ASIA TASKFORCE DISCUSSION PAPER No. 07
DECEMBER 2020

THE RIGHT PRODUCT, SOLD THE RIGHT WAY

Opportunities for Australian businesses in the Japanese Financial Services industry

Asia Taskforce is an initiative of

BCA Business Council of Australia

Asia Society Australia

Knowledge partners

pwc

The University of Sydney Business School

BACKGROUND

This Discussion Paper has been prepared as part of a series of short reports on specific topics identified by the Asia Taskforce (Taskforce) – an initiative of the Business Council of Australia and Asia Society Australia together with knowledge partners PwC Australia and the University of Sydney Business School - to supplement the findings and recommendations contained in the Interim Report.

One of the objectives of the Taskforce was to identify specific industry sectors and countries where Australia has comparative advantage and where there is local demand.

The paper is intended to contribute to a discussion about how Australian capability and talent can help to broaden our economic relationship with Japan and build on the already strong connection between our financial services industries built up over the past 15 years. It provides a starting point for Australian financial services businesses to define the opportunities and, perhaps most importantly, illustrate how organisations can navigate the inevitable risks by bringing the 'Team Australia' approach outlined in the Interim Report to life.

Key points:

In this Discussion Paper we aim to:

- Draw attention to the opportunities that the Japanese Funds Management sector presents
- Outline the role that the Funds Management Industry is playing in transforming Japans economy
- Identify areas where Australian fund managers have comparative advantages
- Highlight the demographic similarities between Australia and Japan that could create opportunities for the development and distribution of "advice-integrated" retirement and savings products
- Highlight some examples of the real-life experience of Australian fund managers who have successfully entered the Japanese market

It is important to note that whilst Financial Services is a diverse and large industry, for the purposes of this work we have narrowed our review and findings to Funds Management. This is due to:

- The pre-existing strength of the Japanese banking and insurance system and the non-obvious strategic advantages that Australia has in commercial banking relative to Japan
- There are some very obvious strengths that Australia has in its retirement savings system (superannuation) and we have included product design and innovation achieved off the back of this sophisticated and mature into Funds Management

OVERVIEW

JAPAN AND AUSTRALIA'S SUCCESSES IN FINANCIAL SERVICES

Japan boasts a highly successful financial services industry, buoyed by its historical economic rise. Japan's economy remains the third largest in terms of gross domestic product (GDP) after the US and the People's Republic of China,[1] with its GDP crossing the US$5 trillion mark in 2019. Its currency, the Japanese Yen, remains the third most internationally used currency for foreign exchange trade after the US dollar and the Euro.

Japan's financial success can be attributed to its protectionist management of the economy, its ability to modernise and embrace new technology, and capacity to industrialise quickly. In Japan, finance and insurance industries compose approximately 6 per cent of total GDP, accounting for US$300 billion. In comparison, GDP in the US is approximately US$20.5 trillion (2018), with the financial industry contributing approx. 7.5 per cent or US$1.54 trillion to total GDP.

Australia also possesses a sophisticated financial services industry that is well regarded as extremely stable. Australia is the 14th-largest economy globally by GDP, with a nominal GDP of US$1.42 trillion. [2]

Australia's success in financial services is underpinned by a mandated retirement savings scheme and bolstered by the continued strength of its investment funds sector. Austrade attributes Australia's "deep and liquid financial markets" to a combination of infrastructure investment, structured products and Australian leadership within the asset management industry.[3] Furthermore, Australia's multicultural society and proximity to Asia has resulted in a multilingual workforce. Australian Bureau of Statistics data shows that the financial and insurance services sector contributed 9.3 per cent to GDP, totalling US$130 billion in 2019. [4]

Why focus on funds management?

Off the back of Australia's large and successful retirement savings system (Superannuation) we have developed a large and mature domestically owned and operated funds management sector. This sector services the investment needs of Superannuation via acting as a third party provider or via the manufacturing of in-house capabilities within super funds. There are some very obvious opportunities for Australia in exporting this capability to Japan via either the establishment of locally based offices, or via the establishment of partnerships via distribution agreements or formal joint ventures.

> **"Through doing so we can improve the diversification of Australia's revenue pool, grow jobs, and further entrench the already very strong economic relationship between our two countries."**

Despite being a highly profitable segment domestically, export of our retail banking capabilities to Japan has remained limited. As in Australia, the highly traditional Japanese retail banking sector is dominated by a few large domestic financial conglomerates, such as Mitsubishi UFJ Financial Group (MUFG), Sumitomo Mitsui Financial Group (SMBC), and Mizuho Financial Group with Australian participants have had limited success. According to Asialink Business, there are currently 53 foreign banks operating in Japan. Australian players Australia and New Zealand Banking Group (ANZ), Commonwealth Bank of Australia (CBA) and National Australia Bank (NAB) all have offices in Tokyo,[5] however legislation mostly restricts their services to commercial and institutional clients. Additionally, the immense time needed to build trust and meet legal requirements means foreign players often struggle to make inroads into the Japanese market. The time required historically to capture a relevant regulatory footprint that then translates into a meaningful Japanese presence has been substantial. For example, ANZ opened its first representative office in Tokyo in 1969, acquired a full banking licence in 1984, and then received approval for a securities licence from the Financial Services Agency (FSA) in 2018.

Similarly, the success of Australian companies in the insurance sector has remained primarily transactional in nature, with flows tending to be unidirectional via Japanese insurers such as Dai-Ichi Life acquiring Australian players including TAL and Suncorp Life & Superannuation. In 2016, Nippon Life paid A$1.63 billion to fully acquire MLC, the life insurance arm of NAB.[6] Another example is the 2017 strategic partnership formed between Challenger and MS&AD Insurance Group Holdings for the manufacturing and distribution of $A denominated annuities into Japan. The attractiveness of the Australian insurance sector to the Japanese is partly due to the maturity of the Japanese market combined with the 10 per cent per annum growth in the Australian life insurance market in recent years.[7]

A 2020 EY Japan Insurance Outlook notes that Japan's life insurance volume is ranked second behind the US in total annual premiums and fourth globally in the property and casualty (P&C) market.[8]

Beyond the insurance and finance sectors, Austrade notes the rising dominance of Japanese players lending to Australia for project finance, particularly for infrastructure projects including the Canberra Metro PPP and Royal North Shore Hospital PPP.[9] This progress was aided by work completed by both the Australia Japan Business Cooperation Committee (AJBCC) and its Japanese counterpart, the JABCC who created the Joint Infrastructure Committee designed to promote collaborative infrastructure investment in Australia, Japan and identified third countries. This was identified as a key area for growth from 2008 onwards.

Global Japanese bank MUFG: Bank is now recognised as the fourth biggest project finance lender in Australia and was attracted by "Australia's low country risk, transparent legal system and robust regulatory oversight of financial markets."[10] More recently, SMBC invested heavily in the NSW Government's development of Western Sydney International (Nancy-Bird Walton) Airport. In comparison, Australian financial institutions are still struggling to tap into Japan which boasts the largest asset management market in Asia Pacific representing a A$15 trillion opportunity set.[11]

Japan is currently seeing major once-in-a-generation changes being implemented across the retail and institutional markets through government-led initiatives designed to re-invigorate the Japanese economy after decades of stagnation and address the challenges of an ageing population.

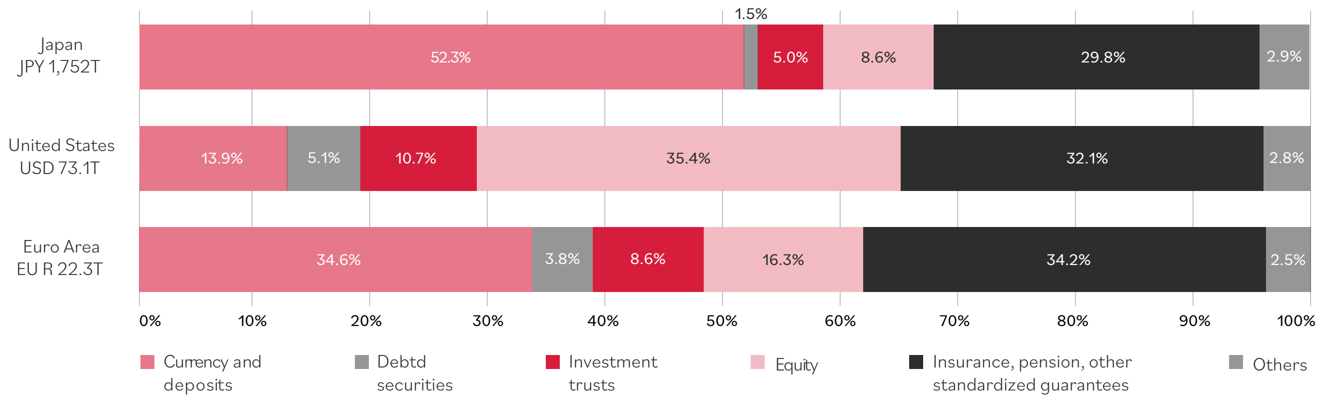
These changes are leading to structural shifts in the asset management industry, namely:

- Unfunded liabilities and the negative interest rate policy are driving asset allocation shifts away from Japanese Government Bonds to risk-based assets in the institutional market. In addressing these challenges, the changing allocation of public pensions funds is having a cascade effect across the corporate pension market and broader institutional market.
- Recognition of the longevity and associated retirement funding challenge – as citizens live longer, they are increasingly forced to fund longer retirements.

The FSA paper issued <insert date> articulated that the gap could be as high as JPY20 m (~US$200,000) per person – as such, systemic approaches that encourage long term asset accumulation are required

- Business diversification – given the collapse in interest rates globally, and the already low levels of lending activity, the commercial headwinds on Japanese banks and insurers is significant. Establishing and growing a funds / wealth management business offers these large corporates one way to diversify into more capital efficient industries (and sustain shareholder value).
- Regulatory change towards clients' best interests is transitioning the retail market, driving the reassessment of business models, shifting from product churn towards net assets under management (AuM), with the need for yield continuing to be an enduring theme. In addition, with only 5 per cent of household wealth (vs. US ~13 per cent; EU ~8 per cent) invested in investment funds ~50 per cent invested in cash, significant opportunities exist with tax-exempt schemes such as the Nippon Individual Savings Accounts (NISA) which the government is pushing to drive savings into investments.

Figure 1 Comparison of financial assets held by households (Breakdown by asset class)



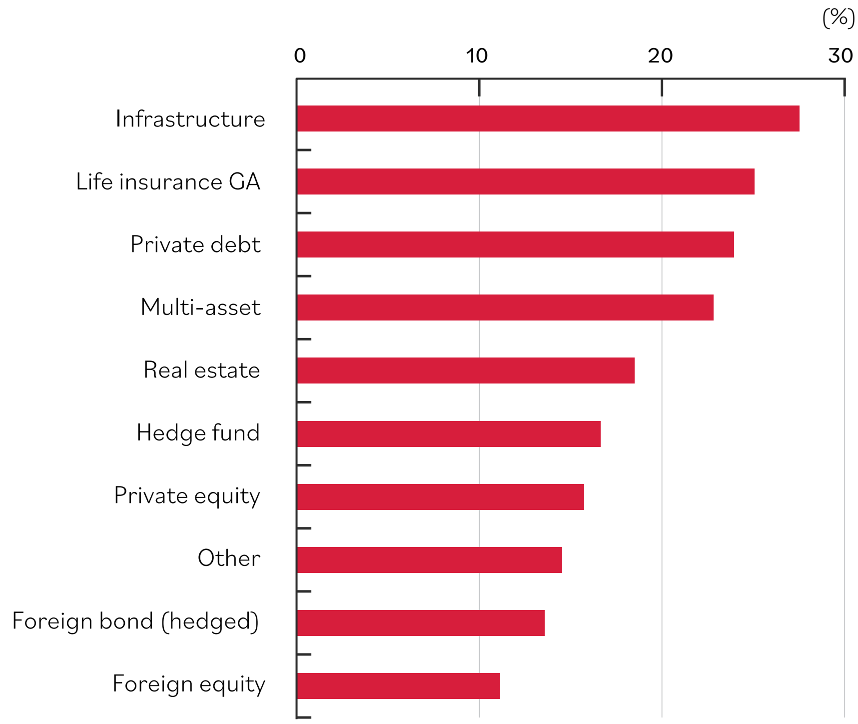
Data for Japan and the United States are as of September 2016; those for the Euro area are as of June 2016
(Source: Bank of Japan, blow of Funds Overview of Japan, the United States, and the Euro area -December 22, 2016)

Overview of current export of funds management capabilities to Japan

Institutional distribution in Japan is arguably more profitable for fund managers, with a bifurcation of attractive institutional capabilities for Japanese portfolio constructors – on the one hand low cost passive allocation and the other active investment in real assets. [12]

The macroeconomic environment continues to reflect on the successful product offerings of foreign fund managers. Most notably, the longevity of the Japanese population has led to the popularity for long duration products with a reliable yield, particularly infrastructure projects.

Figure 2 Asset classes in which pension funds want to invest more

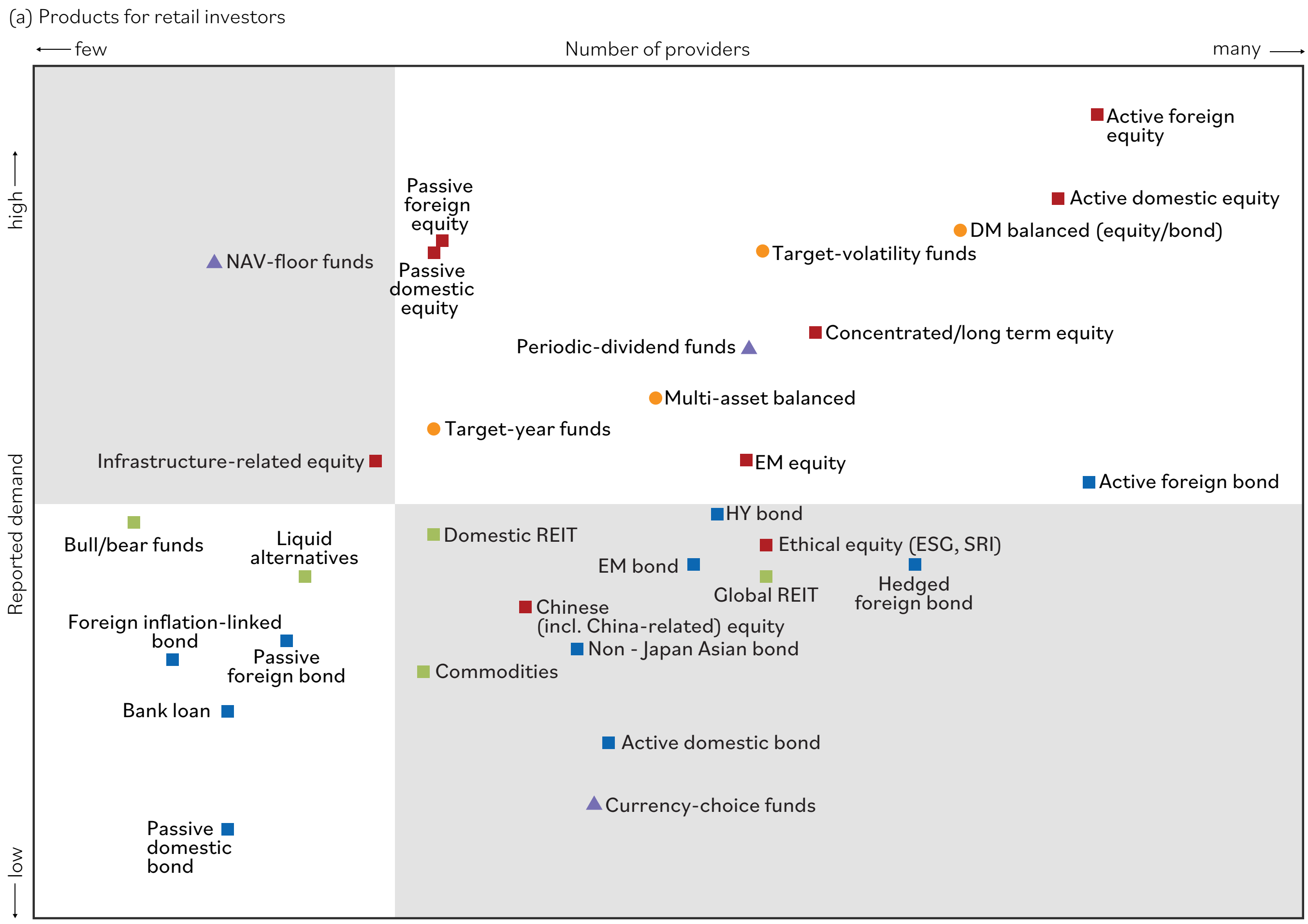


Note: GA: general account
Source: Nomura Securities Fiduciary Services Research Center survey of mainly DB pension funds (August 2018)

Over recent years the progress to export Funds Management capabilities from Australia into japan has been limited. There have been attempts to grow retail distribution via regional APEC initiative of the Asian Regional Funds Passport, which was established in early 2019 following years of work. Both Australia and Japan were founding signatories to this scheme. However its success is likely to be limited by two key issues, Australia's internationally uncompetitive collective investments regime and our withholding tax structure for foreign investors.

The retail space is highly competitive with flows over the past few years indicating that highly differentiated value proposition funds or best-in-class with long, solid performance track records are the keys to success. The map below from Nomura Research Institute shows the supply and demand of products for the retail market.

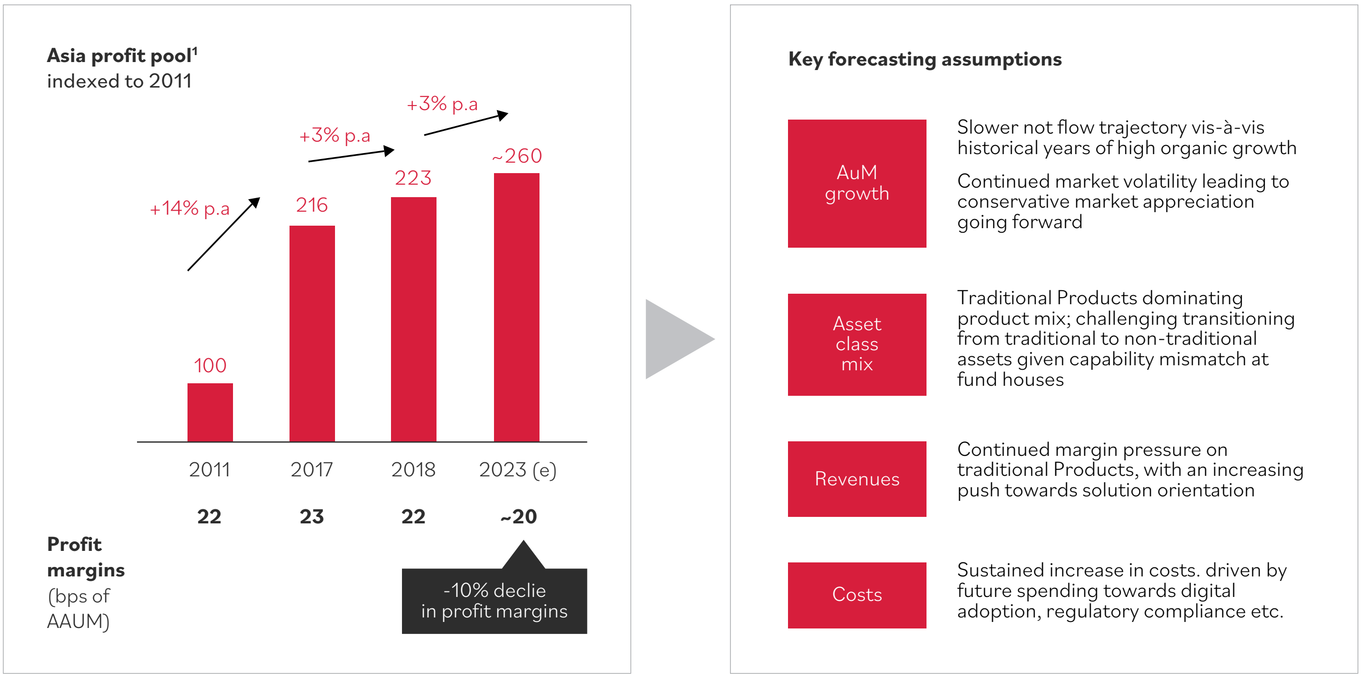
Figure 3 Product supply and demand maps by client segment



Source: Nomura Research Institute, Japan's Asset Management Business 2018-2019

While there is a lucrative opportunity to grow AuM for asset managers in Asia Pacific and Japan, PricewaterhouseCoopers (PwC) research highlights that industry participants are not shying away from the impact focusing on regulation, fee pressure, demographic changes and technology will have on the investment management industry.[13] In 2017, Japan's regulator formed seven principles to steer the industry towards client best interests which included a greater clarity on fees and accessibility of information.[14] Similarly, regulators in Australia are now implementing new standards requiring increased transparency and disclosure of fees and costs.[15] The potential effects of these 'disruptors' have been modelled in the McKinsey & Co chart below which highlights the potential medium-term profit impact as a result of disruptions in Asia.

Figure 4 Disruptions will likely slow growth in profit pools; model prediction of a approx. 10% decline in profit margins in the next 3 years



Source: McKinsey Asia Asset Management Survey; McKinsey Performance Lens Global Growth Cube

This shift in the industry is already well underway and thus presents a great opportunity for asset managers, particularly in the area of passporting. At this point in the market maturation, the most favourable opportunities in financial services remain in funds management. PwC data notes that the AuM of regional passport schemes is expected to rise from US$6.7 trillion in 2017 to US$11 trillion by 2025.[16] If asset managers can differentiate themselves from their competitors by becoming fixated on client needs, a lucrative opportunity awaits. For this opportunity to present itself, fund managers must innovate in the areas of retirement solutions, offer ESG friendly products, capitalise on passive investments and enable clients to interact with their assets through seamless user-friendly technology.

The Australian Financial Services industry has been evolving rapidly over the past 20 years. Arguably we are ahead of where Japan is evolving to (noting Australia's shift from being predominately agency/adviser intermediated in the 1990's, with heavily vertically integrated manufacturing/distribution models to now being commission free, with a focus on client driven advice).

The products we have developed as a result should therefore be more likely to be attractive to Japan as it too moves in this direction.

New market participants will inevitably face challenges when entering the Japanese funds management market. Research has shown that new entrants must develop long-standing relationships, offer specialised investment capabilities and the right product offering in order to successfully establish themselves in the Japanese market. Furthermore, due to the substantial size of the Japanese funds management industry, considerable investments are needed to make meaningful inroads. Importantly, traditional Western management teams and models have proven not to be successful.[17] The lengthy time periods required to gain legal and regulatory approvals present large barriers for foreign fund managers, as was the case with ANZ's entry into the Japanese market. Austrade however notes that other Australian entrants to the Japanese market including AMP Capital, Macquarie Capital, First Sentier Investments and IFM Investors have an already established presence that targets both Japanese institutional and retail investors.[18]

While product development and differentiation are key to success in Japan, fund managers who have a strong brand recognition, a clear understanding of their fiduciary duties and the ability to build long standing relationships founded on mutual trust are the most successful.

The right product, sold the right way

In our view the biggest hurdle for creating success in developing meaningful business success for Australian fund managers in Japan is understanding what products will work for the Japanese institutional and retail markets AND finding distribution partners who can access the client segment to sell these products.

In terms of product offerings and capabilities, they are well positioned for success, but only if the product offering is specifically selected and constantly adapted based on in-depth market knowledge. On the other hand, the distribution challenges can be daunting. One of the first critical questions when considering how to effectively reach Japanese investors is whether or not to partner with a local player, and if a distribution partner is deemed necessary, detailed and nuanced analysis to identify and attract the optimal partner is critical. Any target partner must recognise that the product(s) represents compelling business opportunities and is difficult to replicate, and, even if well-matched, the workings of the partnership itself are likely to be challenging. A successful partnership is anchored in establishing long-term mutual trust and respect among all internal stakeholders, so overall success will ultimately be a function of the suitability of the local leadership and the team together with their appropriate empowerment by HO. If a local distribution partner is not judged as necessary based on business model etc, the calibre of local leadership and the team is possibly even more critical.

The rewards of partnerships can be significant, but not guaranteed. Morgan Stanley, first established in Japan in 1970, went through many reorganisations including upon receiving a dual license for advisory and investment trust businesses in Japan in 1995, however their real success in Japan is said to have resulted from their securities JV with Mitsubishi UFJ Financial Group in 2010. To paraphrase a MUFG Chair speaking to an international audience "We are having a great time - they have the product, we have the distribution!". AMP Capital has also partnered with MUFG Trust Bank (15% shareholder) to effectively access both retail and wholesale markets, with particular success in real asset debt and equity. In other cases, partnerships were short lived, for example Macquarie's 50/50 JV with Shinsei Bank (Macquarie Shinsei Advisory Co. Ltd, MSAC) in 2006 was exited in 2008.

Competitive Advantages of Australian Fund and Asset Managers: Products and Business Culture

Many Australian Fund and Asset Managers have recognised skills and experience in the specialist asset classes becoming more sought after in Japan (for example, ESG, infrastructure, real estate, energy and healthcare). However assembling the quality teams required for them to succeed is not straight-forward due to Japan's unique business culture and bifurcated recruitment market.

In terms of Investment Professionals, despite the advantages of Japanese-savvy leadership, IPs are often non-Japanese nationals that already have established track records (this can be a competitive advantage when recruiting future IPs from Japan since it offers internal development opportunities not available at many competitor local firms). Importantly, with the right leadership, accomplished IPs and highly competent operational staff, Australian managers can differentiate themselves by offering the requisite fit-for-purpose "asset management business culture" (for example, remuneration frameworks, WLB flexibility etc.) to attract top quality recruits from the local market since most traditional Japanese financial services companies struggle to establish and develop teams to sustain such a business culture.

The challenges of access to the market (Distribution)

The Japanese competitor landscape is made up of a number of distribution powerhouses. While often lacking the innovative products now in demand (due to demographics, economic drivers, government policy changes etc.) they still maintain historical "ownership" of their keiretsu-affiliated investors, as well as long-established "credibility" among culturally risk-adverse investors, as well as deep local knowledge and influence.

Whether the new entrant choses a local partnership, or to establish a distinctive market niche, their long-term commitment to investment in people and sustainable support (financial and governance) is the key to success.

> "Many Australian Fund and Asset Managers have recognised skills and experience in the specialist asset classes becoming more sought after in Japan. However, assembling the quality teams required for them to succeed is not straight-forward due to Japan's unique business culture and bifurcated recruitment market."

Practical advice for market entry:

Be clear on the customer group you are targeting

Be clear on the customer group you are targeting – small pension funds, private pensions, affluent, HNW, mass, UHNW... etc.

Ensure the product is unique and specifically suited to Japan's investment needs

Ensure the product(s) is:

- Best-in-class, unique and difficult to replicate; and
- Specifically suited to Japan's investment needs and marketplace (ie. client preferences, regulations, tax, language, market structure etc.)

Investigate and analyse whether to "Partner or Not"

Investigate and analyse whether to "Partner or Not" for distribution. Structure any form of "partnership" to optimise value for both sides, and minimise conflicts or role ambiguity.

Establish a brand based on reliability of unique products

Whether with a partner or not, establish a "brand" based on reliability of unique product(s). Appropriate Financial Services licensing is important in all cases.

Any decision to enter the Japanese market must be based on long-term commitment

Any decision to enter the Japanese market must be based on long-term commitment to the investment in terms of money, time and people. (Don't be discouraged based on short-term cost-benefit analysis – for example, initial investments usually start comparatively small for the Japanese customer to gauge the long-term "fit".)

Identify, attract and develop quality leadership, IPs, operational staff and establishing an appropriate cross-cultural business culture.

Much of the early investment commitment should involve identifying, attracting and developing quality leadership, IPs, operational staff and establishing an appropriate cross-cultural business culture. This will need deep knowledge of the market and available talent pool, plus the investment necessary to attract and develop the very best people available and ensure that they stay. To attract such recruits is not easy in Japan, where the recruitment market is quite illiquid and binary – many top Japanese graduates still go straight into "jobs for life" at traditional financial firms where they develop as "generalists", or those who aspire to work in top foreign firms and achieve specialist expertise are attracted to the top US and European names and are difficult and expensive to unseat. The key will be to convince potential recruits of the relevance and clarity of the Japan entry strategy and its upside. The good news is that the combination of Australia's brand recognition for innovation and excellence in funds and asset management and its attractive "business culture", combined with a genuine commitment to develop recruits as recognised specialists, can be a strong competitive advantage.

Specifications for ideal leadership roles are fairly prohibitive:

- Japanese nationals (or non-Japanese with extensive knowledge and experience in the relevant Japanese market) - business level Japanese language is almost non-negotiable;
- Earlier successful careers with major players in the same space in US, European and/or Japanese markets;
- Influential market presence, including membership of Japanese government advisory bodies etc;
- Often graduates of ivy league universities and/or top Japanese universities; and
- Unlikely to be already part of the Australian/non-Japanese leadership team. Sometimes a "joint" leadership (new Japanese hire plus experienced non-Japanese) is useful in the setup stage.

Other staffing – need to identify, attract and retain "exceptional" staff within the Japanese framework:

- IPs should be acknowledged specialists (often from outside Japan as well);
- The operational team must be able to deliver to the "high-touch" operational excellence required (without exception) by Japanese customers; and
- Support teams need to be able to effectively communicate and collaborate with both Japanese internal and external stakeholders, as well as HO and other overseas stakeholders.

NOTES

1 Asian Development Bank Institute, 2017. TOKYO AS A LEADING GLOBAL FINANCIAL CENTER: THE VISION UNDER THE SPOTLIGHT AGAIN. https://www.adb.org/sites/default/files/publication/327606/adbi-wp758.pdf

2 International Monetary Fund, Data Mapper 2019. https://www.imf.org/external/datamapper/datasets

3 https://www.austrade.gov.au/International/Buy/Australian-industry-capabilities/Financial-Services

4 https://www.abs.gov.au/ausstats/abs@.nsf/Latestproducts/5204.0Main%20Features22018-19?opendocument&tabname=Summary&prodno=5204.0&issue=2018-19&num=&view=

5 https://asialinkbusiness.com.au/japan/business-practicalities-in-japan/banking-and-finance-in-japan?doNothing=1#:~:text=Australian%20banks%20operating%20in%20Japan%20include%20ANZ%2C%20Commonwealth%20Bank%20and,also%-20have%20branches%20in%20Osaka.

6 https://asia.nikkei.com/Business/Business-deals/Dai-ichi-Life-Insurance-to-acquire-Australia-s-Suncorp-for-50-billion-yen

7 https://www.austrade.gov.au/international/invest/importance-of-foreign-direct-investment/japanese-investment-in-australia/real-stories/tal#:~:text=Australia’s%20No.,digital%20pioneer%20for%20Japanese%20parent&text=Leader%20in%20the%20field%20is,dollars%20in%20its%20Australian%20business.

8 https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/insurance/insurance-outlook-pdfs/ey-global-insurance-outlook-japan.pdf

9 https://www.austrade.gov.au/international/invest/importance-of-foreign-direct-investment/japanese-investment-in-australia/real-stories/mufg

10 https://www.austrade.gov.au/international/invest/importance-of-foreign-direct-investment/japanese-investment-in-australia/real-stories/mufg

11 NMI research and https://fundselectorasia.com/apacs-largest-managers-hit-6-9trn-aum/

12 https://www.senryaku.metro.tokyo.lg.jp/en/gfct/pdf/guidebook_01.pdf

https://www.nri.com/-/media/Corporate/en/Files/PDF/knowledge/publication/jamb/JAMB2018_2019_e.pdf?la=en&hash=943742D0F9AED65B8752DC2CBF91E7ED13DA6427

13 https://www.pwc.com.au/asset-management/2018-awm-asia-2025-report-31jan19.pdf

14 https://www.pwc.com.au/asset-management/2018-awm-asia-2025-report-31jan19.pdf

15 https://www.pwc.com.au/asset-management/2018-awm-asia-2025-report-31jan19.pdf

16 https://www.pwc.com.au/asset-management/2018-awm-asia-2025-report-31jan19.pdf

https://www.mckinsey.com/~/media/McKinsey/Industries/Financial%20Services/Our%20Insights/Asian%20asset%20management%20Protecting%20and%20creating%20value%20in%20disruptive%20times/Asian-asset-management-Protecting-and-creating-value-in-disruptive-times.ashx

17 https://www.japanstrategy.com/business-in-japan/

18 https://www.austrade.gov.au/Australian/Export/Export-markets/Countries/Japan/Industries

In October 2019, the Business Council of Australia and Asia Society Australia together with knowledge partners PwC Australia and the University of Sydney Business School formed the Asia Taskforce of senior leaders from the business, education and government sectors to examine how Australian companies and organisations can increase their presence and position in Asia to ensure our continued prosperity and deliver progress for future generations.

While the Special Advisors on Japanese Financial Services named below have provided input into the discussion paper, the views expressed do not necessarily reflect the views of any individual or the organisations they represent.

This report refers to Asia as the countries of South East Asia, South Asia and North East Asia.

This Discussion Paper and other publications by the Taskforce can be found at https://asiasociety.org/australia/asia-business-taskforce

Special Advisors on Japanese Financial Services

- **Sam Hallinan**
  Managing Director, Nikko Asset Management (Chairman)
- **Debra Hazelton**
  Chair AMP Limited and former Senior Advisor for Global Talent Development & Chief Executive Officer in Australia for the Mizuho Financial Group
- **Bob Seidler AM**
  Senior Regional Executive Asia Pacific, Hitachi Ltd
- **Craig Usmar**
  Head of Business Relationships, Japan, AMP Capital
- **Emma Daly**
  Senior Manager, PwC Australia

www.bca.com.au
www.asiasociety.org/australia
www.pwc.com.au/asia-practice
www.sydney.edu.au/business

127079384