 41
Marching towards Basel IV 42
Further regulatory changes likely in superannuation 43
Australian regulatory structure and its impact on M&A 44

Part D Technology 46
Technology as a competitor in financial services 47
Technology as an enabler, with a focus on the customer 52
A key enabler in the drive to acquire and retain customers 54
Reducing customer friction 55
Personalised offerings using artificial intelligence and machine learning 56
24/7 capabilities and availability through multichannel delivery and digital payments 58
Financial reporting 63
Regulatory reporting aided by regtech 64
International drivers in technology 65
Coding error and Australia's largest ever civil penalty 66
Are branch networks now legacy systems? 67

Part E Conclusions and Key Contacts 68
Towards 2030 – M&A will be an important mechanism for boards and management 67

About Us 71

Industry climate: Financial services at the crossroads

The final report of the Financial Services Royal Commission will undoubtedly act as a catalyst for the start of a longer term transformation within the financial services sector. However, it also coincides with the emergence of several other factors that are likely to also drive significant change within the industry. Some of these relate to issues highlighted by the FSRC, including changes to governance, culture, remuneration, simplification and the need to establish trust. Other factors include an increased focus on the customer (assisted by the move to 'open banking'), technological changes, and increased competitive and commercial threats.

Competitive factors, regulatory costs and lack of scale will result in M&A being one of the tools that is increasingly considered for addressing competitive pressures faced by financial institutions.

While the short term impact from some of the changes discussed in this report are more foreseeable than longer term impacts, the long term impacts are likely to create the greatest need for M&A.

Despite solid fundamentals, we anticipate market conditions are shifting which are likely to create additional pressures on financial services institutions. These challenges may create triggers for institutions and competitors to undertake strategic reviews.

Significant regulatory change is upon us. Change is occurring not only from new regulations, but also from the stronger enforcement of existing regulations. The government's FSRC recommendation implementation roadmap, the introduction of the Banking Executive Accountability Regime (BEAR), the impact of Open Data legislation, Productivity Commission enquiries, changes to banking capital requirements (both in Australia, and perhaps more acutely, in New Zealand), and increasing enforcement by regulators, are providing Australian financial services institutions and investors with new regulatory and compliance challenges and questions for their business models. There will be increased onus on boards and management to assist in this transformation process in a timely fashion.

In addition, market dynamics and competitive threats are driving changes in the sector and providing other reasons for reassessment by decision makers. Overall, the prospects for profitability and growth, particularly for the larger financial services players in Australia, look to be challenging. Economic and demographic changes including lower inflation, interest rates and economic growth, high levels of household debt, growing life expectancy and increasing urban density are all combining at the same time. Institutions are facing increasing competition from overseas providers and new, nimble and well-funded technology driven upstarts, which are delivering powerful customer experiences and seeking to disrupt the status quo.

This report considers the factors driving change in the sector, as well as setting out our M&A outlook. While it is difficult to predict what the changes in the sector will be in the coming 10 years, 'business as usual' will not look the same as it does today. It will no doubt be a challenging environment for management and boards to delicately balance responses to the numerous competing issues facing the sector. With many companies slow to recognise the fall in the long term cost of capital, it's an opportune time for M&A, and there are many factors that will influence short term and long term decision making in the future.

Summary of key drivers of M&A

Focuses on culture and governance, customers and business models are among the key drivers of M&A which management can influence (as highlighted in Figure 1).

Figure 1 – Key drivers of M&A, impacts and extent to which management can influence them.

Low Medium High

Source: MinterEllison

	Issues	Short term impact	Long term impact	Extent to which management can influence
Governance and regulatory	Culture and governance	Medium	High	High
	BEAR	Medium	High	High
	Regulation and compliance costs	High	Medium	Medium
	Basel IV	Medium	Low	Low
	Further regulatory change in superannuation	Medium	Medium	Low
	International experience	High	Medium	Low
	Increased scrutiny from regulatory bodies	Medium	Medium	Low
	NZ regulatory capital changes	Low	Medium	Low
Competition	Bigtech	Low	High	Low
	Fintech	High	High	Medium
	Neobanks	Medium	Medium	Medium
	White labelling	Medium	High	Low
	International Players Growth	Low	Medium	Low
	Open banking	Low	High	Medium
	Consolidation	Medium	Medium	Medium
Technology	Legacy IT/ageing infrastructure	High	Medium	Medium
	Branch networks optimisation	Medium	Medium	Medium
	Customer focus	Low	High	High
	Digital banking	Low	High	Medium
	Artificial intelligence/robo advice	Low	High	Low
Economic	High household debt	Low	Medium	Low
	Lower credit growth	Medium	High	Low
	Subdued yields	Medium	High	Low
	Overseas funding	Medium	Medium	Low
	Weaker asset growth	Medium	High	Low
	Focused business models	Low	Medium	High

Part A
Short term M&A context and outlook

Short term M&A context and outlook

The market value of banks stocks has recovered by 8% over the year ending October 2019 as investor concerns regarding the FSRC abated. This has occurred despite weaker credit growth and falling house prices, which have lowered top line growth, while increasing the risks within the existing book of loans. At the same time, banks have experienced falling margins and profitability due to record low interest rates, increased competition, increased operational costs and rising funding costs.

General Insurance

The large Australian general insurers have been seeking to streamline their businesses, simplify management structures and lift profitability. Their M&A activity has focused on divesting some of their overseas operations, smaller portfolios, investments in brokers and managing agents, and claims management service providers.

Life Insurance

Even before the FSRC commenced, the Australian life insurance segment had seen strong M&A activity driven by offshore buyers using their lower cost of capital and opportunities to extract synergies through scale. In 2017 and 2018 the Commonwealth Bank of Australia (CBA) divested its life insurance business to pan-Asian group AIA, Suncorp sold its life insurance business to TAL (a wholly owned subsidiary of Dai-ichi Lite Group, Japan) and AMP agreed to divest AMP Life to Resolution Life (UK)(a deal which presented regulatory challenges to complete). 2019 also saw the sale of ANZ OnePath Life to Zurich (Switzerland). These follow other significant deals such as the acquisitions of National Australia Bank's (NAB's) MLC life insurance business by Nippon Life (Japan), Zurich's (Switzerland) acquisition of Macquarie's life business, and Dai-ichi Life Group's (Japan) acquisition of TAL.

Banking

CBA's divestment of its 20% stake in Vietnam International Commercial Joint Stock Bank is the only pure banking transaction over the last few years. This follows ANZ making several divestments in Asia several years ago. More recently, the major banks have sought to divest themselves of mortgage brokers. There has been speculation in the press that Suncorp will look to divest its banking operations.

Wealth Management

Wealth management is an important area of change for the major banks, with most looking to make divestments in this area over time. However, these changes are not being mandated by legislation. Changing market dynamics have led banks to reassess their ownership of investment platforms and financial planning services, with some deciding to divest these businesses. AMP's portfolio review included the decision to divest its New Zealand wealth management operations as conditions permit. Westpac has decided to continue manufacturing its own investment products.

We anticipate that banks that retained parts of their wealth management businesses may find future compliance costs will outweigh revenue. This could see those businesses come to market as part of a divestment strategy at a later stage.

Private Equity

Both history and theory tell us that mixing private equity with banking can be problematic at times. Both sectors are highly leveraged, and hence boosting one with the other creates potential alarms for regulators. Despite that, there are pockets in the non-bank financial services sector where private equity is currently present, including shareholdings in ClearView, Pepper, Latrobe Financial and Latitude Financial.

Private equity could foreseeably be attracted to other non-bank institutions, with press reports suggesting that Mortgage Choice, Steadfast Group and AUB Group are potential targets. Furthermore, the wealth management operations within banking groups could be equally attractive. These capital light businesses generate relatively predictable cash flows and are therefore ideal for private equity. Currently we are seeing the potential for such a tie-up with global private equity majors being linked to the potential purchase of NAB's MLC business.

Short term
M&A context and outlook (cont.)

The deceleration of credit growth and the subsequent fall in property prices has been partially influenced by regulators, with the Australian Prudential Regulation Authority (APRA) introducing a 10% benchmark on investor loan growth and a 30% cap on interest only loans. Although both have now been lifted, it is expected that loan growth will remain subdued, at least in the short term, before recovering. Moves to strengthen underwriting have had an even greater and ongoing effect. Added to this, APRA is now focusing more on minimising debt to income ratios and keeping low-deposit lending to a minimum. The net effect could be a further tightening in housing credit, which will continue to constrict some housing market activity and reduce the prospects for price appreciation.

The brunt of this low credit growth is seemingly being borne by the larger market participants (and perhaps already reflected in the fall in the market capitalisations of the major banks). Smaller players are benefiting from this environment, with some non-bank lenders or 'shadow-banks' showing accelerated loan growth. Major banks now need to be best in class in relation to each product and market segment. A portfolio approach will no longer work as some smaller lenders target niches.

Banks have also supplemented their deposit base by raising wholesale funding (both long term and short term debt) and securitising existing loans, such as residential mortgages, into Residential Mortgage Backed Securities (RMBS), to make additional loans and take advantage of profitable demand. Much of the wholesale funding has been raised and securitised loans sold overseas. This leads to Australian banks' funding costs being partly driven by what is happening to the cost of funding overseas. This reliance on overseas funding may bring its own set of risks, particularly if the cost of overseas funding rises while the Australian cost of funding falls.

In this climate, it is easier to focus on the short term challenges rather than the long term opportunities arising from the current operating environment and the new ways of doing business being created by technological advancements. Most importantly, notwithstanding the now long prevailing benign credit environment, banks are being proactive in managing their credit exposures to minimise credit losses. Notably, the majority of employees in these financial institutions may not have seen a recession (which has not occurred in Australia in 28 years). Therefore, they may consequently lack some experience in managing a downturn.

While the fundamental drivers of credit quality remain currently unchanged, high household debt, combined with the potential of rising unemployment, remain as the largest risks going forward. Despite solid fundamentals, we anticipate that shifting market conditions are likely to put additional pressures on financial services institutions. The credit cycle may have started to turn, with lenders seeing an uptick in arrears and losses. While doomsday scenarios are unlikely, these challenges may trigger institutions and competitors to undertake strategic reviews that lead to selected portfolio divestment or runoff.

> "Despite solid fundamentals, we anticipate that shifting market conditions are likely to put additional pressures on financial services institutions."

Recent M&A developments in financial services

A number of high profile and complex M&A transactions have been completed in recent years in the Australian financial services sector. This trend has continued, if not been accelerated by the major banks with a number of transactions, some of which are yet to be completed. These transactions are part of a broader trend to creating simpler businesses. They also establish a strong base for buoyant M&A trends to continue.

Recent strategic reviews and M&A processes have been predominantly driven by institutions seeking to pre-empt and mitigate any additional compliance requirements and fallout from the FSRC. In some respects, the sheer size, complexity and poor quality of legacy systems within our larger financial services institutions contributed significantly to the issues highlighted in the FSRC. Hence, solving these inherent problems is not easy and will require significant spending and management time.

Weaker equity markets and an increase in credit spreads over 1H19 (triggers that increase the cost of capital for acquirers and potentially decrease the transaction valuation multiples that buyers are willing to pay) led some to believe that the peak of M&A in this cycle may have already passed. However, aided by the market rebound in 2H19, and according to Merger Market, M&A volumes have been robust. There has been a 7% increase in deal value in FY19 in Australia compared with FY18. However, there has been a slowdown in 1H20.

Short term predictions

M&A predictions in banking

The sector's ongoing response to the FSRC Final Report, new regulation and compliance regimes are likely to bring further scrutiny, and behavioural and structural change to the sector in the short term. We envisage that a number of changes will occur across segments.

The bancassurance model may be in trouble

The bancassurance model appears to be facing significant challenges. With growing capital demands and reduced capital synergies, banks may look to further divest remaining insurance businesses, particularly those dealing in general insurance. For example, CBA will carve out its general insurance business.

A fifth major bank

Long speculated is the idea of a tie-up of regional institutions to form a fifth 'major bank'. A merger of regional banks, servicing different geographic areas would provide greater scale and geographical scope. Additional acquisitions of smaller banks, or mutual or credit unions, could address any additional servicing gaps. This is similar to the process the major Australian banks have undertaken over at least the past 35 years. Clearly the Australian Competition and Consumer Commission (ACCC) would scrutinise any such proposal.

The outlook for auto loan books is very uncertain

ASIC's ban of 'flex commissions' in the car finance market, coupled with a desire to focus on core operations, may lead some of the major banks to review their auto loan portfolios.

The outlook for credit cards is difficult for smaller providers

Credit card operations are businesses of scale. There are only a limited number of providers with such scale in Australia. Many store cards, smaller banks, and some regional institutions provide their customers with white-labelled credit cards from one of these providers. Banks are increasingly focused on the profitability of their loan portfolios. In addition, recent changes to card lending standards aimed at restricting the growth in card credit limits and outstanding balances, and greater competition from buy-now pay-later providers, might lead some providers to divest their credit card operations in favour of white labelling. This will allow them to reinvest the proceeds into more profitable parts of their business.

It is more expensive to do banking in NZ now given increased capital requirements

The Reserve Bank of New Zealand's (RBNZ's) proposal to significantly increase the capital requirement proposals for banks could lead to Australian banks strategically reviewing their ownership of New Zealand banks and potentially moving down a path of divestment. According to a RBNZ discussion paper on capital standards, released in April 2019, the regulatory authorities in NZ are concerned that systematic banking risks in Australia may spread to New Zealand under the current structure. APRA is now also looking to change the capital requirements for holding banks' NZ businesses. This could lead the NZ subsidiaries to modify their lending appetite, depending on the final capital requirements. The RBNZ had also initially rejected AMP's sale of AMP Life to Resolution Life.

Basel IV looks at total loss-absorbing capital (TLAC) for banks and puts floors in internal models for the calculation of risk weighted assets (RWAs). In other countries, regulators have looked to Tier 2 and Tier 3 (unsecured subordinated debt) to boost TLAC. In Australia, APRA plans to use Tier 2 capital to boost TLAC held by Australian banks.

The proposed RBNZ requirements, which propose Tier 1 equity capital rather than Tier 2 or Tier 3 subordinated debt, would be tougher than Basel IV proposals. This scenario could create depressing returns and strategic challenges for Australian financial services institutions operating in NZ. Should the RBNZ embrace a more stringent standard, Australian banks with subsidiaries in New Zealand might consider undertaking strategic reviews and consider all their options for their New Zealand businesses. These changes have already caused Australian banks to review their overall strategy in New Zealand. However, divestment (other than potentially for first mover advantage) or withdrawal is unlikely. The size, nature and pricing of the loan books and other activities will inevitably be put under the microscope.

Fintechs are unlikely to take market share from the major banks in the short term

It is very likely that some existing institutions will strategically invest in fintechs. Smaller specialist lending portfolios, based around a particular asset class, may see greater volumes of M&A. This will be partly driven by shadow banking fintechs operating in niches such as lending to small and medium-sized enterprises, inventory finance, and asset/vehicle finance. Banks may also reconsider their portfolios in these areas given the high capital demands and margin compression driven by increased competition. Alternatively, the fintechs in these segments may be acquired by other fintechs looking to expand or scale up their offerings, or by opportunistic banks that can get niche providers out of difficulty. For example, CBA plans to invest more than $5 billion in technology over the next five years to maintain its leadership position in digital banking. In August it announced a $100 million investment in Klarna which is a buy now pay later fintech.

ATMs are potentially going the way of phone boxes

With falling demand for ATM services associated with the increase in card payments and tools like Apple Pay, the major banks have already removed their ATM fees. We may see major banks and ATM owners look to rationalise their ATMs into one or more 'utility' ATM networks (subject to ACCC approval or authorisation).

Despite media reports, the Australian banking market is still attractive to foreign banks

While the Australian banking sector continues to experience significant problems and the value of banking businesses de-rate materially, foreign banks may look to increase their presence in Australia. One way of doing this is to simply acquire Australian institutions as a way of cheaply acquiring customer relationships and economies of scale. Japanese and Chinese institutions, as well as those from other countries that have a significant savings surplus and limited domestic or existing long term growth opportunities, may identify Australia as an attractive market.

M&A predictions in mortgage broking

Seeming casualties of the FSRC, mortgage brokers continue to lobby against a recommendation on commission structure

Historically, mortgage brokers have been used by banks as a cost efficient way of sourcing new business, with banks paying trail commissions in the form of a deferred spotter's fee. Criticisms of bank ownership of mortgage brokers had been long building. A Productivity Commission report concluded that many brokers had started acting in the best interests of the banks that own them, as opposed to providing competition to the major banks as they did in the 1990s. Two of the major banks noticeably hold mortgage broking businesses, with CBA already announcing plans to divest its Aussie Home Loans business (although now delayed).

The recommendation that consumers pay mortgage brokers, replacing the current commission structure, was aggressively fought by the mortgage broking industry on the basis that it diminishes competition. These Liberal/National and Labor political parties have expressed caution or abandoned this recommendation. We expect that significant political debate on any major reforms in this area will continue, given that there are over 7,000 mortgage broking businesses in Australia employing more than 18,000 people (IBISWorld), with many being small businesses.

M&A predictions in insurance

The insurance sector may see further heightened M&A activity in the short term

The insurance sector was severely disrupted by the FSRC recommendation to remove grandfathering on both financial advice and life insurance commissions, plus the recommendation to review general insurance commissions. This, combined with growing capital demands and reduced capital synergies, may see banks further divest their remaining insurance businesses.

The third party insurance sales model is certainly threatened. Restricting the ability to instigate life insurance sales over the phone will prevent some insurers from using third party call centres to sell direct to customer life insurance products.

Some business units of large insurers now have increased pressure following the FSRC's recommendations to prevent insurance sales alongside the sale of other products.

Insurance brokers and managing agents are likely to consolidate, but it may not be a structural change

The insurance sector tends to go through periods of acquiring brokers and managing agents. This is in order to grow its intermediated business and is followed by periods of selling these businesses as they become less critical for business growth. This process is likely to continue.

There is an unwinding of vertical integration to claims fulfilment

The general insurance industry has moved towards the vertical integration of claims fulfilment, through vehicle and property repairs. This appears to be moving in phases, with insurers acting as the catalyst for an increase in scale. This is partly driven by changes in technology and to drive efficiencies. As the market responds to match this increase in scale, some general insurers are now looking to divest and reduce vertical integration. For example, Capital SMART Repairs was sold by Suncorp to AMA Group at the end of October 2019.

Now that the FSRC is over, there is potential for some deals to reappear

The FSRC has resulted in a few M&A transactions being delayed or falling through, such as the terminated divestment of St Andrew's insurance from Bank of Queensland to (the now defunct) Freedom Insurance Group. A number of other recent M&A deals are at risk of being, or have been, blocked. Suncorp's bid to buy Tower Insurance in New Zealand was blocked by the New Zealand Commerce Commission. In a more certain post-FSRC environment, we could see other interested buyers bid for these assets.

> "The FSRC resulted in a few M&A transactions being delayed or falling through. In a more certain post-FSRC environment, we could see other interested buyers bid for those assets."

M&A predictions in wealth management

Structural separation from the banks is likely to occur over time

CBA has already sold Colonial First State Global Asset Management to Japanese giant Mitsubishi UFJ Trust and Banking, and its financial planners to CountPlus. It is separating its remaining wealth management (less the already divested funds management and financial planning operations) and mortgage broking business into a separate business dubbed 'NewCo'. CBA has confirmed that its Financial Wisdom licensee will be closed and no longer offer licensing services by June 2020.

NAB has stated that multiple options for its wealth management business remain under consideration, including an initial public offering, sale or demerger.

Westpac has made the decision to continue manufacturing its own investment products, believing that this path gives the group greater control in providing their customers with the options they need. However, Westpac has exited from financial planning.

ANZ sought to sell its OnePath wealth management operations to IOOF, completing the sale of its financial planning business. However, APRA's concerns with IOOF have delayed regulatory approvals. APRA's sanctions against IOOF may see the transaction further delayed.

There are opportunities for M&A in financial planning given the turmoil caused by the major banks

At the smaller end of the market, financial planning businesses looking to grow will have many opportunities to acquire businesses that are being divested by the majors. There appears to be particularly strong buyer interest in advisor groups where the clients are well engaged and pay good ongoing fees (as opposed to those businesses that rely on conflicted remuneration models and trailing commissions). Press reports suggest these businesses are pricing at between 3–3.5 times recurring revenues, or 6–7 times normalised EBITDA.

Potential liabilities associated with some financial groups may limit M&A activity, but there are solutions

Given the potential professional indemnity liabilities associated with inappropriate financial advice and fees for no service, it is possible that some smaller financial planning organisations might look to divest the back book of their operations. These 'run-off liability companies' could then be rolled up in a series of M&A transactions, similar to the process used by the insurance industry to transfer run-off liabilities from closed insurance books.

Increased consolidation is likely in super and funds management

As a result of the FSRC recommendations, the APRA Capability Review and Productivity Commission reports, APRA may become far more aggressive in seeking the closure of underperforming superannuation funds or their merger into other, more successful funds.

Similarly, funds management is an area where scale will remain ever more important as investors continue to demand lower management fees. In areas such as exchange traded funds (ETFs) or active management, we expect that funds failing to reach acceptable scale may be increasingly shut down or merged into other funds.

An example of the recent changing activity in this space is the signing of a non-binding memorandum of understanding by VicSuper and First State Super to explore the benefits of a merger. This would make the resulting fund the nation's second largest behind AustralianSuper.

Divestment of wealth management

There is no greater example of the changes happening in the market than the efforts by Australia's major banks to divest their wealth management activities. The days where the big four banks and AMP controlled 80% of the Australian wealth management industry have gone. Figure 2 and Figure 3 highlight the current market share positions in wealth management but this market concentration will change rapidly.

The FSRC did not directly address the future of the vertically integrated business model. However, this model is now under severe pressure and most of the larger players in the sector have, through actual or planned divestments of their wealth management and/or insurance businesses, signalled their intentions to simplify their business models. Contributing factors have included:

(a) the banks, in particular, becoming progressively more circumspect with the wealth management business and seeing more effective use of capital;

(b) lack of customer demand to using their local bank branch as a 'one-stop-shop' for their investment, superannuation and insurance products;

(c) Conflicts of interest between customers' best interests and staff incentives;

(d) the airing and scrutiny of high-profile case studies of internal misconduct by financial planners and the management impost to fix such misconduct;

(e) increased competition from the not-for-profit industry super funds;

(f) increased regulatory pressures such as the MySuper legislation, which forced institutions to offer simple, low-fee accounts for new superannuation customers; and the Freedom of Financial Advice (FOFA) legislation, which banned commissions on financial products (apart from insurance);

(g) anticipated enhanced regulation and associated cost to professionalise services and conduct, and improve the products available to end consumers;

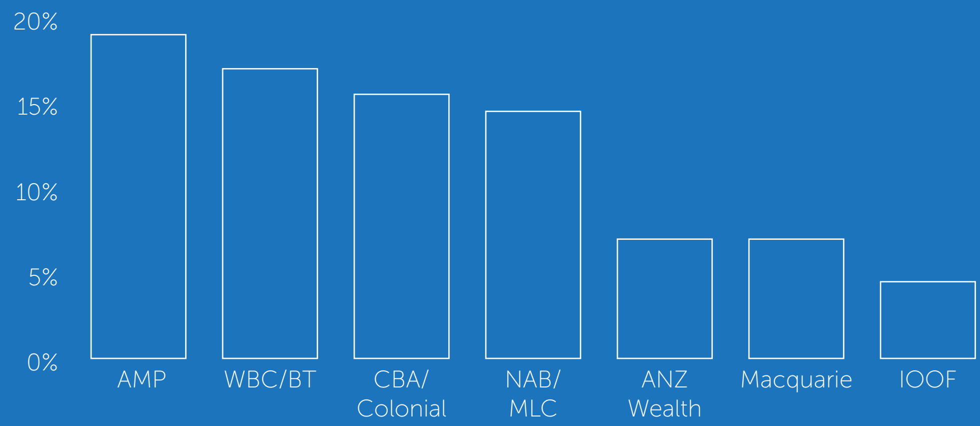
(h) greater management time and responsibilities (under BEAR) for a small proportion of its overall business; and

(i) the need to overcome negative reputational and share price impacts.

Figure 2 – Market share of wealth management/financial planning in Australia (2018)

source: Money Management Magazine.

Figure 3 – Market share of retail funds under management in Australia (2018)



source: Plan for Life.

Recent international trends

International M&A activity in the financial services sector has shown some interesting contrasts over the last 12 months. Deal making between banks continues to be sluggish, while transactions involving asset managers and insurers have increased.

International trends by sector

Banks

Deal making in the banking sector has been subdued for the last decade. This is due in large part to the stricter regulatory regimes that have been put in place since the Global Financial Crisis. In addition, regulators and governments have in many instances effectively barred mega bank deals amongst the largest international and national banks.

However, since US President Trump has come into office, US bank rules have loosened considerably, leading some to predict a pickup in deals, particularly as smaller banks look to consolidate.

In February 2019, US regional lender BB&T Corp acquired another US regional lender SunTrust Bank for $US28.2 billion, creating the sixth largest US retail bank and making it the largest US bank merger since JPMorgan's acquisition of Bank One in 2004. Technology has been mentioned by the bank's executives as the main impetus for the deal. The pooling of resources will allow the companies to develop better digital offerings.

In Europe, Deutsche Bank was unable to reach a deal with prospective partner Commerzbank and has since embarked on an aggressive restructure of its operations, shedding its Asian equities businesses and downsizing its investment bank.

Asset managers

A record was set in 2018 for deal making in the asset management segment. Acquirers have been attracted to the discounted valuations through the segment, which dropped to their lowest level in seven years through 2018. The median valuation for publicly traded asset management companies – measured as the enterprise value multiple to earnings before interest, tax, depreciation and amortisation (EV/EBITDA) – was about 6.2 times last year, well below the peak of 11 times registered in 2011. Interestingly, valuations of privately owned asset managers have maintained valuations of about 10 times over the last five years.

With the trend towards low cost industry funds appearing to be a secular shift, traditional active managers have used cost cutting measures to try to stay profitable. This combination of low valuations and cost out opportunities has also seen significant private equity interest, which in turn may be an attractive option for asset managers as it provides them with an escape from the glare of seasonal earning cycles.

Insurance

The pace of global insurance M&A was robust through 2018, up 9% from 2017, with 382 completed deals. This included 18 $US1 billion+ mega deals, such as AIG's $US5.5 billion acquisition of Validus, and Axa's €12.4 billion acquisition of XL Group. Despite these numbers, mega deals are still difficult to complete, as evidenced by the collapse of SoftBank's proposed acquisition of a stake in Swiss Re.

Recent international trends (cont.)

International regulation driving change

Easing up on midsized US Banks

In November 2018, the US Federal Reserve said that it wanted to ease regulations for US lenders with less than $US700 billion in assets, as a way to lessen the burden on big commercial lenders that do not have volatile Wall Street businesses. Under the proposal, midsized lenders would face lower liquidity and compliance requirements, while smaller banks would get even easier treatment.

The proposal stems from a law the US Congress passed in May that ordered the Federal Reserve to reduce regulatory burdens on community and regional lenders.

Europe's banks face new rules

Ten years after the financial crisis, the regulatory revolution continues for European banks. The past year has seen reforms passed which will open up European banking to more competition, tighten rules on trading, dent reported profits and boost capital requirements. Taken together, these changes should also make Europe's financial system healthier.

European Union (EU) finance ministers were able to reach agreement on reforming bank capital rules, a major step towards boosting the bloc's financial stability and a stepping stone towards a deal on a backstop for its bank rescue fund. The accord came after 18 months of heated debate among the 28 EU governments on how to apply new global bank capital rules.

Under the accord, European banks will have to abide by a new set of requirements aimed at keeping their lending in check and ensuring they have stable funding sources.

The new rules also required large foreign banks to set up intermediate parent undertakings that would bring their EU operations under a single holding company. The move effectively mirrors US rules and is seen as crucial to protecting the bloc's financial stability against risks posed by major banks.

Concerns are still held that the 'Too Big to Fail' problem persists in Europe. Since 2008, the five largest banks in the Eurozone have increased their share of the total assets of the entire banking industry from 44% to 48%. Critics argue that implicit subsidies for 'Too Big to Fail' banks remain in place as well. Since creditors continue to believe that those banks would get bailed out in a crisis, they can borrow at lower interest rates than smaller banks.

Canada strengthens standards

In 2018, the Canadian Office of the Superintendent of Financial Institutions (OSFI), implemented changes to mortgage underwriting standards, creating a stress test for borrowers making a down payment exceeding 20%. This will require banks to increase their loan-to-value ratios, which will be strictly enforced by OSFI.

Canada's banking regulator also increased the amount of capital that its biggest lenders must carry, to protect them against risks at home. Regulators pointed out that despite positive credit performance and generally stable economic conditions, now is a prudent time for banks to build resilience against future risks to the Canadian financial system.

Part B
Long term drivers

Long term drivers

The financial services sector has and will continue to be a key pillar of the Australian economy, and an enabler of productivity, jobs and economic growth. However, we anticipate that a number of longer term changes will see the sector look fundamentally different by 2030. It is here that we see the greatest opportunities and need for M&A.

Regulatory & stakeholder

Ongoing changes to international and local regulatory and compliance conditions are inevitable, including to banking capital requirements, banking executive accountability, open banking, tightening of social responsibility, culture, reputational and shareholder priorities. The impact may be further regulatory and remediation cost cutting into profit margins and potentially market value. Non-core business units might be divested and we might see fundamental institutional shifts towards simplified operations, and possible consolidation and market concentration by astute buyers.

Competition

We're likely to see new competition from nimble, agile and sophisticated companies, especially those with smart technology offerings. This would result in shifts in market share and power, and the formation of more strategic alliances among traditional players wanting to stay relevant.

Technology

We're seeing greater customer expectation for customised, agile and on-demand systems, coupled with ongoing advancements in technology solutions, especially in quantum computing. This will result in further outlays to upgrade ageing infrastructure and systems just to 'remain in the game'. Part D provides further insights about this driver.

> "We're seeing a number of other interrelated and coordinated forces that will drive longer term change in the sector."

Economic

Shifting economic conditions, especially from the current and expected prolonged low interest rate environment, and also leverage risks, will result in different credit and operating conditions.

Economic and commercial issues

Taking a long term view, despite a solid base, market conditions are shifting. When combined, they are likely to create additional pressures on financial services institutions. While doomsday scenarios are unlikely to eventuate, these challenges may create triggers for institutions and competitors to undertake strategic reviews.

Fall in financial services market value

In 2018 and early 2019 there was a significant reduction in the collective market value of Australian financial services institutions, which has since partly recovered. This is highlighted in Figure 4.

A confluence of factors have led to this reduction and then recovery in market value. These include:

(a) the FSRC;

(b) actions by regulators to slow investment and interest-only lending growth;

(c) weaker credit growth and falling house prices;

(d) falling margins and profitability ratios due to competition, increased operational costs, and rising funding costs;

(e) market uncertainty and volatility due to international market and concerns;

(f) moves by APRA to slightly ease new mortgage stress test requirements;

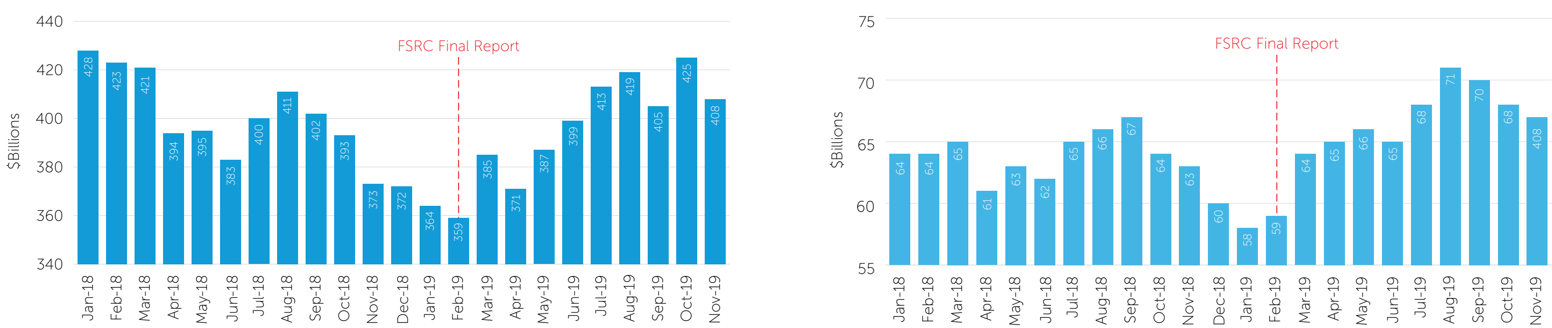
(g) APRA's timetable for revisions to the capital framework for authorised deposit-taking institutions (ADIs); and

(h) interest rate cuts by the RBA.

Figure 4 – The reduction in market value of ASX200 financial service sector (January 2018–November 2019).

Banks (Big 4 plus BEN, BOQ, CYG & GMA)

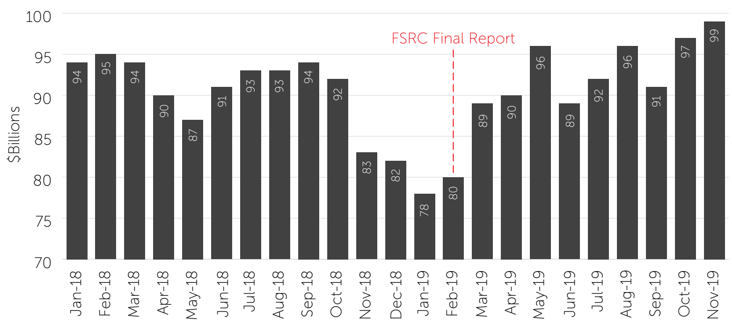
Insurance (SUN, AM, IAG, QBE, MPL, NHF, SDF)



source: Start of month market capitalisations, ASX200List.com, accessed 20 November 2019.

- The market value of bank stocks has fallen 16% in the last year or ~$70 billion
- The market value of insurance stocks has fallen 17% in the last year or ~$14 billion
- The market value of diversified financials has fallen 7% in the last year or ~$5 billion
- The total decline in market value for larger Australian listed financial services stocks is approximately $90 billion or ~15%.

Diversified financials
(ASX, CCP, CBG, ECX, IFL, JHG, MFG, MOG, PDL, PPT & PTM)



source: Start of month market capitalisations, ASX200List.com, accessed 20 November 2019.

Economic and commercial issues (cont.)

Challenges to credit growth

Currently in Australia, banks are facing an undeniably challenging credit growth outlook, which is largely being driven by the slowdown in the home loan market (represented in Figure 5 by housing finance commitments and investments), especially in the last 12 months. This weakening in housing credit is a product of economic and market fundamentals, namely slower economic growth, low inflation and overextended property prices.

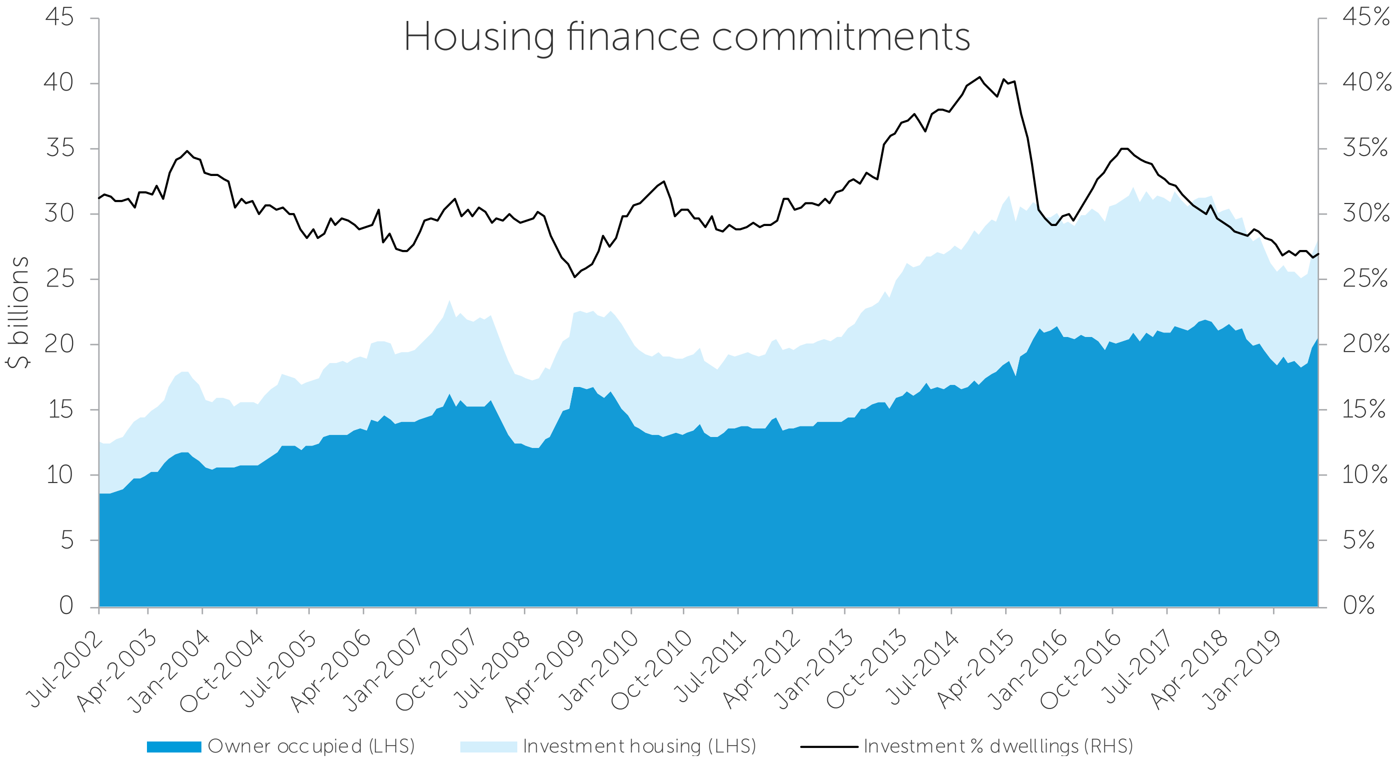
The deceleration of credit growth has also been influenced by regulators. In late 2014, APRA introduced a 10% benchmark on investor loan growth. Investment lending volumes as a proportion of total lending volumes for household finance peaked at 44.4% in May 2015, just after APRA's imposition of investment lending 'speed limits'. In March 2017, APRA also implemented a cap on interest-only lending at 30% of all new mortgages, which has led to a substantial drop in demand for this product (largely used by investors).

Although the 10% benchmark was lifted from 1 July 2018, and the 30% cap was lifted from 1 January 2019, the likelihood of a quick rebound in housing credit remains low. The 30% cap on interest-only lending had a much more broad-based dampening effect on investor activity. Moves to strengthen underwriting have had an even greater and ongoing effect. Added to this, APRA is focusing more on minimising debt to income ratios higher than six times and maintaining a focus on keeping low-deposit lending to a minimum.

The net effect could be further tightening in housing credit, which will continue to constrict housing market activity and reduce prospects for price rises.

> “This weakening in housing credit is a product of economic and market fundamentals, namely slower economic growth, low inflation and overextended property prices."

Figure 5 – Housing finance commitments (1985 to now)



> “Banks are facing a challenging credit growth outlook, which is largely being driven by the slowdown in the home loan market."

source: ABS 5671.0 Table 8, Seasonally adjusted data, aggregated into owner occupied and investment categories, http://bit.ly/2OkMu9r, accessed 22 January 2019.

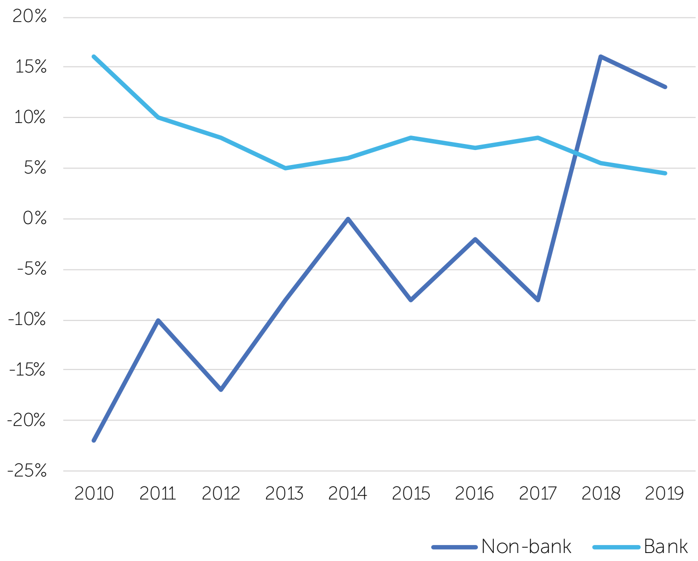
Economic and commercial issues (cont.)

As Figure 6 highlights, system-wide housing credit growth in Australia has slowed over the last year due to the restrictions imposed on APRA regulated banks. In this environment, the non-bank lenders or 'shadow banks' have stepped in and are now showing accelerated loan growth.

Furthermore, as overall credit growth has slowed, some banks have been more affected than others, most notably ANZ. Recently released APRA stats for June 2019 show that ANZ's owner-occupied home loan market has declined dramatically, by 0.75%, in the past year to 15.65%. This is the largest one-year fall recorded by APRA in relation to the big four banks. In February 2019, ANZ Chief Executive Officer, Shayne Elliott, conceded that the bank had become too conservative in its home loan approval process.

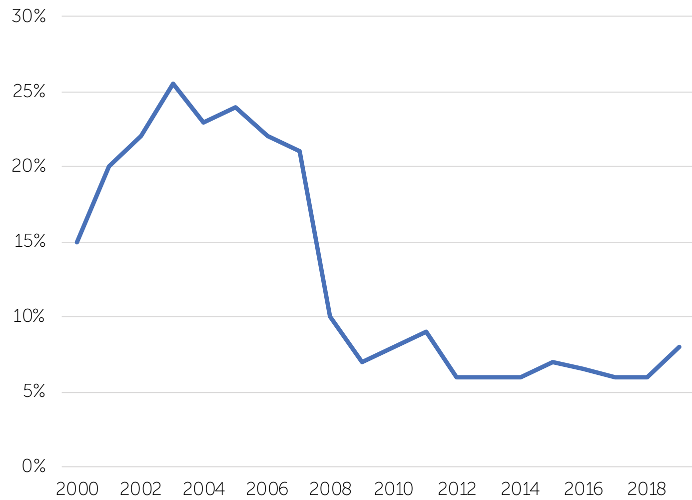
Figure 6 – Shifts in non-bank lending

Housing credit growth in Australia (year on year)



sources: APRA, RBA.

Non-bank market share of financial commitments



source: ABS.

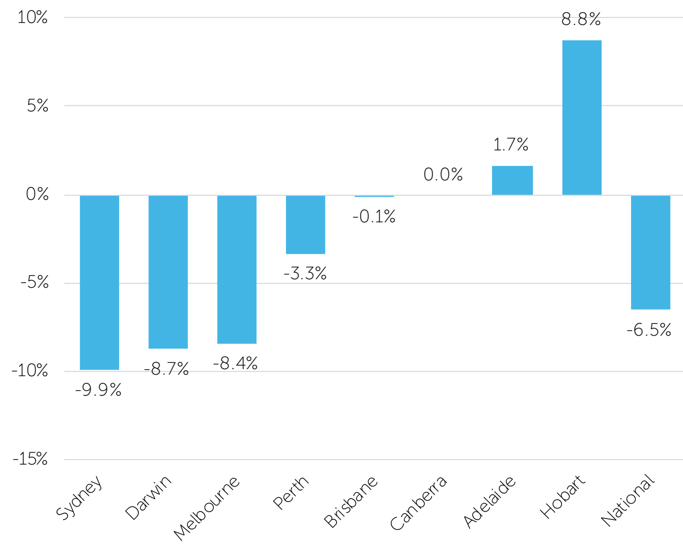
Figure 7 highlights that growth rates in other forms of credit, such as business and personal credit, have also been slowing alongside housing.

Figure 8 also highlights that tighter credit assessment and availability has led to declining housing prices, particularly in Australia's largest cities. There has been less of an impact in other smaller capital city markets (where the Household Expenditure Measure may not be as distorted as it is in the Sydney and Melbourne markets).

Figure 7 – Credit growth in Australia (year on year)

source: RBA.

Figure 8 – Median house price changes 2018



source: Domain Group.

"Tighter credit assessment and availability has led to declining housing prices, particularly in Australia's largest cities."

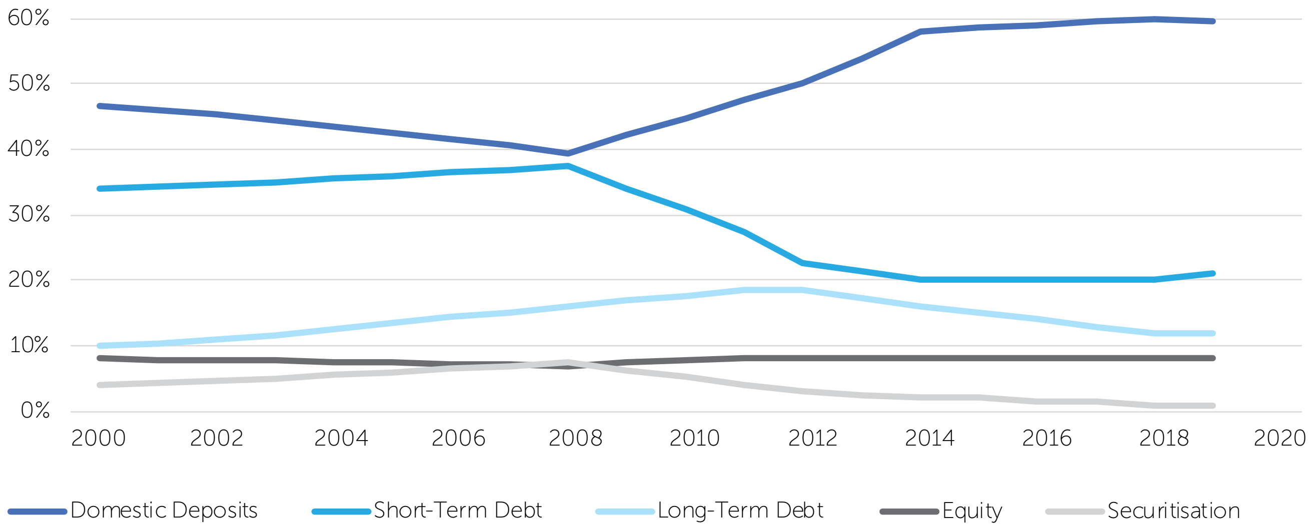
Economic and commercial issues (cont.)

Asset and liability mix/ funding mix

One driver of rising funding costs is the funding composition for Australian banks, which is a function of the deposit to loans ratios (DLRs). These were improved to just above 60% with the implementation of the Basel III standards. Banks have supplemented their deposit base by raising wholesale funding (both long term and short term debt) and securitising existing loans such as residential mortgages into residential mortgage backed securities (RMBS) to make additional loans given profitable demand. This funding composition is highlighted in Figure 9.

The majority of wholesale funding has been raised and securitised loans sold overseas, which leads to Australian banks' funding costs being partly driven by what is happening to the cost of funding overseas. Australian banks are likely to have rising funding costs, despite interest rate stability in Australia, as the US looks to increase rates and other markets linked or pegged to the US dollar implicitly follow suit.

Figure 9 – Funding composition of Australian banks through time



sources: APRA, RBA, S&P

Banking in a low interest rate world

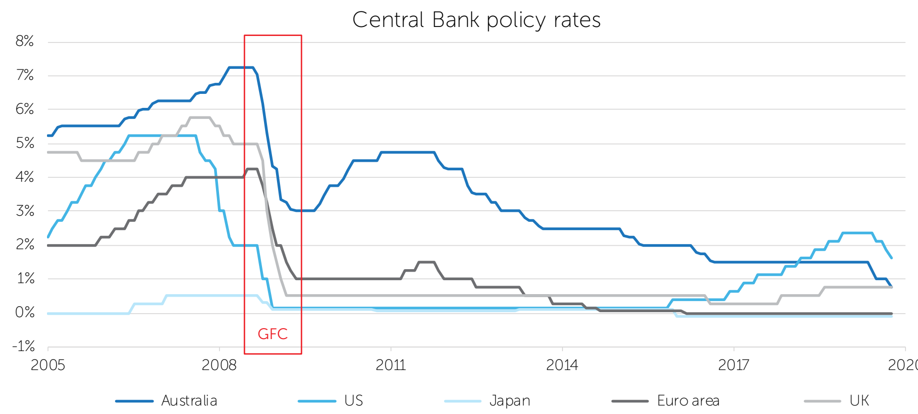
Over the last decade, low interest rates have become a permanent feature throughout the economies of the developed world (as highlighted by Figures 10 and 11).

This unprecedented period of loose monetary policy has been driven by the need to nurse economies back to a path of growth after the Global Financial Crisis. Although we have seen economies stabilise, and in some cases stage robust recoveries, the policy experiment of ultra-low rates and quantitative easing has not been without consequences. Side-effects are now apparent in asset prices, which in many instances, have been increasingly stretched from underlying fundamentals. This was most visible in the US stock market, but also extends to other corners, such as private equity. In Australia, the impacts of the global debt binge seem most apparent in residential property.

Low interest rates for long periods bring other challenges. For example, low rate environments reduce bank profitability, as net interest margins are compressed. At the same time, investors (both retail and institutional) can be pressured to increase their risk exposure to start chasing returns. The dangers of increasing risk exposure are often not apparent in a benign environment.

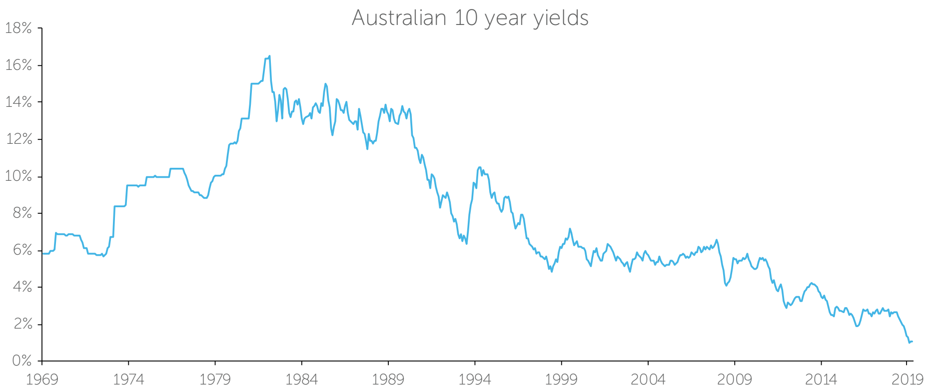
Banks are being proactive in managing their credit exposures to minimise credit losses, in part prompted by APRA. During a benign credit environment, it can be difficult to determine where credit exposures could deteriorate, and, given the economic uncertainties, it would be brave to predict too far out. However, the fundamental drivers of credit quality remain unchanged, with high household debt combined with rising unemployment (resulting in households being unable to service their debt) producing the largest risks.

Figure 10 – Low interest rates in leading developed markets



source: RBA.

Figure 11 – Low long term interest rates in Australia



source: RBA.

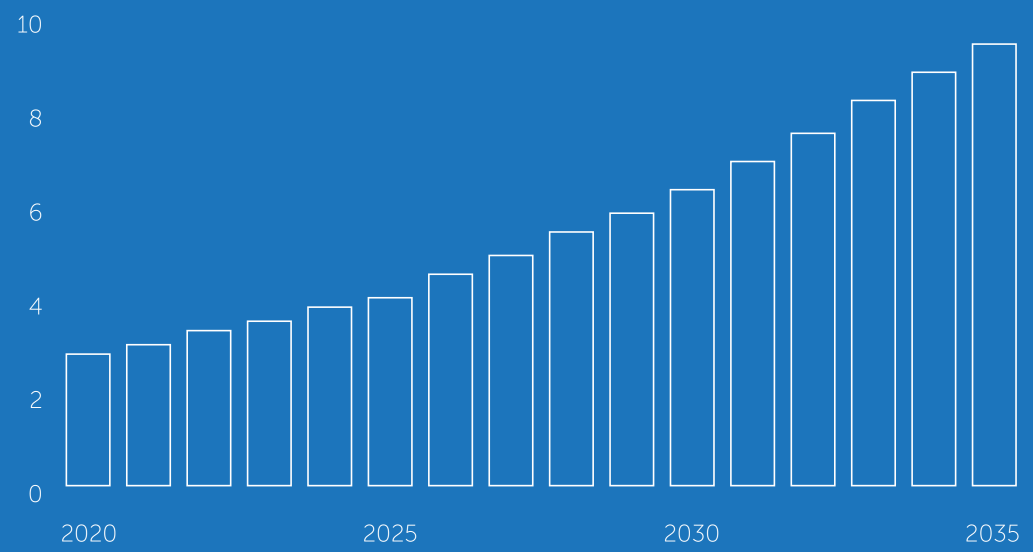
Funds management and investment platforms

As Figure 12 highlights, Australia's superannuation asset pool is expected to grow from $2 trillion to $9.5 trillion by 2035. This significant change in the landscape will have a long term impact on M&A in the sector.

In Australia, next generation specialist platform providers, such as Hub24, Netwealth and Praemium offer their services to independent financial planners. These specialists have already captured significant market share of net funds flows into investment platforms, and are quickly growing assets under management. They are challenging existing platform operators by offering greater functionality, flexibility and accessibility. Their growth has been further aided by the brand damage large wealth management businesses experienced due to the misconduct revealed by the FSRC.

Over the past couple of years, we have seen a huge exodus of funds away from the traditional giants of the Australian wealth management sector, and into the lower cost industry super funds. A key question that looms for 2020 and beyond is whether this switching has been a reaction to the negative headlines from the FSRC, or whether other forces are at play. We believe the broader global theme of lower cost (often passive) investment managers winning funds off higher cost legacy providers, is set to continue playing out with no end in sight.

Figure 12 – Australia's projected superannuation assets ($ trillion)



source: Austrade.

Part C
Governance & culture, and regulatory issues

Governance & culture, and regulatory issues

Since the Global Financial Crisis in particular, the Australian financial services sector has seen an increase in global and local regulatory scrutiny. While some significant regulatory and compliance changes will occur in the aftermath of the Financial Services Royal Commission (FSRC), financial institutions face a number of regulatory pressures as a result of measures designed to make them more resilient, and accountable to customers, which may drive transformative structural change in the sector.

M&A due diligence processes will become more onerous

Acquirers will undoubtedly increase their due diligence as a direct result of the FSRC, and may also seek increased levels of warranties and indemnities from vendors. In addition to financial due diligence, companies may wish to consider undertaking more thorough regulatory and cultural due diligence to prevent inheriting or acquiring any regulatory, legal or compliance liabilities.

Increased governance considerations will most likely slow M&A

With the Treasurer required to approve M&A deals in the financial sector, there is good reason to anticipate that governance considerations will be relevant to approval. Given the recommendations of the FSRC, if regulators voiced concerns to the Treasurer around an organisation's governance, they might be sufficient to affect the course of the proposed transaction. Governance concerns appear to be delaying the completion of the acquisition of OnePath's Pension and Investments business by IOOF.

Remuneration changes are unlikely to drive M&A activity, but may be an important qualitative consideration in how a deal is structured

If remuneration changes limit incentive pay or change its structure, it could impact how M&A is structured for both boards and management. Increased emphasis on long term incentives under APRA's BEAR regime, consistent with those discussed in the final round of FSRC hearings with Macquarie Bank, might actually lincrease M&A if any changes encourage boards and management take more calculated risks.

Part C written by:

Mark Standen
Partner

mark.standen@minterellison.com

Culture and governance

Weak corporate governance practices are in the spotlight. This follows APRA's prudential inquiry into CBA, the FSRC, risk governance self-assessments, and the Remuneration Report first strikes for the major banks at their recent annual general meetings.

In his interim report, and reiterated in his final report, FSRC Commissioner Hayne stated six informing principles that reflect the norms of conduct that lie behind compliance which are:

(a) obey the law;

(b) do not mislead or deceive;

(c) act fairly;

(d) provide services that are fit for purpose;

(e) exercise skill and care; and

(f) when acting for another, act in the best interests of the other.

The FSRC Final Report laid blame for misconduct at the feet of directors and senior management. During public hearings, the blurring of lines between board and management was evident.

Many of the governance failures observed during APRA's prudential inquiry and the FSRC arose because corporate governance practices fell short of these six guiding principles. (For more information, view our report, *Delivering sustainable stakeholder value in a post-Hayne Royal Commission world: https://bit.ly/338qWlF)*

The FSRC implementation roadmap

In August 2019, the Commonwealth Government published its implementation roadmap for action to be taken in response to the FSRC.

Of the 76 recommendations, 54 were directed to Government, 12 to the regulators and 10 to the industry. Of the 54 recommendations directed to the Government, over 40 require legislation.

In addition to the FSRC's 76 recommendations, the Government announced a further 18 commitments in its response to address issues raised in the FSRC Final Report.

According to the Government, it has implemented 15 of the commitments it outlined in response to the FSRC Final Report. They include eight out of the 54 recommendations directed to the Government and seven of the 18 additional commitments the Government made as part of its response. Significant progress has also been made on a further five recommendations, with draft legislation either introduced to Parliament, or released for comment, or detailed consultation papers have been issued.

> “Of the 76 recommendations, 54 were directed to Government, 12 to the regulators and 10 to the industry.”

Government implementation plans

(taken from the Commonwealth Government's Restoring Trust in Australia's Financial System: Financial Services Royal Commision Implementation Roadmap, August 2019 (Government Roadmap))

Legislation to be introduced by the end of 2019

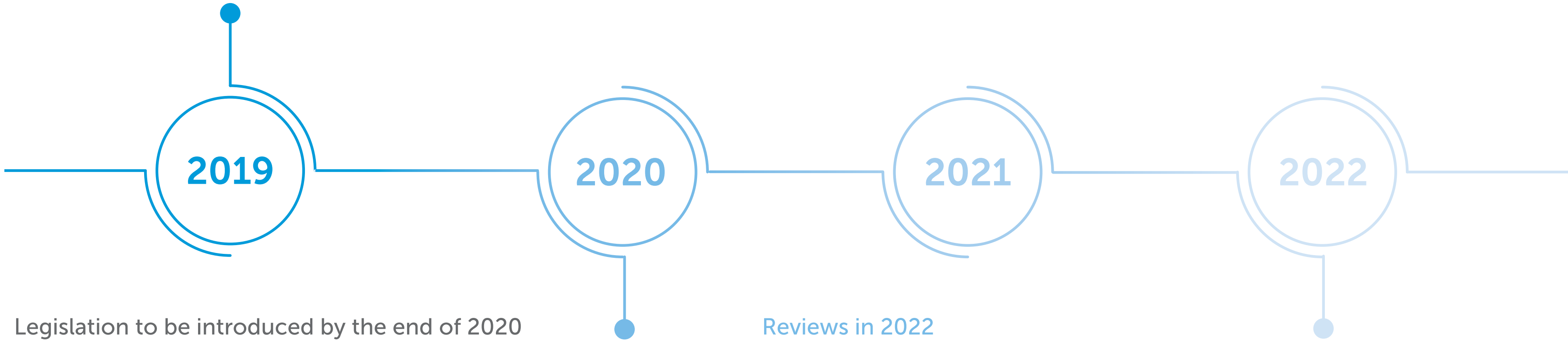
Measures to improve consumer protection include:

Recommendations

1.2 – Mortgage broker best interests duty
1.3 – Mortgage broker remuneration
2.4 – Ending grandfathered commissions for financial advisers (legislation introduced on 1 August 2019)
4.2 – Removing the exemptions for funeral expenses policies
4.7 – Application of unfair contract terms provisions to insurance contracts
4.8 – Removal of claims handling exemption for insurance

Other measures include:

1.11 – A national farm debt mediation scheme
1.5 – Regulating mortgage brokers as financial advisers – This recommendation will be progressed following the review of financial advice reforms (recommendation 2.3), given that review may recommend changes to the regulation of financial advisers
3.5 – One default superannuation account – Implementation of this recommendation will be considered in the context of the findings and recommendations of the Productivity Commission's report *Superannuation: Assessing Efficiency and Competitiveness*



Legislation to be introduced by the end of 2020

Measures to strengthen financial regulators include:

Recommendations

3.9 – Extending the Banking Executive Accountability Regime (BEAR) to Registrable Superannuation Entities licensees
4.12 – Extending the BEAR to APRA-regulated insurers
6.6 – Joint administration of the BEAR
6.7 – Statutory amendments to facilitate co-regulation
6.8 – Extending the BEAR to all APRA-regulated financial services institutions

Reviews in 2022

Recommendations

1.4 – Council of Financial Regulators and the Australian Competition and Consumer Commission review of changes to mortgage broker remuneration and operating of upfront and trail commissions
2.3 – Review of measures to improve the quality of financial advice – Consistent with the FSRC's recommendations, the review will examine all exemptions including the ban on conflicted remuneration, including for general insurance, consumer credit insurance, timeshare and stockbroking remuneration, and stamping fees
2.6 – Review of each remaining exemption from the ban on conflicted remuneration. This review will occur as part of the review of measures to improve the quality of financial advice (recommendation 2.3)

Regulator implementation plans

(taken from Government Roadmap)

ASIC approach to enforcement

6.2 – ASIC has established an Office of Enforcement. Its purpose is to strengthen ASIC's enforcement culture and effectiveness, and to implement a single enforcement strategy. The office will lead the application of ASIC's 'why not litigate' enforcement approach.

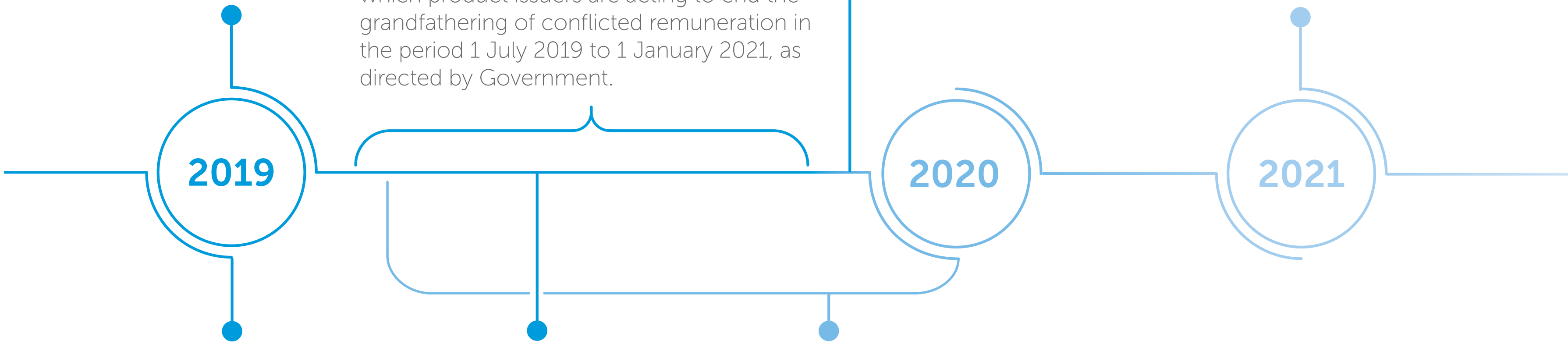
Supervision of culture governance

5.7 – Issues of culture and governance are priority areas for APRA. APRA is reviewing its program of work to enhance its regulatory and supervisory approach in these areas following the Government's announcement of additional funding as part of the 2019–20 Budget. APRA intends to publish a statement of its approach by the end of 2019.

ASIC Life Insurance Commission's review

2.5 – ASIC will include the factors identified by the FSRC in its post-implementation review of the 2017 life insurance reforms. ASIC's review will take place in 2021.

ASIC will monitor and report on the extent to which product issuers are acting to end the grandfathering of conflicted remuneration in the period 1 July 2019 to 1 January 2021, as directed by Government.



Co-operation memorandum

6.10 – APRA and ASIC are reviewing the co-operation and co-ordination arrangements between the two agencies, including revising the existing Memorandum of Understanding. This review is expected to be completed before the end of 2019.

ASIC application of BEAR to regulators

6.12 – ASIC will implement this recommendation in anticipation of the Government establishing a financial regulator oversight authority. ASIC will develop and publish accountability statements before the end of 2019.

APRA BEAR product responsibility

1.17 – On 28 June 2019, APRA released for consultation a proposed heightened product accountability regime, which requires ADIs to identify and register accountable persons to hold end-to-end product responsibility for each product the ADI offers to its customers. In November 2019, APRA released an information paper discussing its approach to transforming governance, culture, remuneration and accountability, addressing FSRC recommendations and its capability review recommendations; highlighting draft Prudential standard CPS 511 Remuneration. It plans to respond to feedback in early 2020 and finalise thereafter.

The BEAR case on potential talent gaps

The BEAR has significantly impacted many aspects of governance in big banks since it was implemented in mid-2018. BEAR applies to small and medium banks since 1 July 2019. ADIs, their subsidiaries, Australian branches of foreign ADIs, and those in director and senior executive roles in these institutions are now being required to meet heightened accountability obligations in addition to deferred remuneration and notification obligations.

BEAR articulates greater detail and adds transparency to executive responsibilities. All accountable persons must be registered with APRA, which also has new and strengthened powers. While BEAR potentially adds complexity and increases short term cost to some areas, if properly implemented, those downsides can be more than offset by longer term efficiency gains through better accountability, a reduction in a sales culture and streamlined governance. The key is to treat BEAR as a business rather than compliance issue and to avoid stultifying decision making with 'tick a box' requirements for documenting decisions.

BEAR requires institutions to defer a portion of variable remuneration of accountable persons for at least four years. Based upon similar UK regulations (the 'Senior Managers Regime'), BEAR may also present some unique challenges for the sector. For example, deferral and increased potential liability may create indirect challenges in relation to attracting senior global talent into the market. Australian businesses do not operate in isolation. They participate in a global market for senior talent and need to remunerate key hires accordingly or they will fail to attract the required talent.

Going forward, further guidance on implementation and transitional arrangements will be released by APRA. Regardless of size, BEAR will require a comprehensive review of, and make substantial changes to, policies and procedures relating to governance, employment, compliance, risk and training.

Consistent with the recommendation from the FSRC, the Commonwealth Government has announced it will expand BEAR to other financial services entities - life and general insurers, superannuation trustees and non-financially regulated financial entities - in a manner similar to APRA's alignment of consistent prudential standards across the industries it regulates. The broader financial services industry needs to prepare itself to meet the standards required.

The RBNZ is now also considering the need to strengthen executive accountability in New Zealand as part of its review of its powers, particularly after recent identified management shortcomings at the New Zealand subsidiary of one of the major Australian banks. It is looking at both the UK Senior Managers Regime and Australian BEAR as it considers similar regulations.

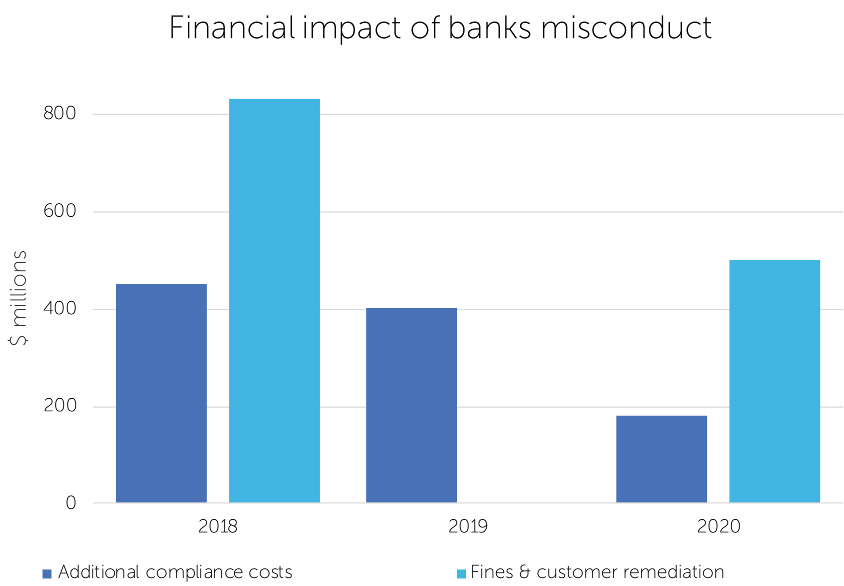
Regulation and compliance costs

Increasing regulation and compliance responses are having significant impacts on financial institutions' operations and profitability. Various estimates from management consultancies such as Bain suggest that governance, risk and compliance (GRC) spend accounts for between 15% and 20% of 'run the bank' costs, and 40% of 'change the bank' costs. These percentages are considerably higher than they were a decade ago and will continue to rise.

For example, earlier this year, media reports disclosed that Morgan Stanley had estimated that Australia's big four banks, in addition to the various costs directly incurred responding to the FSRC, are due to outlay an additional $2.4 billion over the next two years in remediation and compliance costs (as highlighted in Figure 13). Macquarie has derived a number approximately twice this size to resolve financial planning malpractice issues, based on Westpac's estimate of $750,000 per adviser, which is over and above what has been already provisioned.

It would be safe to assume this level of change is the 'new normal' and financial services institutions will adjust how they address this increasing burden. This could be through absorbing the costs, business exits, or outsourcing, or through developing better technology systems.

Figure 13 – Estimated remediation and compliance costs on the big four banks (2018 - 2020)



source: Morgan Stanley.

Marching towards Basel IV

The Basel Committee on Banking Supervision (BCBS) has designed a series of agreed minimum requirements with the aim of strengthening regulation, supervision and risk management of banks. As Figure 14 highlights, these requirements have been increasing since 2013.

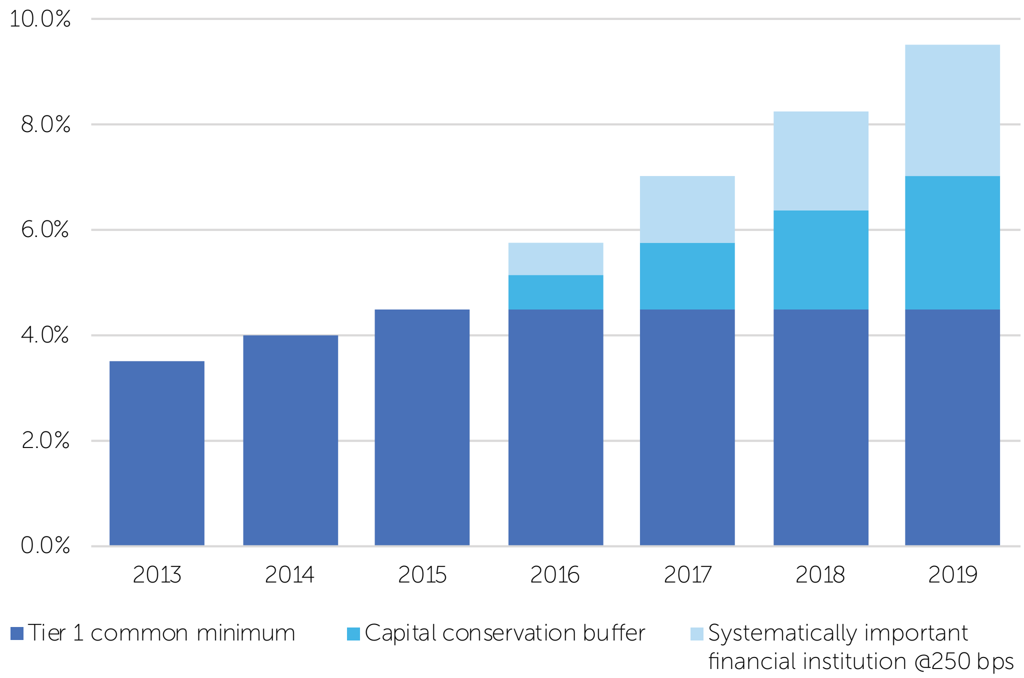
The BCBS has proposed reforms that are designed to make banks across the world more resilient and increase confidence in the banking system. The most recent proposals announced in December 2017, referred to as 'Basel IV', include updates to the methods banks use to calculate their capital requirements, with the aim of making outcomes more comparable across banks globally. One principal feature is the way banks calculate risk weighted assets (RWAs). The BCBS proposes that a calculation of a bank's RWAs using internal models should not fall below 72.5% of the calculation using standardised models. This lower limit is known as an 'output floor'.

The BCBS proposes a nine year implementation timetable, which allows considerable time for preparation. A five-year phase-in period would commence on 1 January 2022, with full implementation from 1 January 2027. APRA has signalled it intends to introduce these reforms per BCBS's timetable, rather than ahead of BCBS's timetable, to keep Australian banks competitive with overseas players.

APRA has now announced its approach to Total Loss Absorbing Capital (TLAC), departing from the approach embraced overseas by having Australian banks raise additional Tier 2 capital, rather than adopting a Tier 3 capital approach. The RBNZ approach appears to be even more conservative, looking for New Zealand banks to meet additional TLAC requirements with equity capital.

Frameworks such as Basel are almost universally welcomed by regulators, governments and retail shareholders. For institutional investors, while recognising the merits, there is also an awareness that one of the outcomes of these changes is lower levels of profitability and lower shareholder returns.

Figure 14 – Basel capital requirements since 2013



source: Avondale Asset Management.

Further regulatory changes likely in superannuation

The recent Productivity Commission report, outstanding recommendations from the 2014 Murray Financial System Inquiry final report and FSRC recommendations will likely drive further changes to superannuation in coming years.

These reports have recommended many potential reforms to superannuation. A few potential key reforms to superannuation include:

(a) procedures for winding down chronically underperforming funds;

(b) procedures for selecting default funds for new employees who don't have an existing fund; and

(c) the upcoming legislated increase in superannuation contributions from 9.5% to 10% and whether this is removed, or implemented.

> Many potential reforms to superannuation have been recommended."

Australian regulatory structure and its impact on M&A

In a post-FSRC environment, we anticipate that many aspects of M&A, from due diligence to regulatory approvals, may become more challenging. The following section highlights some key issues that arise from the increased scrutiny of regulators

Part C written by:

Paul Schoff
Partner

paul.schoff@minterellison.com

ASIC came under criticism during the FSRC for not being sufficiently litigious in enforcing the law and has since changed its processes to address this criticism. Understanding litigation and enforcement risk, and anticipating future regulatory actions assumes additional importance for M&A activity.

Following the FSRC, ASIC has taken the stance of 'why not litigate?' when considering potential investigations. It is believed that ASIC is planning to put up to 50 matters into the courts in the coming months. In September 2019, ASIC announced that it was going to pursue the Bank of Queensland, and Bendigo and Adelaide Bank in court over 20,000 loans to small businesses with unfair contract terms. ASIC alleges that the Bank of Queensland has 3,018 non-compliant loans for sums of less than $1 million each, while Bendigo and Adelaide Bank has more than five times as many or 15,529 non-compliant loans for similar sums.

ASIC has launched an appeal against a controversial judgment over allegations of irresponsible lending by Westpac that found in favour of the bank. The regulator alleged the bank broke responsible lending laws 261,987 times because it used a benchmark in place of proper inquiries as to the suitability of the loans for the borrowers.

APRA

APRA came under criticism during the FSRC for not being aggressive enough in its interactions with a number of institutions, resulting in a subsequent review of its operations. For example, IOOF's acquisition of ANZ's OnePath business was criticised for its lack of independence and poor governance. APRA has since launched unsuccessful legal action against IOOF, and certain directors and senior management. As such, M&A in the future may require more corporate restructuring to meet APRA's best practice requirements, and M&A regulatory approvals may have more onerous conditions attached to them.

It is expected that there will be greater scrutiny of the remuneration of boards, management and frontline staff, and the incentives offered in regard to product sales. Should remuneration changes limit incentive pay, or change its structure, it could also impact M&A as it could alter the incentives for boards and management to undertake such M&A. Alternatively, increased emphasis on long term incentives (such as those discussed in the final round of hearings with Macquarie Bank) might lead to more M&A if any changes encourage boards and management to take more calculated longer term strategic decisions.

On 23 July 2019, APRA released a draft prudential standard (CPS 511) aimed at clarifying and strengthening remuneration requirements in APRA-regulated entities.

The key reforms APRA is proposing include the following:

(a) to elevate the importance of managing non-financial risks, financial performance measures must not comprise more than 50% of performance criteria for variable remuneration outcomes.

(b) minimum deferral periods for variable remuneration of up to seven years will be introduced for senior executives in larger, more complex entities. Boards will also have scope to recover remuneration for up to four years after it has vested.

(c) boards must approve and actively oversee remuneration policies for all employees, and regularly confirm they are being applied in practice to ensure individual and collective accountability.

Australian Government
Australian Taxation Office

The ATO may not be a direct financial regulator, but it does collect significant amounts of tax from the financial sector, with the major banks some of the nation's largest taxpayers. Implications for this revenue base will be part of any scrutiny of future M&A transactions. Given the Treasurer is responsible for the ATO, concerns regarding tax revenue might be relevant to the Treasurer's decision to approve a financial sector M&A transaction.

ACCC
AUSTRALIAN COMPETITION & CONSUMER COMMISSION

The ACCC can take action in court to prevent a merger if it believes that it will have the effect or likely effect of substantially lessening competition. Acquisitions of regional banks during the Global Financial Crisis were approved for prudential stability reasons but it is unlikely that such transactions would be permitted again. Further, the ACCC is focused on the risks to competition of large incumbents acquiring small or startup players – for example, fintech startups or digital banks that may have few customers or a very small market share but carry the potential to enhance competition in the future.

Unlike the approach of other regulators, as a general rule, the ACCC tends to negotiate outcomes in the M&A space rather than go through a court process.

Part D
Technology

Technology as a competitor in financial services

The shift in consumer expectations, rapid advancement of technology solutions and perceived gaps in the market have resulted in the entry of new non-traditional competitors from other sectors who look to offer innovative and valued solutions and take market share from the incumbents. This trend will continue with incumbents entering into strategic alliances to align with new technologies, making venturing arrangements with new startups or acquiring companies to keep intellectual property and market advantage.

Bigtech

Bigtech, namely Google/Alphabet, Amazon, Facebook and Apple (amongst others), have the balance sheet, 'disruptive spirit', existing infrastructure and capability to build alternative solutions for consumers who have traditionally used big financial services institutions. At the same time, they can offer solutions that are convenient and easy to use, reducing friction for customers.

Figure 15 highlights some of the current ways in which bigtech has started moving into financial services. Apple Pay, Google Pay, Samsung Pay, and the Microsoft and Mastercard identification initiative are all existing threats from bigtech which may be just the opening foray into a larger financial presence. We have already seen the impact of Apple Pay, with Commonwealth Bank of Australia (CBA), Westpac, National Australia Bank (NAB) and Bendigo Bank, all delaying its adoption due to disputes over charges for using it. ANZ was able to differentiate itself through its early adoption of Apple Pay.

Social media-based messaging programs are also offering fund transfers via messaging programs such as WeChat Pay and within Facebook Messenger. While Apple Pay Cash and Facebook Messenger payments are not yet available in Australia, we are already seeing strong growth in WeChat Pay, and in the other major Chinese money transfer platform Alipay on the back of a large increase in the number of Chinese visitors to Australia.

Facebook has more recently floated its 'Libra' digital currency proposal, a 'stablecoin'. It then lost support from a range of other companies once the regulatory complexities of its proposal became evident.

Figure 15 – How bigtech is moving into financial services

source: FT, Company Reports.

Part D written by:

Anthony Borgese
Partner

anthony.borgese@minterellison.com

Technology as a competitor in financial services (cont.)

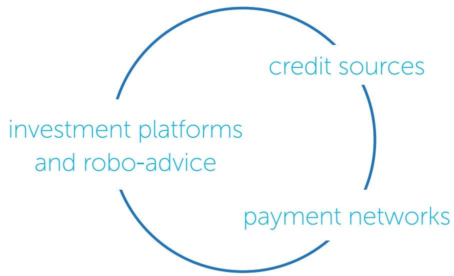
Fintech

Outside of bigtech, new fintech players are seeking to improve and automate the delivery of financial services. Following an initial 'land grab', further consolidation in the fintech space might occur as institutions look to increase their scale. Additionally, larger incumbents might look to acquire fintechs as a way of securing, rather than developing, more efficient financial services systems and processes that will better enable the transfer of their existing customers onto these digital offerings. For example, CBA recently paid $100 million to invest into Swedish fintech Klarna.

Figure 16 highlights that smaller, more agile fintech players are already gaining market share through offering payment networks, credit sources and investment platforms.

Figure 16 – How fintech is disrupting the financial services sector

Fintech is disrupting existing businesses in the financial services industry from three distinct angles:



source: MinterEllison.

Payment networks have seen significant innovation in Australia from a range of fintechs. This has already encouraged the major banks to lift the opportunities they offer in this space. Notable examples include several buy-now pay-later institutions which have emerged over recent years, including Afterpay, Zip Money and Humm from FlexiGroup. ASIC recently conducted a review into this rapidly growing sector, given some businesses within it are not covered by credit or lending laws. Other segments where fintechs are gaining relevance in the Australian market include independent POS terminals and alternative FX payment networks.

New credit sources continue to show strong growth in Australia. 'Shadow banking' or the provision of credit intermediation via wholesale finance rather than deposits, operates under much lower regulatory hurdles than an APRA issued banking licence. Interestingly, restrictions around using the word 'bank' have encouraged many of these fintech-inclined businesses to use 'money' or 'financial' in their company names instead.

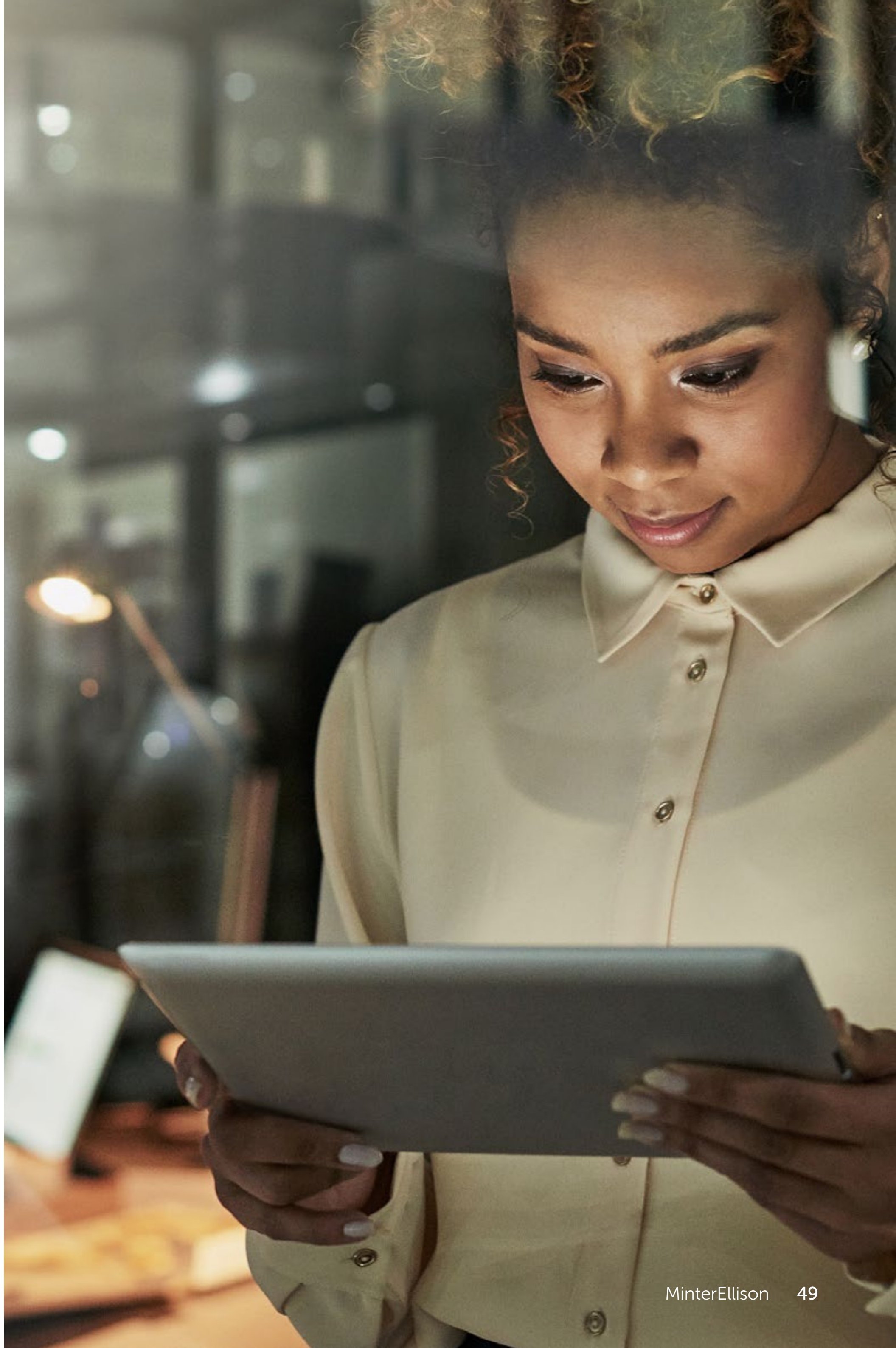
The Financial Services Royal Commission (FSRC) examined how bank credit underwriting met responsible lending requirements. This has led to a credit squeeze, with banks conducting much greater due diligence on potential borrowers, slowing down the flow of credit and lowering borrowing capacities for a number of borrowers. As such, many borrowers are now opting for non-bank lenders, who are providing either larger borrowing capacity or faster access to credit. This trend is clearly observable in the mortgage market and small to medium-sized commercial borrower market. Through this process, many shadow banks are embracing a fintech approach to sales, distribution and servicing.

In Australia, Latitude Financial is probably the most high-profile business to transform itself into a fintech. To allow this evolution, the business, formerly known as GE Money Australia, has aggressively invested in technology over recent years. Other businesses operating in the area between shadow banks and fintechs include Prospa, Athena Home Loans, LaTrobe Financial, Bluestone, Pepper Money and RESIMAC.

Given the credit growth occurring in shadow banks, we anticipate that at some stage there might be a regulatory impetus for some of them to obtain banking licences. The precedent for such action occurred during the depths of the Global Financial Crisis when American Express, Goldman Sachs, Morgan Stanley and others were issued banking licences to permit the US Government to support these institutions with Treasury Asset Relief Program (TARP) funds. The Australian analogy would be for shadow banks to receive banking licences to allow the Reserve Bank of Australia to provide them liquidity, although this might already be possible through Residential Mortgage Backed Securities repurchase agreements. As the US experience has shown, once shadow banks receive banking licences, they eventually begin to offer traditional banking products such as deposit and savings accounts, providing competition to existing banks.

Robo-advice is another avenue of growth for fintech investment platforms. Groups such as Hub24, Netwealth and Praemium are offering their services to independent financial planners. These businesses are gaining market share of flows into investment platforms, and growing assets under management. In the same way as we are seeing in payments and credit provisioning, the robo-advisor fintechs are offering greater functionality, flexibility and accessibility, and lower prices compared to the traditional businesses. Potential future growth could be aided by customers shifting away from larger wealth management businesses after the FSRC.

Some of the robo-advisors currently operating or set to launch in Australia include Stockspot, InvestSMART, Ignition Direct, Quiet Growth, Raiz Invest, Clover, Plenty, Six Park and Acorns, while AMP has effectively been developing robo-advice to assist its planners through its online goals-based advice initiative. A common feature of these robo-advisors is the use of exchange traded funds (ETFs) to keep investment fees down.



Technology as a competitor in financial services (cont.)

Neobanks

Neobanks, a sub-category of fintech, are startup companies looking to become completely new banks. They are often funded by venture capital or via strategic investments by other companies and investment funds (including superannuation funds). Many neobanks globally are attempting to position themselves as enabling better personal financial management, through the use of spend trackers and budgeting tools, and are digital institutions (i.e. technology companies), that do not use paper-based processes.

Neobanks are noteworthy for several reasons:

(a) their processes are fully digital, which provides superior operational leverage once these businesses achieve scale, allowing them to price products more aggressively;

(b) they are working to provide a better customer experience and provide better financial management tools than offered by existing banks;

(c) many of their employees are experienced bank executives who have become disenfranchised with perceived inefficient and clunky processes within major banks and have innovative ideas on how to perform those processes better;

(d) the shift to open banking will allow neobanks to quickly and efficiently acquire customers from existing banks; and

(e) consolidation of or cooperation between neobanks and other fintechs and/or shadow banks could enable neobanks to offer a broader product range. It may also reduce the relative advantage existing banks have in being able to conveniently provide a wide range of services to a client.

There are several neobanks targeting the Australian market. Volt and Xinja have both recieved unrestricted authorised deposit-taking institutions (ADI) licences. Judo Capital is targeting the small and medium-sized enterprise market while Revolut is planning to launch in Australia, with a reported waiting list of 20,000 potential customers.

In time, the proliferation of neobanks may see consolidation within the sector, or alternatively, larger institutions acquiring neobanks for some of their technology platforms. NAB's launch of Ubank was effectively it launching its own neobank under its banking licence.

CUSCAL has now made a similar move with its 86400 neobank, while Douugh is partnering with Regional Australia Bank to use its banking licence.

“The proliferation of neobanks may see consolidation within the sector. Alternatively, larger institutions may acquire neobanks for some of their technology platforms."

White labelling

White labelling can be used to the benefit of both product manufacturers, and the companies that place their brand on the white labelled product. The product manufacturer benefits from increased sales, while the brand selling the white labelled product strengthens its customer relationship, increasing the number of products in the relationship. This has associated benefits such as reducing the tendency to lapse and increasing expected customer lifetime. However, if the product manufacturer is providing the customer service, poor service could damage the brand and reputation of the brand selling the product, and adversely affect its other business.

Common financial services products in Australia where some white labelling occurs include mortgages, credit cards, insurance and annuities:

(a) mortgage brokers have access to a range of white labelled mortgages, provided from the major banks broker aggregation businesses and through RMBS packages;

(b) white label credit cards are provided to several regional banks, retail outlets (Woolworths) and an airline (Qantas) from a major international bank, allowing these other businesses to benefit from economies of scale in credit card operations;

(c) insurance products are often labelled with brokers, or agents, brand names. However, they are underwritten by a non-related licensed insurer, often where the broker has arranged a particular insurance package or product with the underwriter – in general, life and health insurance; and

(d) annuities are also white labelled by some industry super funds, manufactured by the only specialist provider of annuities currently operating in the Australian market.

When smaller companies switching from product manufacturing to white labelling another company's product, it increases the scale of the white label product provider, creating a handful of large companies with significant scale. This concentration can act as a barrier to new entrants into the market served by the white labelled product.

White labelling also has the effect of creating illusionary competition, with multiple brands offering effectively the same product from the identical product provider. The effect of such illusionary competition can be to reduce the amount of shopping around customers do. They find no price differences between different white labels of the same product, so might abandon their search rather than looking further. The ACCC has flagged that it is starting to monitor the impact of white labelling, particularly by groups that own multiple retail brands, and can create the illusion of competition between their own brands.

"The ACCC has flagged that it is starting to monitor the impact of white labelling, particularly by groups that own multiple retail brands."

Technology as an enabler, with a focus on the customer

The financial services sector is increasingly reliant on agile technology infrastructure and systems to meet the demands of customers and regulators, confront risks posed by competitors and cyber threats, and make best use of its most valuable asset – its data.

Incumbent institutions are responding to the competitive pressures presented by technology. Figure 17 highlights that banks, for example, are investing in fintech through direct replacement of legacy systems, development of mobile apps or the development of their own tools.

Technology within financial services is increasingly seen via several different perspectives, as:

(a) a key enabler in the drive to acquire and retain customers;

(b) a source of productivity gains and cost savings from process automation and artificial intelligence;

(c) an area with significant legacy, resulting in heightened operational risks; and

(d) a potential disrupter, not only from the fintechs but from the technology giants.

The multi-purpose application of technology was highlighted by CBA in May 2019 when it stated that it would continue its investment in digital technology to increase its edge and fight off of fintechs. CBA is forecasting that it will spend over $5 billion in the next five years. In 2018, according to KPMG, spending on technology by the big four banks rose 7% to $7.2 billion in total. Similarly, NAB is currently investing aggressively in technology. While laying off 6,000 employees as part of its transformation strategy, NAB is also hiring 2,000 employees in the technology space, seeking to increase productivity and automation. It is lifting its technology spend to $4.5 billion over three years, while reducing total expenses by $1 billion per annum by FY20. Westpac recently announced that it is partnering with 10x to provide 'Banking-as-a-Service (BaaS)' functionality.

Figure 17 – How financial services institutions are investing in fintech

25% of **retail banks** will replace legacy banking systems through startup providers by the end of 2019

61% of **financial services clients** will use mobile apps at least once a month

83% of **financial services executives** believe parts of their business are at risk of being lost to stand-alone fintech companies

source: Centric Digital.

Regulatory Technology (Reg Tech) is also poised to play a key part in assisting banks, other financial institutions and regulators to comply with and monitor their many regulatory obligations. This process automation should lead to more comprehensive legal compliance, while reducing the cost of compliance. ASIC and the ASX currently use algorithms and machine learning to look for suspicious trading activity and to track the activity of people associated with market participants. It is also likely that Austrac uses algorithms to classify and risk score the thousands of daily reportable transactions.

A key area of investment is artificial intelligence (AI). We are already seeing this in financial advice through the development and rollout of robo-advisors by AMP, IOOF and fintechs. Banks use AI to gain additional customer insights to improve services, such as fraud detection, lifting cross sell via 'next best' offer algorithms and creating a digital banking experience that is seamless and easy to use.

Tech giants offering innovation in the payments space are also pressuring existing institutions. Apple Pay, initially resisted by CBA, NAB and Westpac, has now been adopted by a number of Australian banks (for reference see https://www.apple.com/au/apple-pay/banks/au/en-au.html), with Westpac likely to adopt it soon. Many retailers have obtained Alipay and WeChatPay facilities to cater to international visitors to Australia from China. Increasingly these alternative payment methods are attracting transaction funds, and reducing the transaction funds held with traditional banks. Morgan Stanley suggests that $22 billion of revenue is at risk across the major banks in Australia, with 30%, or $6.7 billion, of CBA's revenue at risk, given its overweight consumer presence.

A key enabler in the drive to acquire and retain customers

Open Banking, being the first implementation of the recently legislated Consumer Data Right (CDR) has the potential to become a major disrupter through facilitating greater competition with consumer-initiated transfers of data. This can be seen as both a threat and an opportunity for the major banks.

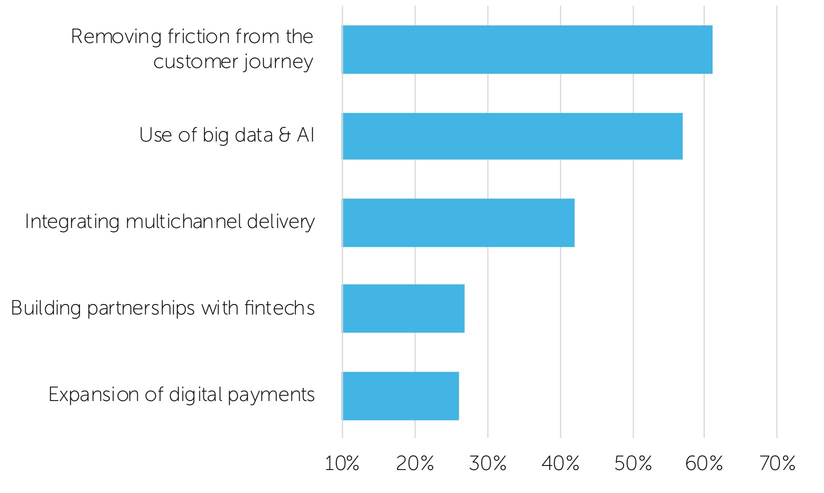
The major banks are well placed to use the implementation of open banking in their own drive for customer growth. By combining customer data, analytics and AI they have the potential to add real value for consumers. This presents a challenge to better use available customer information.

In order to bring personalised experiences to customers and compete with new, more agile players, financial services institutions need to increasingly employ systems that easily draw upon the vast pools of data at their disposal. Legacy systems generally make it more difficult to gain customer insights that could help formulate vital strategies for the future. The result is that traditional banking infrastructure cannot react fast enough to form valuable interactions in real time. Some banks have attempted to solve this by implementing modern customer relationship management (CRM) and application programming interface (API) software overlays, addressing most of their needs in real time. Others have moved to modernise their core banking to gain the flexibility and efficiency that will enhance the customer experience.

The provision of APIs may be a key way that banks can differentiate themselves in coming years, making banking a little less commoditised, and with APIs potentially becoming another barrier to customers switching banks. The use of APIs might cement existing customer relationships. The first signs of this occurring are from the integration of banking APIs into business accounting software packages such as Xero, MYOB and Reckon, with adoption of these software packages being further encouraged by initiatives such as the Australian Tax Office's single touch payroll reporting initiatives.

There is now extreme pressure on financial services institutions to adapt to the digital age. Pressure is coming from digital-savvy customers who expect their bank to provide the same transformative experience they receive from Uber in the transport industry, or from Amazon in the retail industry. The smartphone enabled consumer demands a tailored experience, delivered in real time, at the push of a button or the swipe of a finger. The increasing number of neobanks looks set to accelerate change and increase the pressure on existing institutions to adapt.

Figure 18 – Most important trends for retail banking



source: DBR (2018 survey of a panel of over 100 global financial services leaders).

Reducing customer friction

Dai-ichi Life, the Japanese life insurer who in Australia owns TAL and recently acquired Suncorp Life, is now considered to be one of the leading life insurers in Japan, renowned for its customer service principles and execution.

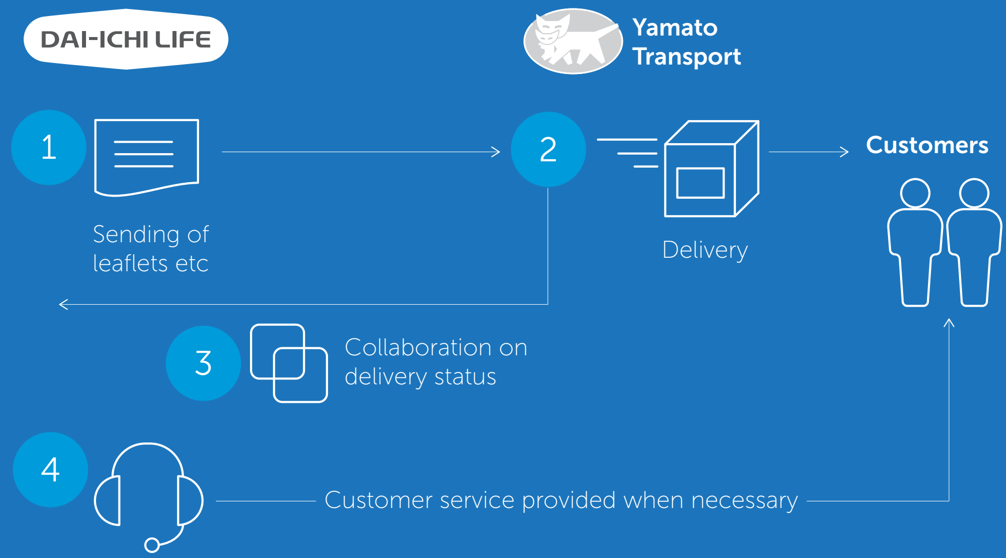
Dai-ichi has not always had its claims process right. The Japanese Financial Services Agency, its regulator in Japan, issued it with an administrative order in July 2008 to improve its claims administration, after finding numerous shortcomings including underpayments and poor advice to customers regarding their ability to claim. To its credit, the subsequent investments Dai-ichi has made in its claims payment processes and in educating its staff has now made it a leading global example on how to get claims administration right.

For Australian life insurance and financial advice businesses, who received severe criticism during the FSRC for charging dead people, Dai-ichi makes a useful case study on how to improve claims administration.

Its efforts question, as the FSRC Commissioner did, the defence some industry participants raised that they had not been notified of a customer's passing.

Dai-ichi uses simple and effective technology partnerships and systems to minimise errors and exhibit clear customer service. It clearly documents how its claims process works on its website (https://bit.ly/330kf5h). In relation to life insurance claims, Dai-ichi uses direct data feeds from a range of different sources in Japan, filters them through its own systems and generally pays out to the insured's beneficiaries or estate before they even make a claim. Furthermore, Dai-ichi has created a partnership with Yamato Transport Co., Ltd. Originally it was to meet proceeds of crime regulations, by verifying customers identities, however it also enables Dai-ichi to check on the welfare of elderly residents via Yamato's delivery services.

Figure 19 – Dai-ichi's partnership initiative with Yamato Transport.



Graphic source: Dai-ichi Life, https://bit.ly/330kf5h, accessed 25 January 2019

Personalised offerings using artificial intelligence and machine learning

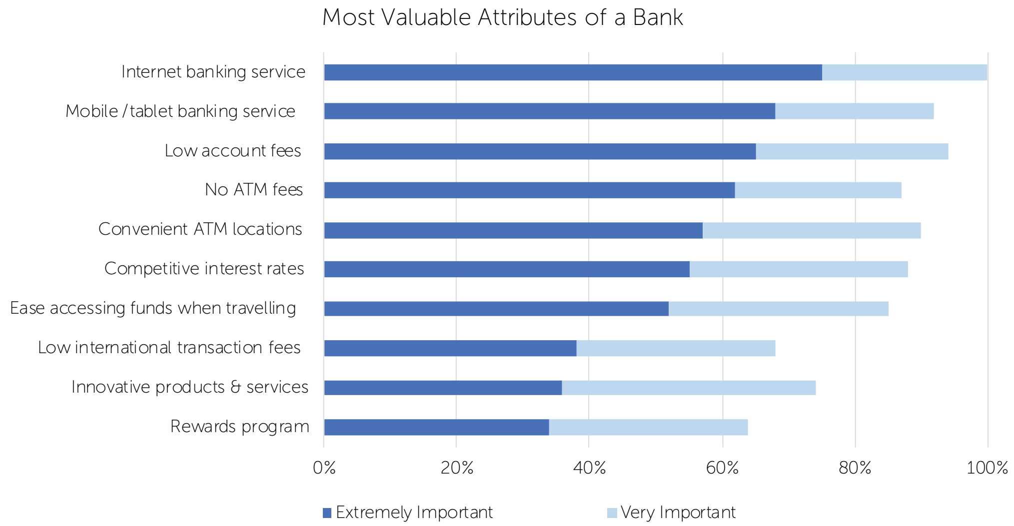
Growing amounts of customer data are enabling greater personalisation of financial services.

It is now common for banks to use algorithms, similar to those used by online retailers, to personalise cross selling via phone, internet banking or mail offers. Availability of other data sources, such as supermarket loyalty card data, provides additional information which helps develop a more complete and refined categorisation of individuals. These larger datasets are facilitating the use of AI and machine learning (ML) to derive and implement superior algorithms and interfaces, such as for offering robo-advisors. Failure by financial services institutions to embrace developments in these technologies risks them being left just as custodians, with the ownership of the customer relationship shifting to the providers of AI and ML algorithms and interfaces.

Banks have also been getting more personal regarding fraud detection. Software used by banks and other credit providers builds customer profiles and analyses each transaction. By comparing this data to past behaviour, banks can estimate whether a given transaction is fraudulent.

Robo-advisors provide another avenue for providing personalised financial advice to the mass market in a cost effective manner. Robo-advice uses algorithms employing personality questionnaires in order to conduct a needs and goals analysis and recommend appropriate investments.

Figure 20 – Most valuable attributes of a bank (survey findings)



source: BPay Banter.

“Failure by financial services institutions to embrace developments in artificial intelligence and machine learning risks them being left just as custodians. Ownerships of the customer relationship would shift to the providers of algorithms and interfaces.”

24/7 capabilities and availability through multichannel delivery and digital payments

Like many businesses, financial services institutions sometimes struggle to keep up with evolving customer demands. The evolution of internet banking over the past 20 years from, for example, slow websites accessible only via desktop computers to portable apps featuring real-time facial recognition for smartphones has been remarkable. It has been accompanied by extraordinary growth in the number and value of transactions occurring via these digital interfaces. These are now the predominant forms of banking transaction, accounting for $3 in every $5 worth of transactions. This is also evident in Figure 21, which highlights the steady increase in the use of digital interfaces by CBA's customers (from 50% of transactions in 2014 to 60% of transactions in the December 2018 half).

Other segments of the sector have also seen advancements in 24/7 capabilities. For example, insurers encourage customers to immediately record information on potential claims through websites and mobile phone apps. Life and health insurers are also using rewards and reduced premiums to encourage customers to use digital interfaces to undertake and measure healthy activities, such as physical exercise.

Similarly, convenience created by digital point-of-sale (POS) payment systems, especially the emergence of Tap and Go and Near Field Communications (NFC) technologies provided by Apple Pay and Google Wallet, are creating additional pressures for financial institutions. For example, Figure 22 highlights the large increase in the use of Tap and Go payments by CBA customers (from less than 1% to nearly 18% in four years). This highlights the demand for fast and effective payments and reinforces the fact that consumers are now carrying less cash.

Seeking to improve the timeliness of financial transfers, the RBA established a real-time payments system. The New Payments Platform went live in 2018. The first-generation technology platforms built on top of this system, such as PayID and OSKO payments, allow real-time 24/7 cash transfers between accounts (subject to some anti-money laundering (AML) and counter-terrorism financing (CTF) restrictions).

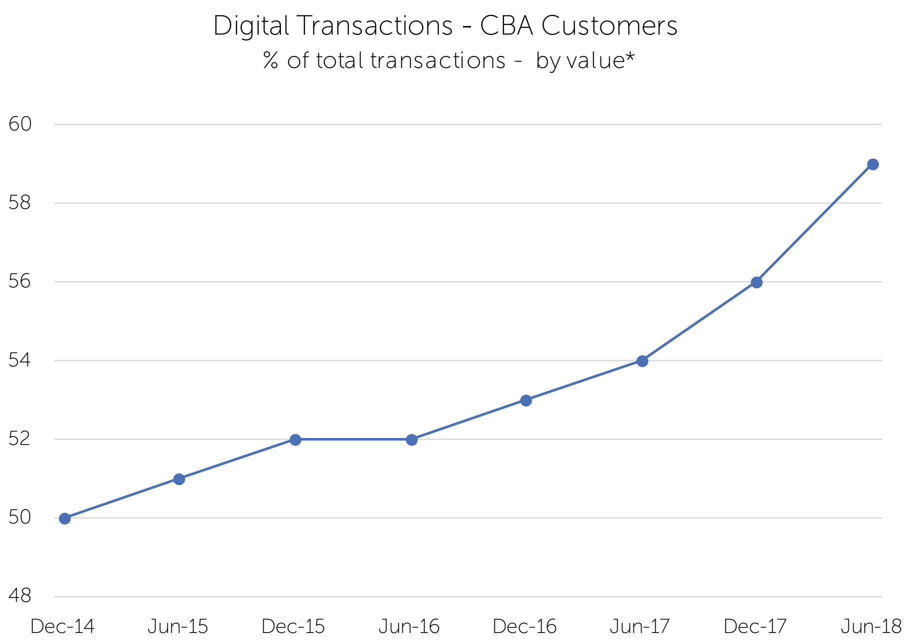
The threat of competition (even through customer benchmarking against other perceived leading sectors such as online retailers, travel providers and communications businesses) has kept financial services institutions busy updating their POS and digital interfaces to be faster and easier to use and provide convenience for customers. Failure to keep up with these demand driven changes, provides an opening through which competition can emerge.

The predominant forms of banking transactions now occur via digital interfaces, accounting for

$3 in every

$5 of transactions

Figure 21 – The growth of transactions through digital interfaces, CBA (2014–2018)



*Digital transactions include transfers and BPAY payments made in the CommBank app and via NetBank

Source: CBA

Figure 22 – Growth in reliance of tap and pay transactions CBA customers (2014–2018)

*Volume of Tap & Pay transactions for each six month period (includes HCE, Paytag and Tokenisation).

Source: CBA

Legacy systems

Most of Australia's financial services institutions continue to operate using the same core banking systems, that emerged in the 1970s. While legacy systems have generally been effective in the past, Figure 23 highlights a critical need to make transformative changes to IT infrastructure and operations just to remain competitive. This is due to recent and significant improvements to technology, performance, trust and data use, coupled with growing customer requirements for on-demand and flexible access to services in real time and the rise of agile competitors.

Similarly, as highlighted in Figure 24, some senior global bank executives expect that in the near term banks will focus on shifting customers from physical to digital interaction, as well as using technology to cut costs and improve margins, while delivering better customer segmentation experience and meeting regulatory requirements.

Successful post-M&A system integration can be a significant differentiator of efficiency and productivity. In contrast, the complexity introduced by lack of, or poor, system integration, can lead to significant operational expenses.

The result of this scenario is that significant budgets, expectations and burdens are being assigned to IT teams to maintain competitive advantage and avoid market share erosion from the customer-rich experiences offered by innovative and agile fintechs and bigtech.

Figure 23 – Examples of challenges faced by ageing legacy technology systems

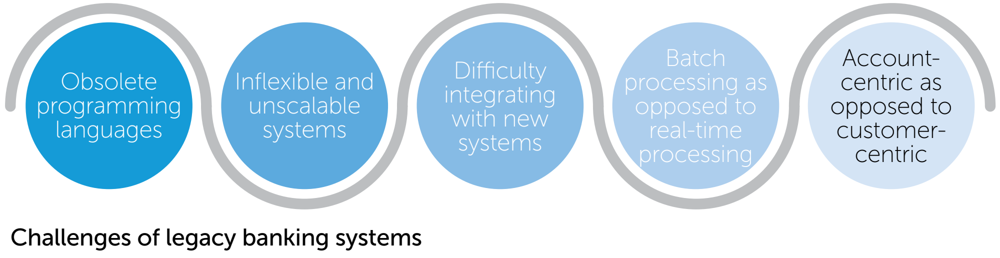
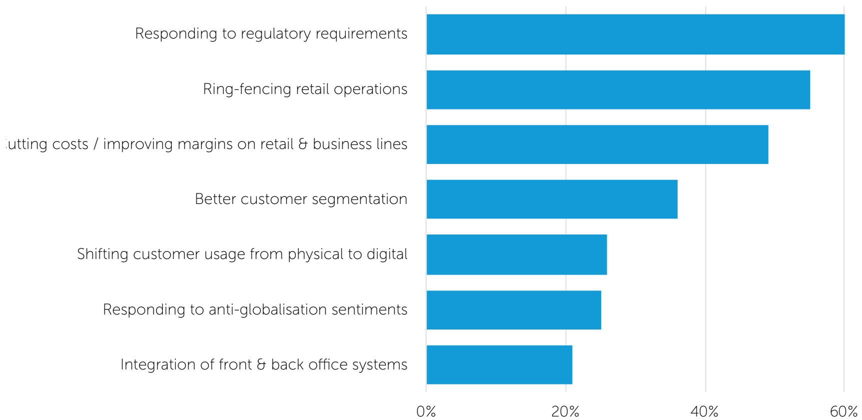


Figure 24 – The top priorities of global bank executives up to 2020



source: temenos, EIU.

Legal issues arising from poor legacy systems

While internal budgets for upgrading legacy systems may be set based on operational objectives, there are also a diverse range of complex legal issues associated with legacy systems that financial services institutions need to grapple with. This is often because of these operational objectives. Legacy systems typically hold longstanding customer information on superseded products or information from acquired institutions. The FSRC and other recent regulatory actions have highlighted some of the dangers of prioritising operational and financial objectives (and systems) ahead of regulatory, compliance and customer relationship needs. These changes include:

(a) some institutions have failed to keep customer records up to date where legacy or acquired systems are incompletely integrated into other CRM systems (i.e. lost customers). This may have contributed to the charging of dead customers revealed by the FSRC. The regulatory risks of failing to keep CRM systems up to date in real time is growing as 'know your customer' requirements increase in response to enhanced AML and CTF requirements. However, legacy systems are making it more difficult to fulfil these requirements, as evidenced by CBA's $700 million penalty from AUSTRAC for regulatory reporting failures, stemming from a coding error when updating its ATM fleet, which resulted in it failing to report over 53,506 threshold transaction reports and properly monitor 778,370 accounts. At the time of writing, AUSTRAC had just alleged that Westpac had breached AMI and CTF rules on more than 23 million occasions;

(b) some intitutions have failed to keep legacy or acquired products compliant with legislative and regulatory reforms, sometimes through an inability to modify algorithms and processes coded in obsolete programming languages. This is due to the people familiar with these languages having all retired, or in code that has been lost following corporate activity, which may have contributed to overcharging customers;

(c) the 'no worse off' requirement for life insurance feature upgrades has led to cohorts of legacy or acquired policies where some aspect of a change has violated this requirement. This means legacy systems are kept running to support these legacy policies, creating operational inefficiencies. Insurers may be better off asking a court to rule that policy changes do not violate this requirement, to maintain scale and product administration efficiency;

(d) a variation of legacy policy tranches emerged during the FSRC, where some financial services institutions were not improving investment product offerings for existing customers, but instead launching new products for new customers, to maintain existing product profitability. This behaviour came under heavy criticism at the FSRC, given tax considerations act as a disincentive for switching from superseded investment products, raising legitimate legal questions as to whether trustees were acting in the best interests of the trust members;

(e) financial services companies also face the regulatory constraint of not being able to develop processes via an iterative fast-fail approach (i.e. make mistakes) embraced by technology companies for customer products and systems, given their prudential requirements and the loss of public trust due to misbehaviour revealed by the FSRC; and

(f) the introduction of Open Banking, presents numerous corporate governance and privacy challenges for existing institutions that will need to meet forthcoming open data requirements.

The appetite of financial services institutions for investing in regulatory and customer systems will increase in the wake of the FSRC Final Report. The technology investments involved will likely cost billions of dollars and take years, but should mitigate the risks or prevent a recurrence of the circumstances which led to the FSRC.

Financial reporting

The most popular way for banks operating in a legacy environment to achieve digital core transformation is to adopt core banking platforms that are already built on modern technology. This method of transformation remains a pain point, as it is a large undertaking that creates a multitude of risks that would otherwise be minimised, given many layered systems have been designed around financial controls that need to be updated.

Such a complex operation may take years and is also extremely expensive. As this process is often longer than CEO (or board member) tenures, CEOs and boards also often lack the appetite to make such investments as they will not benefit from these investments during their tenure. Hence the high rate of failure, with McKinsey suggesting less than 30% of first-generation Core Banking Systems (CBS) replacements having succeeded.

> "Financial services institutions' appetite for investing in regulatory and customer systems will increase in the wake of the FSRC final report. The technology investments will likely cost billions of dollars and take years, but should mitigate the risks of recurrence of the circumstances that led to the Royal Commission."

Regulatory reporting aided by regtech

Historical financial reporting has had the most management attention and subsequently it has also been the area where the technology has focused on. Since the FSRC, there has been a view that financial intuitions need to bring their regulatory systems up to the same standard as financial information systems.

Some regulatory reporting is based on manual processes, done via spreadsheet, which are prone to errors and omissions, rather than with formal automated (and audited) systems used to aggregate, process and report the data. Sometimes spreadsheets are used because they are a quick fix for fulfilling regulatory requirements pending a more permanent response.

However, updates to automated systems can also lead to errors and omissions, as CBA was unfortunate to experience with its intelligent deposit ATM machines. It took two years to fix a coding error, which meant that CBA failed to comply with AML and CTF laws during this time. This then leads to an array of questions around corporate governance.

Regtech, a segment of fintech, is supporting financial services institutions to overhaul their regulatory reporting processes to increase efficiencies. ASX listed Kyckr is one such regtech organisation assisting major multinational banks. It specialises in real-time 'know your customer' information on businesses, using real-time feeds from government company registries.

Major Australian financial institutions including ANZ, Westpac, NAB and IAG are corporate partners of fintech startup hubs such as Stone and Chalk. One of the benefits of being a corporate partner is that it allows these large institutions to identify regtech offerings that will enhance or supersede their current regulatory reporting processes. It also helps them to identify other fintechs of interest, that they might like to secure a strategic interest in, or potentially acquire. They can show their interest in these fintech businesses by participating in the fintech's funding rounds, or undertaking some other form of partnering.

International drivers in technology

The rapid pace of technological change over recent years has the potential to usher in a new phase of financial globalisation, with benefits for investors and consumers across the world. For governments and regulators, however, making effective use of technology's potential will require a new wave of global policy coordination, meaning that regulatory frameworks will need to be internationally coordinated and upgraded.

The way in which these regulations come about is set to evolve. What has already become apparent is that globally aligned standards, data templates, protocols, conduct-of-business and anti-fraud rules are necessary.

"Making effective use of technology's potential will require a new wave of global policy coordination. Regulatory frameworks will need to be internationally coordinated and upgraded."

Coding error and Australia's largest ever civil penalty

CBA takes its regulatory obligations extremely seriously and prior to agreed breaches of AML and CTF laws suggested it had invested 'more than $230 million in anti-money laundering compliance and reporting processes and systems.

Despite this sizeable technology and compliance investment, CBA and AUSTRAC agreed to a $700 million penalty – the largest ever civil penalty in Australian corporate history – to resolve Federal Court proceedings relating to serious breaches of anti-money laundering and counter-terrorism financing (AML/CTF) laws.

Used overseas by leading global banks prior to their deployment by CBA in May 2012, intelligent deposit machines (IDMs) are a type of ATM that accepts cash and cheque deposits and credits them 'instantly' to the recipient's account, which can be located domestically or internationally. IDMs are faster, more efficient (removing staff from the process) and more convenient than the envelope deposit ATMs that many IDMs replaced.

AUSTRAC alleged CBA's IDMs could accept up to 200 notes per deposit, or up to $20,000 per cash transaction, with no limit to the number of transactions made per day. It accused CBA of not assessing the risk of the machines being used for money laundering or counter-terrorism financing. CBA suggested that the failure of its IDMs to report transactions above the reporting threshold was due to a coding error, which AUSTRAC suggests took two years to fix after the error's discovery. AUSTRAC claimed action was not taken prior to rolling out the machines nor once they were in use and even allegedly when law enforcement raised "significant instances of money laundering" occurring through the IDMs. AUSTRAC also alleges that after CBA became aware of suspected money laundering, it failed to report suspicious matters and did not monitor customers for money laundering risk.

CBA has since limited the size of deposits at its IDMs and restricted the ability to deposit funds at its IDMs into CBA accounts only. These actions go a long way to preventing further recurrences of its ATM problems.

Are branch networks now legacy systems?

With the increase in digital payments, the volume of transactions occurring in bank branches is declining. Banks have taken notice, and branch numbers are now declining too. Operating a large branch footprint is an expensive proposition, due to the cost of both the real estate and headcount involved. Increasingly, challenger banking institutions are seeking to compete digitally rather than building out a branch network, where the costs of customer acquisition and service are a fraction of those through a broker or branch.

With banks facing an outlook of slower revenue growth and increased regulatory scrutiny (and compliance spending), the need for expensive branch networks are being reassessed and optimised. Many urban branches are being closed with little customer complaint, due to the low frequency with which customers now use branches given the digital alternative available.

However, falling numbers of branches present problems for sections of banks' customer bases including:

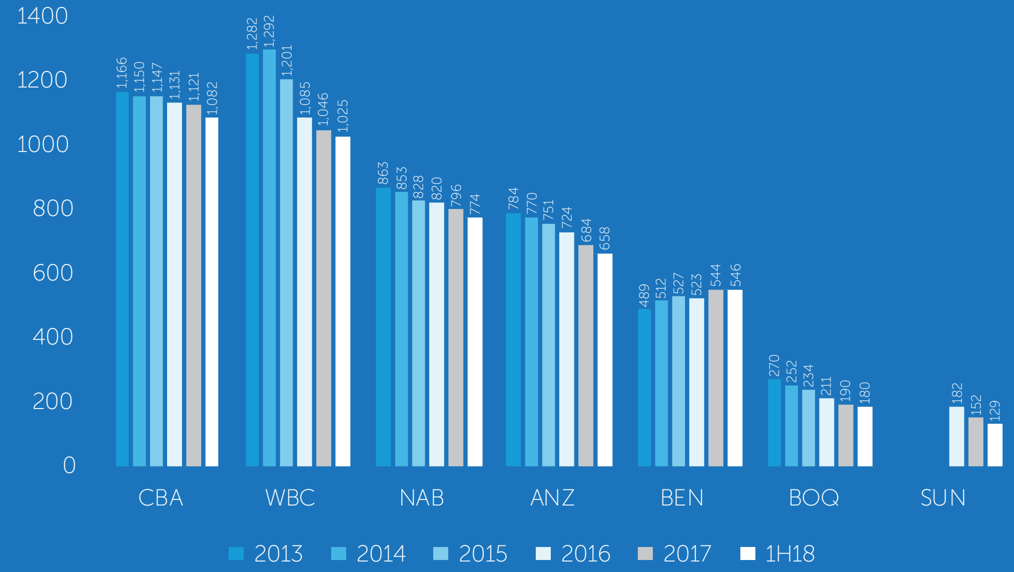
(a) regional, rural and remote customers, where the distance to the nearest branch becomes unreasonable (a focus of some of FSRC case studies);

(b) older and disabled customers who are unable to use or uncomfortable with digital payment technology (a subject of complaints to the Disability Anti-Discrimination Commissioner); and

(c) young customers, such as those aged under 14, who need to obtain their parent's or guardian's permission to use digital payment systems (apps and cards) – something hard to obtain efficiently electronically.

Anti-discrimination laws exist to ensure that segments of the population are not discriminated against. Some disability advocates have achieved favourable court decisions against banks with some banks' offerings found to breach discrimination legislation. It is possible that further legal cases could be run against banks where people may be able to argue that some branch closures are discriminatory.

Figure 25: Australian branch numbers FY13–1H18: WBC had the largest branch cut since FY13, although all major banks are reducing branches BEN is the only bank with rising branch numbers.



Note: CBA, BEN and SUN are showing FY18 figures, not 1H18. WBC's FY14–16 branch reductions were driven by in-store kiosks being closed. NAB's reported branches include some business banking centres. ANZ FY13–14 numbers estimated via APRA branch data.

source: Company data, Morgan Stanley Research, APRA.

Part E
Conclusions and key contacts

Towards 2030 – M&A will be an important mechanism for boards and management

While much of the focus in the last year has been on the FInancial Services Royal Commision (FSRC), we believe that there are many other factors that may prove even more important for the financial services industry in the longer term. Some of these factors relate to issues highlighted by the FSRC including changes to governance, culture, remuneration, simplification and the need to reestablish trust. Other factors include an increased focus on the customer (assisted by the move to Open Banking), technological changes along with increased competitive and commercial threats. The final report of the FSRC will act as a catalyst for a transformation within the financial services sector.

Bill Gates famously suggested that "most people overestimate the change that will occur in the next two years and underestimate the change that will occur in the next ten". While the short term impact of some of the changes discussed in this report are more foreseeable than longer term impacts, the long term impacts are likely to create the greatest need for M&A.

The FSRC has shown that issues can no longer be dismissed as non-systemic, because if they are repeated or exploited frequently enough, they become a systemic issue – from charging dead people to coding errors inadvertently facilitating money laundering. If these problems aren't nipped in the bud they become so large, that the easier solution is to separate the problematic division from the rest of the company.

A similar phenomenon occurs with ignoring small, fast-growing segments of markets. Eventually these segments become so large that they can no longer be ignored. What would have previously been trivial bolt-on M&A to serve such a market is instead replaced by materially strategic M&A to fill a key gap in the company's market offering.

A few regulatory changes will significantly shape the Australian financial services landscape in coming years. Namely, the recommendations that arise from the FSRC impact of Open Data legislation, and changes to banking capital requirements.

Combining these with existing financial services headwinds such as low interest rates, high household debt levels, falling house prices, legacy systems and intense and innovative competition, the financial services landscape over the next 10 years will change more rapidly than it has over the past 10.

Banks, insurers and other regulated financial services businesses are legally required to perform their regulated functions correctly, with the FSRC likely ensuring this will remain a focus for management for some time. However, the IT industry has demonstrated that moving to minimum viable functionality, embracing rapid failure and iterating rapidly allows for faster product development and evolution. This places financial services at somewhat of a competitive disadvantage in innovating new functionality. However, as long as financial services industry players are able to be fast followers, existing market share and customer relationships should allow them to largely safeguard their existing market positions.

> “While the short term impact of some of the changes discussed in this report are more foreseeable than longer term impacts, the long term impacts are likely to create the greatest need for M&A."

Towards 2030 – M&A will be an important mechanism for boards and management (cont.)

In theory, the FSRC presents an opportunity over the medium term for fintech businesses to grab market share from traditional financial services providers. In the near term, this will probably not be realised given that banks dominate market share and that many fintechs are seeking to work with larger players, rather than directly compete. However, with fintechs currently only having about a 1% share of the Australian consumer loan market, the potential for them to experience solid growth is beckoning particularly in light of the likely continued tightening of credit from APRA regulated banks.

There are steps that the banks need to take to address the challenges highlighted in this report. This will inevitably involve trade-offs, with banks still pursuing growth as credit potentially slows, and as they attempt to deleverage their existing exposure while focusing on upgrading technology.

A key element of change in the financial services sector will be M&A as existing companies look to transform themselves. They will do this by slimming down and becoming more focused, expanding into areas promising higher growth, or acquiring or integrating with innovative fintechs offering superior customer experiences, or stronger regulatory compliance.

> "A key element of change in the financial services industry will be M&A. Existing companies will look to transform themselves– by slimming down and becoming more focused, expanding into areas promising higher growth or acquiring or integrating with innovative fintechs."

About us

MinterEllison is an international law firm headquartered in Australia, renowned as one of Asia Pacific's leading law firms. For close to 200 years, we've been a trusted advisor to our clients. What sets us apart is that we're driven by a strong sense of purpose: we create lasting impacts for our clients, our people and our communities.

Our culture is built on the foundations of trust, integrity and fairness. But what drives us, is that we're here for the long-term wellbeing and prosperity of our clients.

We think beyond the law. To provide innovative and lasting solutions for our clients, we provide multidisciplinary teams who bring an industry or sector focus. This approach helps our clients realise their strategic goals, grasp business opportunities and create value for their stakeholders.

Get in touch with us

Victoria Allen
Partner
P: +61 2 9921 4567
M: +61 434 565 615
E: victoria.allen@minterellison.com

Rahoul Chowdry
Partner
P: +61 2 9921 8781
M: +61 4 55 887 887
E: rahoul.chowdry@minterellison.com

Contributors and key contacts

Louella Stone
Partner

Mark Standen
Partner

Paul Schoff
Partner

Anthony Borgese
Partner

Harriet Eager
Partner

Michael Lawson
Partner

Donna Worthington
Partner

Maged Girgis
Partner

Geraldine Johns-Putra
Partner

Glen Wellham
Consultant