Feature

A NEW FUTURE FOR BANKS

The royal commission has been this year's major investor relations challenge for financial services companies.

By Ben Power

Australia's Financial Services Royal Commission has exposed a shocking litany of misdeeds by local financial institutions.

It's also created a major investor relations challenge for the major banks and AMP, with reputations on the line and financial services' structural and regulatory landscape under a cloud.

"Investors haven't been through a royal commission like this," says Andrew Martin, portfolio manager at Alphinity Investment Management.

"We were expecting a lot of stuff to come up, but we weren't expecting how widespread the issues were and for the royal commission to be so aggressive, combined with the extent of public anger. It's probably turned out to be quite different to what we as investors all thought."

It's difficult to know what the outcome might look like, which is a particular problem for markets. Warwick Bryan, an investor relations consultant who headed the Commonwealth Bank's investor relations team for a decade, notes, "the one thing investors hate is uncertainty."

The royal commission has also damaged share prices and the banks' reputation among investors. The S&P/ASX 200 Banks Index fell 13 per cent from the time the commission was established on 14 December last year to a low in mid-June.

The commission is, however, only one variable that influences the index. Investment group CLSA's banking analyst Brian Johnson says the royal commission initially weighed on the major banks' share prices. But its impact has become interrelated with many factors, including a bottoming of interest rates and regulators' move to tighten credit underwriting standards.

Johnson says most investors were already aware of many of the issues around the banks that have emerged during the royal commission. Although revelations around AMP and the insurers were new.

AMP has been one of the worst hit. Its share price has crashed almost 40 per cent since March, amid allegations the company gouged customers with 'fees for no service' and that it misled regulators.

Daniel Smith, general manager of proxy adviser CGI Glass Lewis says his organisation has received dozens of calls over the last few months about the royal commission.

"A lot of our clients are quite concerned about what's going on with, not just the banks but other financial institutions, and trying to understand where that materiality lies."

Uncertainty is one of the biggest issues for shareholders. Investors simply don't know what the post-royal commission landscape will look like. "It's difficult to know where everything is going to land," says Martin, who believes one issue is the appropriate discount to make for heightened risks.

"I don't know what structure they're going to be in and how the regulator is going to deal with them."

The level of collaboration between banks and regulators in the future is just one example of the uncertainties with which investors are grappling.

While collaboration may have been appropriate in the past, Martin expects regulators to be more aggressive and to want quick results through court proceedings now.

Front foot

The banks and AMP have been responding to the royal commission's challenges in a number of ways, with many actively engaging with investors.

Martin says investors have been meeting – in groups and individually – with the major banks' management, chairs and boards. General counsel has also been explaining proceedings. "They have all been proactive," he says.

Bryan says that when they communicate with investors, the banks are likely being honest about the uncertainty they face. "Unfortunately, there is not much companies can do to remove uncertainty," he says. "You can only really communicate around what you know about."

Based on his experience, Bryan says, the banks' messaging is likely to be along the lines of: "We have a good business, but we are in an environment where there is an enormous amount of uncertainty. At this stage, it is difficult to predict what change is going to look like and we can't therefore give you a definitive forecast of what the implications might be from an operational and financial perspective for the organisation."

The banks are also remorseful. "They are well beyond trying to paint a picture

Illustrations by Angelo Vlachoulis

that the commission is wrong," Martin says. But they have also been trying to put the royal commission's findings into context. One of the banks' key narratives, Martin notes, is they largely knew about all these issues, self-reported many of them to regulators, and were dealing with them.

But perhaps one of the biggest moves the banks and AMP have made to calm down investors has been installing new CEOs, chairs and boards. At AMP, for example, CEO Craig Meller and chair Catherine Brenner have been replaced. Martin says companies with new CEOs have been drawing a line in the sand and telling investors they are changing their business culture.

The companies have also been winding back remuneration. CGI Glass Lewis's Smith notes that in the covering letter to CBA's 2018 annual report, the bank announced employees had taken a $100 million hair cut in bonus payments over the past couple of years to reflect individual and collective accountability for past actions. "That's meaningful," he says. NAB has also recently announced it will lower and simplify executive remuneration.

Smith adds CBA has, "done a good job, starting from the top with Catherine Livingstone all the way down, at owning their past misdeeds, controlling the message and being appropriately contrite and then backing it up." (CBA's changes also relate to AUSTRAC's penalty against the bank for serious breaches of anti-money launching and counter-terrorism financing laws).

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Too little too late?

The question, however, is whether these moves will be enough to prevent a shareholder backlash when the major banks hold their AGMs.

"I think they will certainly be going into the AGM season with a degree of caution and apprehension," Bryan says. "There will always be some people who are going to stand up and be critical. Whether that translates into proxy advisers suggesting boards be replaced, or remuneration reports be rejected, I honestly don't know."

"There should be intense scrutiny," Martin says. "Share prices have gone backwards. Boards need to be held accountable and they need to explain, as they have to institutional investors, to the broader investor base their thoughts about where things are going, what they've done and what they're doing about fixing up issues. There will certainly be a lot of explaining."

Smith says that ahead of AGM season, investors are trying to work out whether directors or executives should be held accountable and whether bonus payments for this year or previous years are inappropriate.

He says accountability for past indiscretions means being able to see the forest from the trees and he has empathy for victims. But what's he's focused on is whether there is evidence systemic risk-taking behaviour which may have inflated profits or revenue in the short term has been at the expense of long-term, sustainable returns.

"A bank's misconduct regarding an individual loan might make for juicy headlines, but it may not indicate widespread practice. By contrast, an apparently systematic practice of charging fees for no service and potentially misrepresenting that to a regulator may indicate a bigger problem."

Smith says it is important to keep in mind the royal commission is ongoing, which may mute the shareholder backlash this AGM season. "Unless banks explicitly acknowledge misconduct, investors right now don't have firm ground on the other findings," he says.

Bryan says the extent of shareholder backlash will also depend on what businesses have done to address issues. "Companies that don't appear to have done much will probably be facing questions about what they're planning to do to hold people accountable and what degree of accountability the board should hold."

Smith agrees a company's response could determine the level of AGM agitation. "It depends on each financial institution and what the bank has 'fessed up to and the materiality of that."

After a recent rally, the S&P/ASX 200 index is now down less than eight per cent since the royal commission started. That indicates the banks, at least, have done a sound job on the investor relations front. "I think they have been doing a pretty good job," Martin says. "All the financial companies I have been speaking to around this stuff have been open about it. There is no caginess."

CLSA's Johnson notes that, despite initial alarm, the impact of the royal commission may not be as great as first thought. He says the penalties under existing legislation will likely be manageable, and some changes – including greater credit discipline and an end to conflicted commission structures – are positive for banks.

There is also an element of investor fatigue around the commission, Johnson adds, and banks are also offering relative value, trading on forward price-to-earnings (PE) ratios of 13 to 13.5 times while non-bank industrials are trading on PE ratios of 22 times.

But there is still a long way to go. The commission handed down its interim report on 28 September and its final report is due on 1 February next year. Investors will then have to wait to see which recommendations become law and how regulators implement them.

That means investor uncertainty will continue. As such, the banks' investor relations challenge remains in place.

"Look at what's happened offshore in other western countries," says Alphinity's Martin. "We've seen lots of regulatory scrutiny of banks in the last 10 years. It's going to take a long time for this to play out in terms of earnings and investor and customer expectations."

"We're not going to wake up in 12 months and it's all over," Martin adds. "I think we'll wake up in 12 months and still be right in the middle of dealing with it."

Governance to the fore

The Financial Services Royal Commission has highlighted the growing importance of environmental, social and governance (ESG) factors in investor analysis of companies.

Research by the Responsible Investment Association shows 44 per cent of institutions already incorporate ESG factors into their screening of listed companies. "The royal commission may bring further attention to and interest in the practice of integrating ESG into investing," says Daniel Smith, general manager of proxy adviser, CGI Glass Lewis.

Susheela Peres da Costa, head of advisory at ESG research firm Regnan, says when assessing the royal commission's impact, it's important to note there are two types of ESG screens.

The first is to completely exclude a stock or industry, such as tobacco or controversial weapons, from a portfolio. The royal commission has triggered action from funds that exclude stocks deemed unethical. On 10 May this year, Sydney-based ethical wealth manager, Australian Ethical announced that based on its Ethical Charter, it was screening out AMP and divesting its holdings because of ethical standards breaches.

But it is unlikely that most funds, outside ethical boutiques, will completely screen out or divest the Australian banks and major financial institutions, even after royal commission revelations.

Peres da Costa says screening out major domestic financial companies requires high conviction, given their huge weighting in the ASX.

Peres da Costa says a more common form of screening is ESG integration, where investors incorporate various ESG factors such as ethics and reputation into their traditional market analysis and valuation.

"It dives deeper than traditional analysis on issues such as ethics and reputation," she says. "It doesn't necessarily exclude a stock or industry from a portfolio; but it might factor in a premium or discount to the price that someone is willing to buy or own it at."

ESG integration is growing strongly but Peres da Costa says the royal commission is just one factor driving that growth. "The royal commission is absolutely one of those, but it's one of many," she says, adding other factors include guidance from regulators such as APRA and ASIC around issues such as climate change. "There is a recognition that issues formerly thought of as fringe are actually economic for many companies."

The royal commission has highlighted ESG integration works for investors, da Costa says. "The good funds that were doing it properly and using high quality research were alert to these issues long before the royal commission," she says.

It has also highlighted the growing importance of ESG factors when companies communicate with investors.

"There is an opportunity for companies with strong ethical controls and credentials to communicate these to an increasingly interested equity market," she says. "Companies that protect trust in the quality of their products, services, and business conduct are, all other things being equal, more attractive."