Mining Journal

Miners get a break

Australia's just-completed banking royal commission showed how deeply engrained cultural practices, accepted unquestioningly, can produce perverse and unacceptable outcomes. Some longer-term opportunities for mining industry investors may result.

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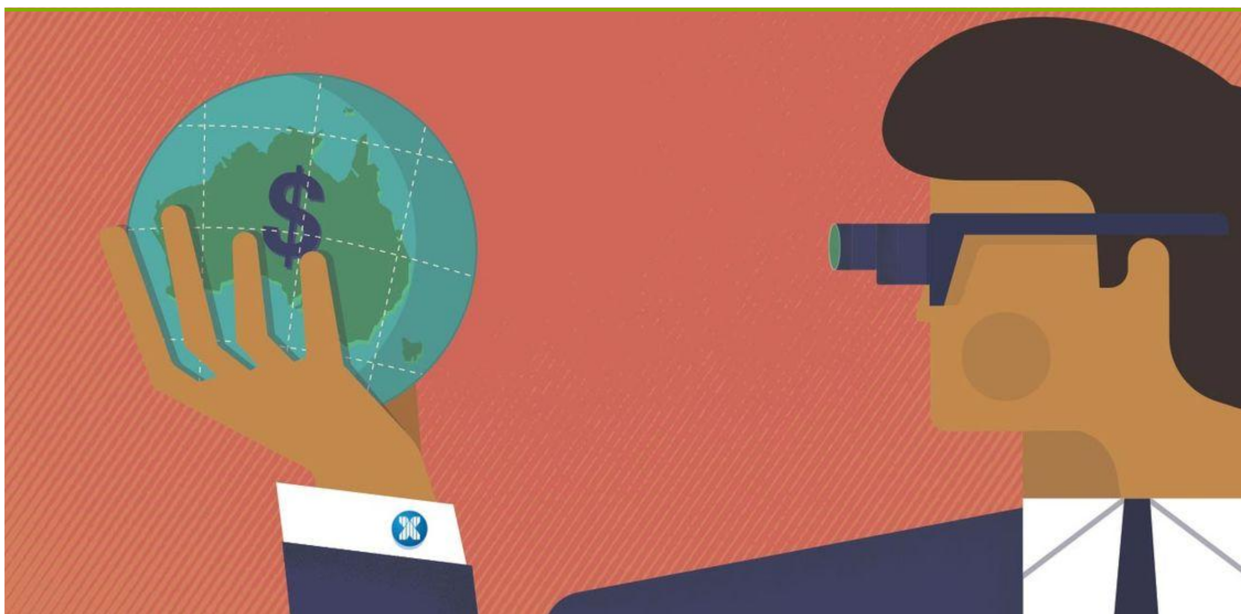

14 February 2019

The Australian government finally succumbed in December 2017 to political nagging to call a royal commission into the conduct of Australia's financial services industry. The final report was released on 4 February 2019.

As the former high court judge heading the enquiry started to probe industry figures publicly, evidence emerged daily of administrative sloppiness, callous management and rampantly corrupted incentive schemes working against the best interests of customers.

In contrast to their overseas counterparts, there were no collateralised bond failures, capital mismanagement or mispriced security offerings threatening the industry's viability. Australia's finance sector was, in contrast, a financially successful industry with an unhinged moral compass.

Despite the commission's findings, opposition to a royal commission had been right in one respect. The grimmest fodder for the nightly television news, peppered with images of executives squirming in witness boxes, emanated from the recently burgeoning financial advisory subsidiaries of the banks.

Strictly speaking, the culprits were not bankers as much as financial advisors responding to perverse incentives to diddle their clients.

A government policy intervention - compulsory superannuation savings - was behind the banks' push toward a one-stop financial services model. Having gained the trust

of customers through traditional deposit taking and lending, encouraging customers to move assets to in-house investment products was a temptingly small step.

Investors flocked to the banks in a ringing endorsement of these new business opportunities. Once upon a time, miners and banks had jostled more-or-less on equal terms for a share of investible funds. After years of falling bond yields, unbroken economic expansion and officially guaranteed growth, the banks had comprehensively overtaken Australia's resources sector as an investment destination.

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Dividend franking for Australian taxpayer investors was an added boon for the banks. Dividends added slightly under six percentage points annually to bank investment returns, compared with a little over three points for the leading miners, over the past 18 years. Franking credits added to the effective yield from locally tax-paying financial institutions.

As fresh boundaries are placed on banks' growth options, the once clearly inferior investment case for miners is on the cusp of a potential rebalancing.

A second aspect of the royal commission findings to benefit miners is also linked to the future role of investment advisory activities.

The pattern of Australian savings flows has changed radically since the introduction of universal compulsory superannuation. A new generation of gatekeepers for the pool of national savings has supplanted the broking intermediaries along St Georges Terrace, Collins Street and Pitt Street, who have been so important in satisfying the mining industry's hunger for capital.

Whereas brokers might have seen their roles, at least in part, as helping to identify the best opportunities at the small end of the equity market, the new gatekeepers are just as likely to block access.

Financial advisers tied to national chains owned by the banks are heavily constrained in what they are allowed to recommend to their clients by overarching compliance regimes driving investment selection. As a result, a larger population of mining companies is chasing a diminishing proportion of the nation's investible savings.

The longer-term prosperity of the mining industry in Australia - and globally to the extent Australian savings are used to fund offshore exploration efforts - will depend on companies gaining greater access to the pools of funds that had been rendered inaccessible over the past two decades.

Mining will not benefit automatically from a remodelled banking sector. It will have to show it has something to offer but it will have been gifted the best chance in a generation to regain access to pools of capital from which it had been excluded.

Light was shone by the royal commission on the role of incentives in driving executive behaviour and corporate performance.

At the heart of the problem was a business model ironically embraced by both banks and their customers. Financial advice was offered at a loss in exchange for longer-term income flows linked to asset size. Customers generally preferred trailing commissions over up-front fees that would have better reflected the true costs of the advice they were getting about the management of their financial assets.

Advisers, offered a share of the regular flow of fees, were implicitly encouraged to move clients into financial products onto which commission trails could attach. Similarly, within the traditional banking

business, the number of staff members engaging with customers about home mortgages was cut back in favour of external brokers paid by the number and value of the loans they generated.

The consequences were as unsurprising as they were damaging. Trailing commissions on products, rather than payments for services, resulted in the sharply criticised practice of fees being deducted indefinitely from the assets of the dead. Mortgage brokers were little interested in whether borrowers could repay their loans as they bulked up their businesses. Executives nearer the top of the corporate pinnacle were rewarded for the boosted profitability. The structure of incentives, followed unquestioningly, dictated offensive outcomes.

In mining, how directors consistently fail to properly measure risk in valuation is a culturally embedded practice with negative impacts but no meaningful dissenters. So-called ‘skin in the game' dictates prioritising news flow over long-term value creation for the bulk of the industry. The near universal practice of milking cash from one project to fund another, without an assessment of the capital management alternatives, sustains executive prestige often at the expense of the best interests of shareholders.

The banking royal commission has shown how deeply embedded and popularly espoused practices can easily lead to unacceptable conduct, if left unquestioned. There is no threat of a mining royal commission but it will be doubly hard for any industry to avoid scrutiny in the future, if questions about conduct emerge.

Conveniently, at least for the time being, the mining industry is better off for being of less political interest than the luckless banks.

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