Creating a $20bn Fintech national investment fund to connect demand for tech investment in super funds with local talent and capability and build a major Fintech sector in Australia

2018 FSC Future Leaders Program

FINANCIAL SERVICES COUNCIL

Max Nicholson
BT Financial Group

Abstract

The world's next great financial centres will be built on innovative financial technology. However, Australia's investment in fintech companies is trending downwards, perpetuating a vicious cycle of brain drain and capital drought. Australia's investment levels are already significantly lower than other countries in our region.

At the same time, Australia's superannuation funds are dramatically underinvested in private equity and venture capital, suppressing potential returns for investors. Current PE and VC mechanisms aren't working for Industry Funds due to fee levels, or for large SMSFs because of minimum investment requirements. Using global benchmarks, there is more than $20bn of pent-up demand for high-growth tech investment in private companies.

Creating a national Fintech Investment Fund, operated by the Future Fund and designed to meet the requirements of Industry Funds and large SMSFs, will release this pent-up demand into a $20bn pool of fintech investment. With carefully targeted mandates, this fund will stimulate and grow a new technology-based financial sector in Australia.

Build, start up and early marketing costs for the Fintech Investment Fund will be around $20m. Staggered implementation over 3-4 years would see the fund fully operational by 2021.

Executive Summary

Financial technology is critical to becoming a great financial centre

Developing financial technology in Australia is an economic imperative. We are on the cusp of unprecedented change in the distribution, delivery, and manufacture of financial services and products.

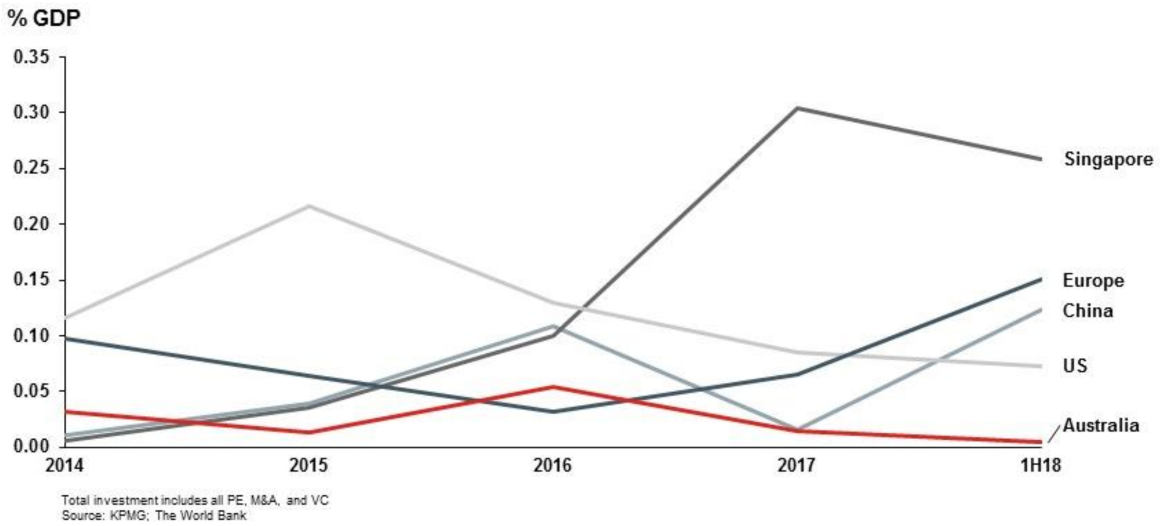
The economic benefits derived from our financial services industry are currently under threat from this digital disruption. Apple Pay has taken 10-19% of credit card interchange margin from US banks[1], while in China, Alipay and WeChat have cut banks completely out of about half of all consumer purchases[2]. 'Bigtech' platforms threaten the more than $13bn p.a. in tax revenues from Australian Financial Services companies because they use their global supply chains to minimise tax[3].

More broadly, the digitisation of financial services is expected to make 30% of financial services jobs redundant in the next five years and create employment in financial technology[4,5]. Australia is at risk of losing 135,000 jobs unless this expected redundancy can be offset by creating financial technology jobs.

Australia has fallen behind in investment in fintech

Australia trails both world leaders and our region in private equity and venture capital investment in fintech. Chinese state-owned enterprises have set up a US$1.44bn fintech fund and the Monetary Authority of Singapore has committed S$225m to developing a fintech ecosystem[6].

Figure 1 – Fintech investment as a proportion of GDP



Australia's anaemic investment in fintech companies results from a vicious cycle of brain drain and capital drought. Lack of access to capital in Australia and entrepreneurial support has led to an exodus of our start-ups and technology experts. Tyro's Josh Stollman, a fintech executive, called this brain drain "completely and utterly a disaster"[7]. It has reduced investment opportunities leading to Australian investment dollars going offshore. The Future Fund's own venture program has focused VC investment in the US rather than domestically[8].

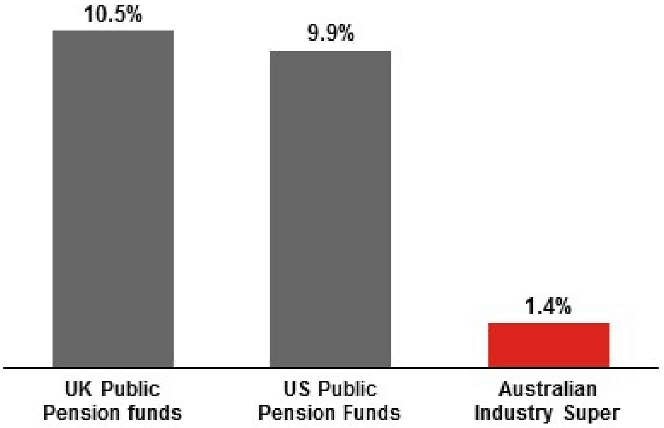
There is pent-up demand for tech investment in the $2.7T Superannuation sector

Australia's Super funds are also underweight in private equity and venture capital compared to pension funds across other OCED countries[9]. Industry Funds have a preference for lower investment management fees which precludes many PE and VC opportunities[10]. Many SMSF funds don't have the requisite size for investing as limited partners in PE or VC funds. Even amongst those that do, they often lack the experience and knowledge to feel confident finding and investing in these funds.

However, SMSF investors are acutely aware of the recent period of wealth creation in private, technology companies and this drives their demand. Commsec data reveals large increases in SMSF holdings of international equities in order to get access to technology disruptors. Google, Facebook, Apple, and Amazon, are four of the top five companies in SMSF portfolios[11].

Strategic Insights report that Industry Funds have less than 2% allocated to private equity, compared to about 10% amongst US and UK pubic pension funds (Figure 2). This demonstrates demand for a solution with low fees and that can solve what the AFR has termed the "culture clash" between private equity and industry super[12].

Figure 2 – Pension fund asset allocation to Private Equity



Sources: Millman Public Pension Fund study of largest 100 pension funds in US; Pension Protection's 'Purple Book' UK report; Strategic Insights reporting March 2018

Establishing a Fintech Investment Fund for Super investors

A. Setting up a nation-building fund within the Future Fund

The Future Fund is a widely-trusted sovereign fund, it is the natural home for a fund with a nation-building mandate. As well as an existing investment management team, it has all the required prudential and compliance infrastructure and governance already in place.

The Fintech Investment Fund would have a nation-building mandate:

i. Outperform a designated return hurdle
ii. Invest exclusively in Australian unlisted fintech companies
iii. Manage a pipeline of investments from early seed funding to later-stage private equity
iv. Focus in sectors and technologies where Australia has a natural or likely competitive advantage, regionally or globally.

B. Target investors

The fund should target Industry Super Funds and SMSFs with over $1m in assets. SMSFs and Industry Funds are forecast to be the largest groups of Super over the next decade[13].

The Fintech Fund would bridge any "culture clash" between PE and VC with Industry Funds, who are amenable to nation-building investments. Australian Super, Hesta, StatewideSuper, and Hostplus have invested with the Federal Government in medical research ventures[14]. To further the appeal to Industry Funds it is recommended the fund charge fees only to cover operating cost, rather than for profit.

The fund would also offer SMSFs a safe and trusted way to invest in PE and VC. Units in the fund would be available at low minimum investment requirements compared to what's currently needed to invest as a limited partner in a private fund.

C. Scaling and operating the fund

The fund's first investment in Australian fintech should be a software provider who can run the fund's registry system on leading technology. Using the technology of a firm currently building an Initial Coin Offering (ICO) platform would allow the fund to operate at low cost with a digitised back-end. Each unit of the fund would be offered as a 'coin' on a distributed ledger and smart contracts would provide digital AML and identity verification of SMSFs. A web portal for investors and secure custodial storage of the private keys associated with their coins is also needed.

The fund would raise capital annually with each vintage committed for 7-10 years. To build the supply of fintech investment opportunities in Australia, each vintage should be scaled up over time but not so quickly as to crowd out investment opportunities in the market. The expectation of a growing pipeline of investment in Australia will attract fintechs and skilled workers.

D. Budget and implementation

A $20m budget is needed to fund a technology build (from a portfolio company vendor), marketing, and to cover three years of additional OPEX in the Future Fund. To make the fund a success marketing campaigns should be run to appeal to investors as well as to attract fintechs abroad to Australia. Adding marketing, sales, and additional investment team headcount to the Future Fund will increase OPEX.

A staggered implementation is recommended from 2019 to 2021. Vintages in 2019 and 2020 should be restricted to Industry Funds and run on a beta technology release. The 2021 vintage can be opened to a restricted pool of SMSF investors and run on the first deployment of the full release.

Proposed capital raisings, implied FUM and other key metrics for the fund are set out in Table 1.

Impact and benefits

Investment of $20b over ten years will attract fintech companies and technology experts to Australia and drive investment product innovations that build on the government's offer. Becoming a fintech hub will enable Australia to export financial services to Asia and technology innovations will yield positive externalities for other sectors.

The fintech fund can win the hearts and minds of super members and tap into latent demand for PE and VC investment opportunities. Technology-themed and socially-minded investments resonate with retail investors as seen as by the increasing importance of ESG and prevalence of technology disruptors in SMSF stock portfolios[15]. Member engagement will drive high recognition of this government initiative in the electorate.

Conclusion

Investment in financial technology is critical to Australia becoming a great financial centre of the future and maintaining the current contribution of financial services to our economy. Creating a fintech fund to aid investment in unlisted fintechs is needed to break the cycle of underinvestment and brain drain. The Fintech Investment Fund provides the government an opportunity to solve for the access to capital needed to create a great financial centre of the future.

Table 1

		2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Capital Raising											
Vintage Size	**$m**	**200**	**340**	**578**	**983**	**1,670**	**1,837**	**2,021**	**2,223**	**2,446**	**2,690**
FUM											
Industry Funds	$m	200	560	1,075	1,837	2,936	3,869	4,556	6,122	7,956	10,095
SMSFs	$m	0	0	119	459	1,258	2,579	4,556	6,122	7,956	10,095
Total	**$m**	**200**	**560**	**1,194**	**2,296**	**4,194**	**6,448**	**9,112**	**12,244**	**15,912**	**20,191**
Market Share Industry Funds											
Industry Funds total assets	$m	563,436	612,455	671,251	735,691	837,400	953,170	1,084,945	1,234,938	1,405,667	1,600,000
Industry Fund allocation to alternatives	$m	73,247	79,619	87,263	95,640	108,862	123,912	141,043	160,542	182,737	208,000
Fintech Fund share of ISF alternatives	**%**	**0.3%**	**0.7%**	**1.2%**	**1.9%**	**2.7%**	**3.1%**	**3.2%**	**3.8%**	**4.4%**	**4.9%**
Market Share SMSFs											
Total assets of SMSFs with >$1m	$m	590,292	620,988	651,416	682,033	712,042	768,271	828,939	894,399	965,028	1,041,234
Market of share of SMSFs with >$1m	**%**	**0.0%**	**0.0%**	**0.0%**	**0.1%**	**0.2%**	**0.3%**	**0.5%**	**0.7%**	**0.8%**	**1.0%**
OPEX											
Increase in Future Fund OPEX	$m	2.0	2.1	2.1	2.2	2.3	2.3	2.4	2.4	2.5	2.5
Fee rate on Fintech Investment Fund	%	0%	0%	0%	0.10%	0.05%	0.04%	0.03%	0.02%	0.02%	0.01%
Fee Income	$m	0	0	0	2.2	2.3	2.3	2.4	2.4	2.5	2.5
Net impact on OPEX	**$m**	**2.0**	**2.1**	**2.1**	**0**	**0**	**0**	**0**	**0**	**0**	**0**
CAPEX											
Technology build	$m	5.0	5.0								
Marketing	$m	1.2	1.2	1.2							
Total	**$m**	**6.2**	**6.2**	**1.2**							
Budget allocation											
CAPEX	$m	13.7									
OPEX	$m	6.3									
Total	**$m**	**20**									

Key model assumptions and data sources

- Capital raisings grow at 70% p.a. to 2023, then 10% p.a. until 2028
- Returns assumed to be historical 10 year average for PE and VC in Australia
- Industry Funds allocation to alternatives remains constant at 13%
- IBIS World and KPMG forecasts of Industry Fund and SMSF total assets are used
- Strategic Insights reporting on current super assets and allocations are used

References

[1] Apple Pay fees reported as 0.15% (*UK Banks put squeeze on Apple Pay fees,* The Financial Times, July, 2015); US interchange fees range from 0.8% - 1.5% (Visa and Mastercard Scheme rates reported by Home Merchant Services)

[2] Data from Aite Group reported in *Why China's payments apps are giving US bankers nightmares*, Bloomberg, May 2018

[3] *Taxes and other levies paid to governments in Australia by the banking industry,* Australia Bankers Association, June 2017

[4] *Former Citi CEO: 30% of banking jobs will be wiped out in 5 years,* Business Insider, September 2017

[5] *The Future of talent in banking: workforce evolution in the digital era*. Ernst & Young, April, 2018.

[6] *Scaling the Fintech Opportunity: For Sydney & Australia,* KPMG, July 2017

[7] *Should the Australian brain drain to Silicon Valley be encourage?* CIO Executive Council, July 2016

[8] *Sovereign investors hunt for 'unicorns' in Silicon Valley,* Reuters, May, 2017

[9] *Does Private Equity have a role in Superannuation Portfolios*, Dr Kar Mei Tang, The Australian Private Equity and Venture Capital Association, June 2013

[10] *Australian Superannuation funds underweight private equity*, The Australian Financial Review, September 2017

[11] *SMSF Trading Trends Report,* Commsec, September 2018

[12] *Superannuation Funds are going to war against private equity over fees.* The Australian Financial Review, August 2016

[13] *Super Insights Report,* KPMG, 2018

[14] *Biggest venture capital commitment in Australia's history: Brandon Capital raises $200m to beat the commercialisation drain,* The Australian Financial Review, April 2015.

[15] *SMSF Trading Trends Report,* Commsec, September 2018

THE FINTECH INVESTMENT FUND

MAX NICHOLSON BTFG

OCTOBER 2018

FINANCIAL SERVICES COUNCIL

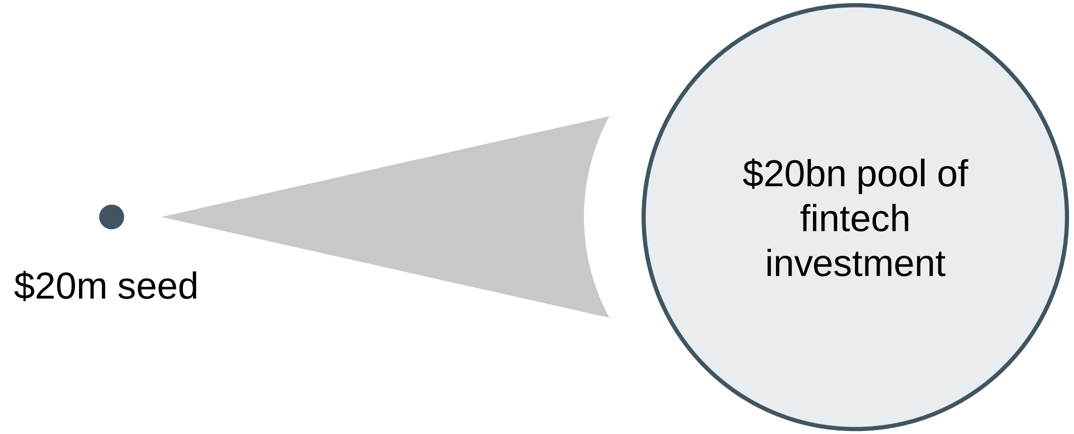
Becoming a great financial centre requires more than $20m

We've got a problem with investment…

"A young Australian with world-beating technology has more chance of being struck by lightning than raising capital"

Morgans Financial

…we need to turn $20m into a $20bn pool of investment



The Federal Government should create a Fintech Investment Fund within the Future Fund

- **Context**: Investment is critical to financial technology, financial technology is critical to becoming a great financial centre

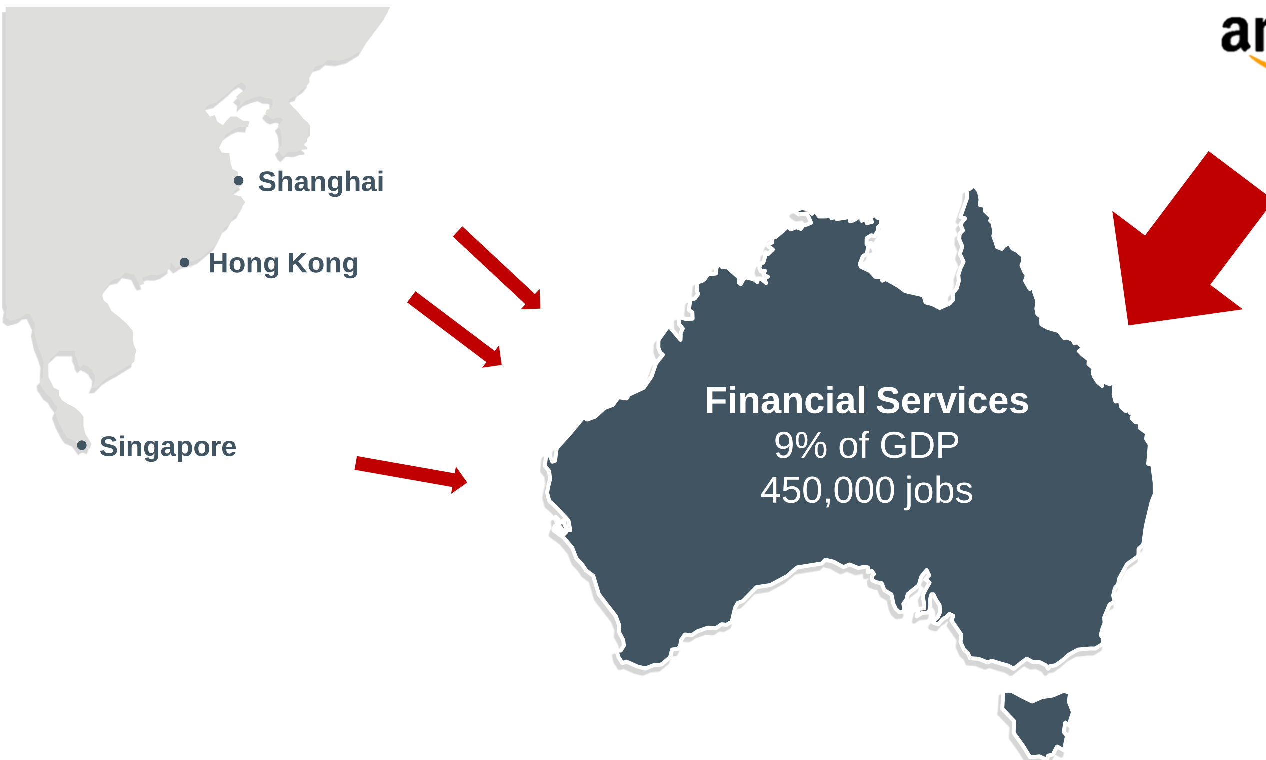
- **Challenge**: Australia lags the world and our region on fintech investment

- **Solution**: We need to facilitate investment from Super into fintech - the best way to do this is through creating a Fintech Fund within the Future Fund

Australia is under threat from bigtech and regional fintech hubs

Regional fintech hubs

Bigtech platforms

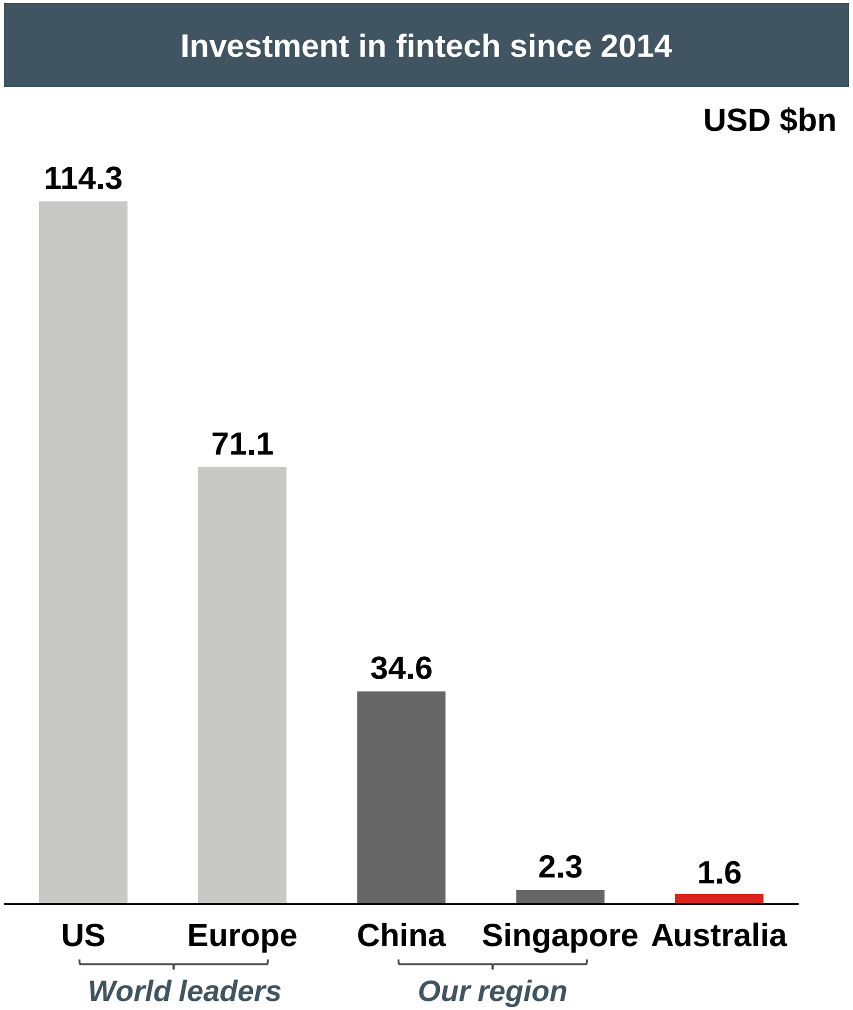


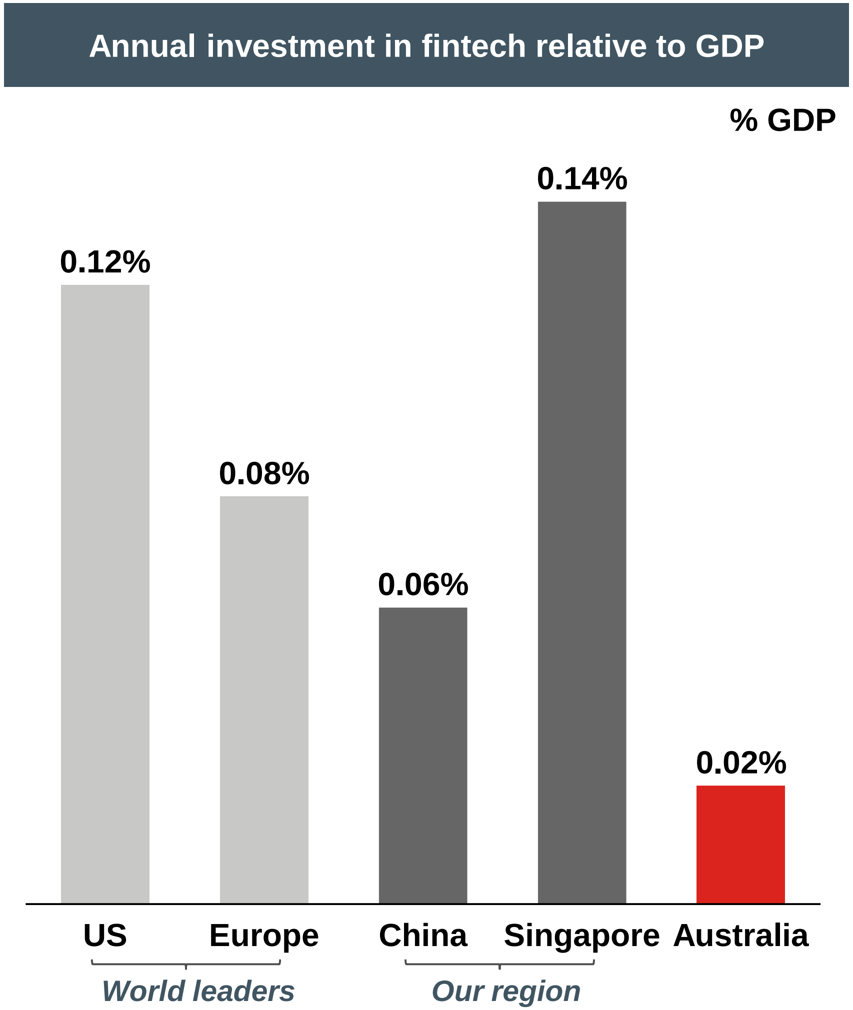
At risk

- **$1.27bn in tax revenues**
- **135,000 Australian jobs**

Source: Australian Government Treasury; ABA tax reports

We're really underprepared for this threat

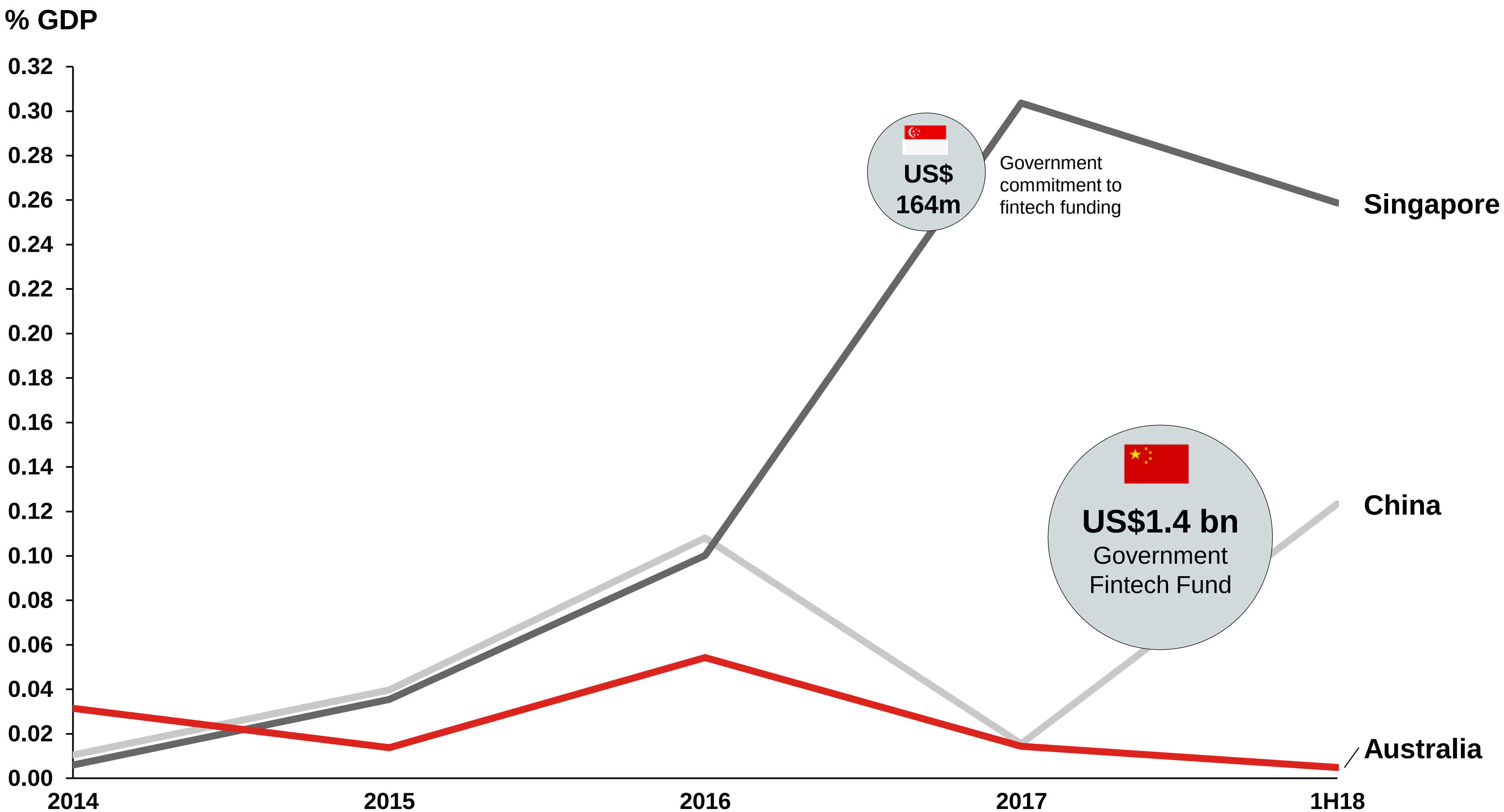




Total investment includes all PE, M&A, and VC activity from 2014 to 1H 2018. Average investment over GDP from 2014 to 1H 2018 is used.
Source: KPMG; The World Bank

Our region's governments are injecting capital into fintech

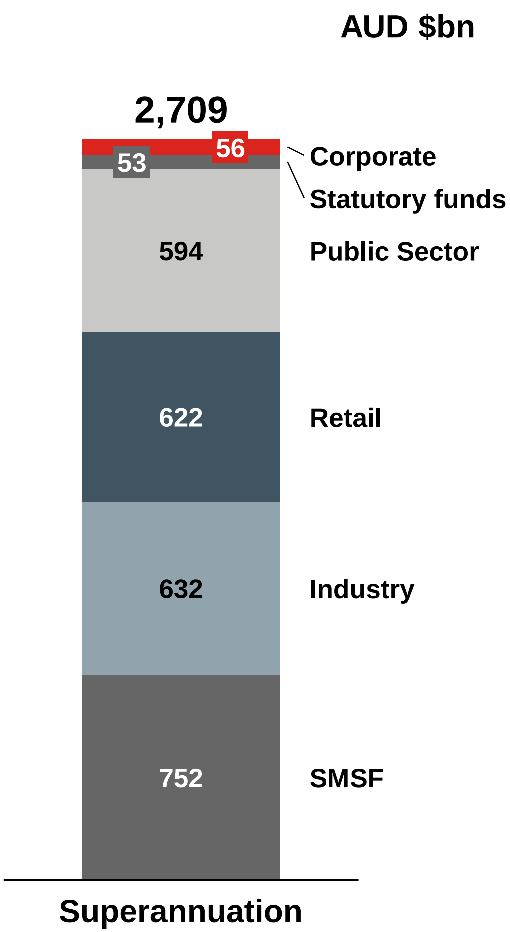
Total investment in fintech relative to each country's GDP



Source: KPMG; The World Bank

Opportunity for directing investment from Super to fintech

Super[1]



Fintech Fund

Private market

× Industry funds averse to higher fees

× SMSFs lack size or know-how to act as limited partners

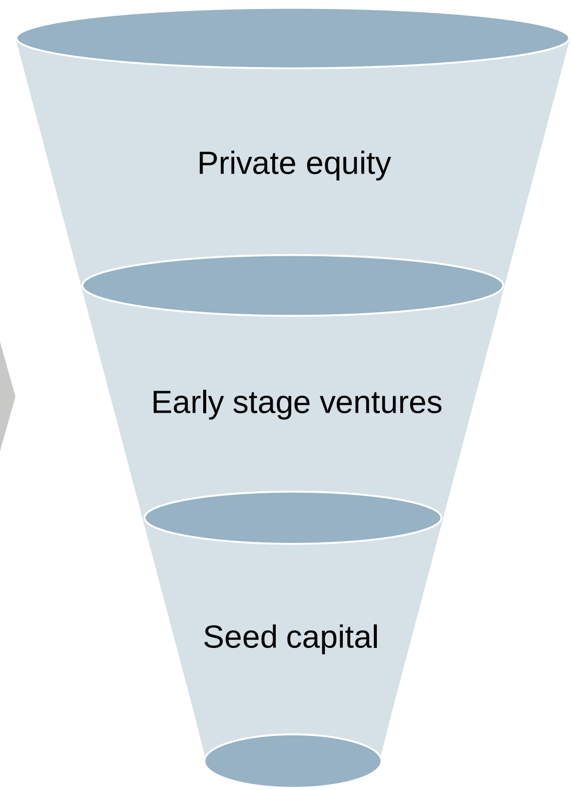
Government's Fintech Investment Fund

✓ Not for profit and low fees

✓ Low minimums

✓ Safe and trusted

Fintech companies

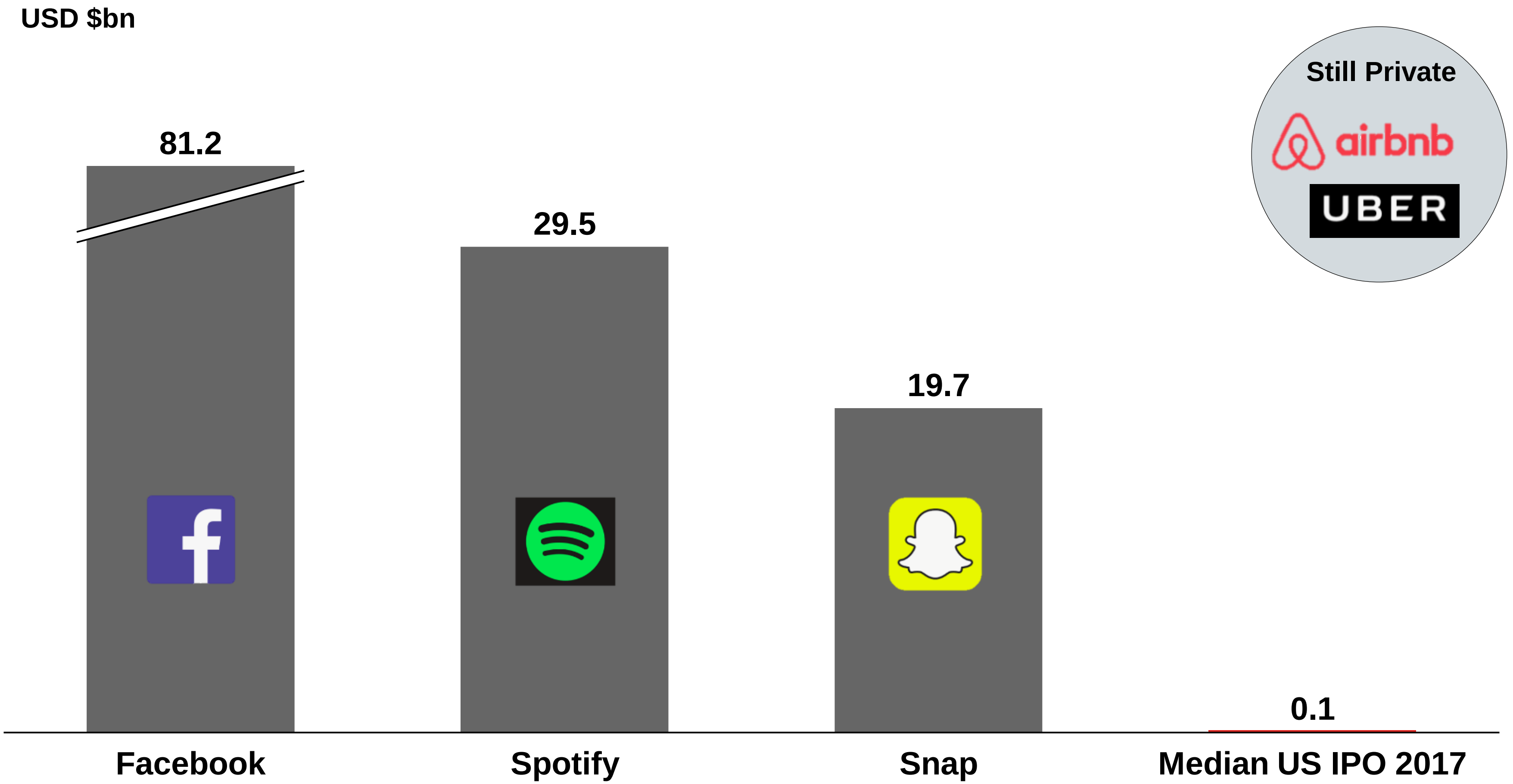


1. As at June 2018

Source: APRA statistics

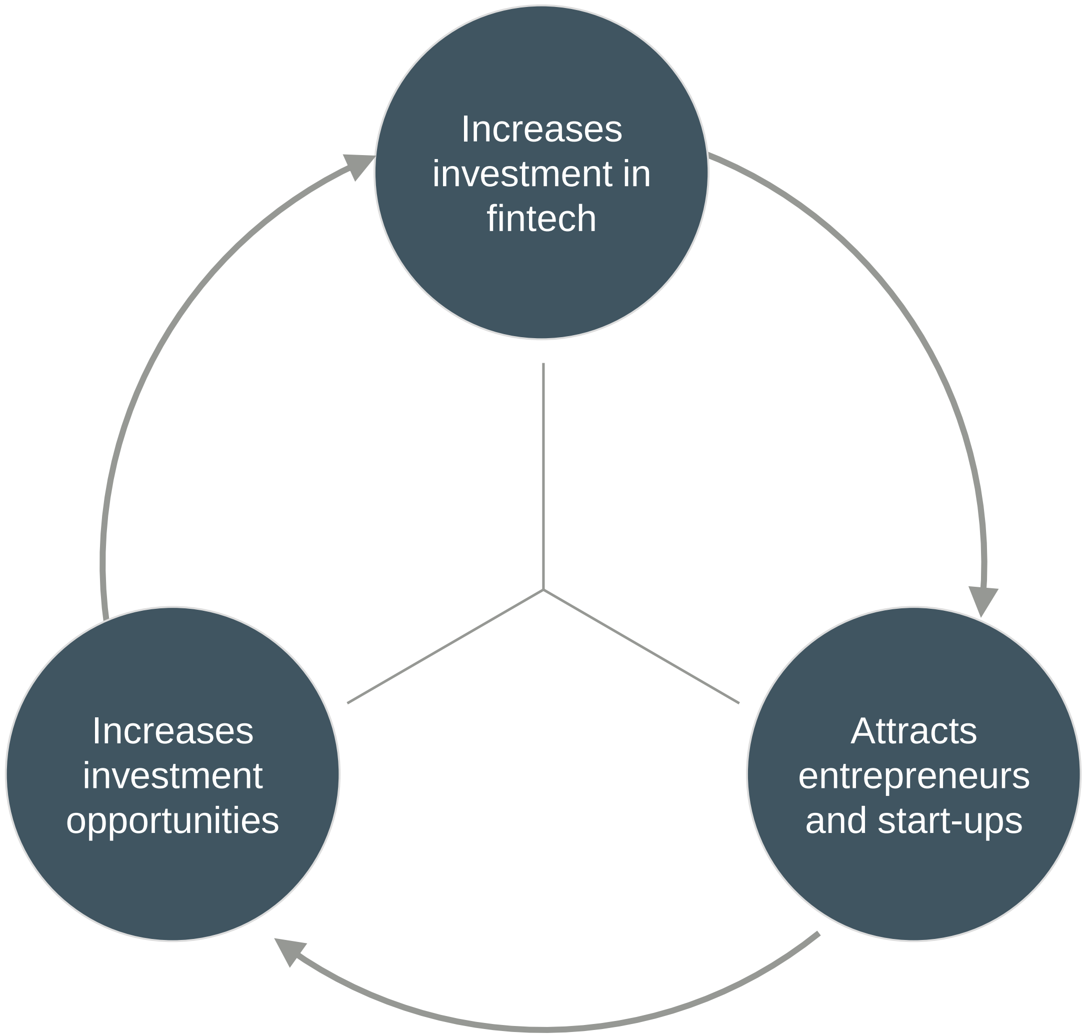
There is strong demand from investors - creation of wealth in private companies is front of mind

Bigtech IPO value compared to US median[1]

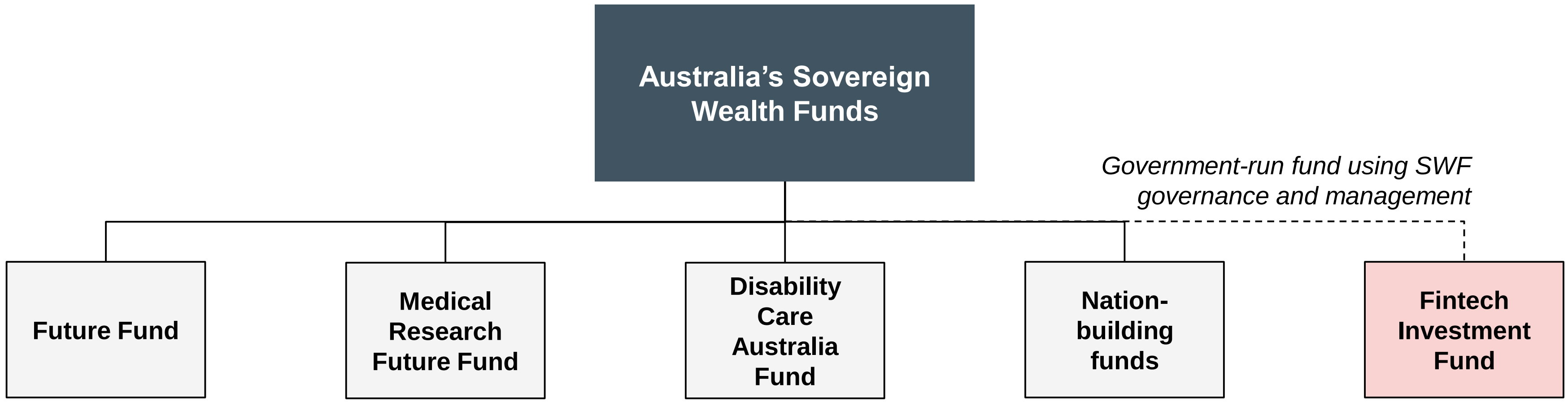


1. Median US IPO value $120m in 2017; Spotify IPO was a direct listing
Source: Statista; Pitchbook

Investment begets supply of investment opportunities



We should run the Fintech Investment Fund as part of the existing Future Funds



Leverage existing governance and management

Governance	Future Fund Board of Guardians
Management	Future Fund Management Agency

Major changes

New type of fund	Unit trust for SMSFs and Industry funds with new compliance, technology, and other requirements
Restricted mandate	Investment only in Australian private fintech companies and impact of investment

Setting up the fund within the Future Fund will require considerable changes to how the Future Fund operates today

	Investor	Future Fund	Inv. Manager	Distributions
1 **Existing Medical Research Future Fund**	**Government Savings** - Allocated in budget papers and governed by Act of Parliament	**Board of Guardians** - Governance and oversight **Management Agency** - Running of the fund - Investment manager selection, due diligence	**External Managers** - Investment mandates - Investment management services for direct assets	**Minister of Health** - Determines drawdowns **Advisory Board** - Determines research funding and innovation strategy for Health Research
2 **Proposed Fintech Investment Fund**	**Retirement Savings** - Raised from SMSFs and Industry Super Funds	**Board of Guardians** - Governance and oversight **Management Agency** - Running of the fund - Investment manager selection, due diligence	**External Managers** - Investment mandates - Investment management services for direct assets	**Super Investors** - Paid returns after liquidity events in the underlying portfolio of each vintage of the fund
3 **Changes to Future Fund Operating Model**	**New Capability** • Marketing • Account managers • Product management and offer documents • New technology	**New requirements** • Compliance • New governance requirements for board • Impact of investments not just returns	**Restricted Mandates** • Investing with more restricted mandates • More nuanced requirements of external managers	**Paying distributions** • Governance and mechanism for distributions needed (technology and product solution)

Additional headcount and adjustment to statutory obligations are needed to augment the Future Fund

Fintech Investment Fund Act (2019)
- Clarify statutory obligations of board and management

Future Fund Board of Guardians

- Hon Peter Costello (Chairman)
- Ms Carolyn Kay
- Mr John Poynton AO
- Dr Jane Wilson
- Ms Erin Flaherty
- Mr Michael Wachtel

Future Fund Management Agency

Chief Executive Officer
David Neal

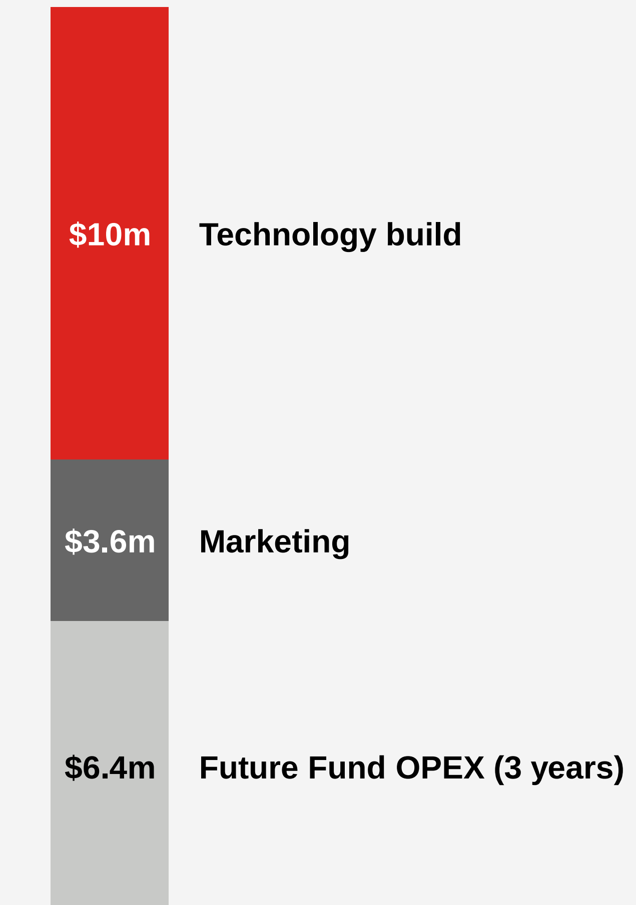
- **Chief Investment Officer**
  Raphael Arndt
  - **Deputy CIO, Private Markets**
    Wendy Norris
  - **Fintech Doman Expert 1 FTE**
- **General Counsel & CRO**
  Cameron Price
  - **Compliance Manager 1 FTE**
- **Chief Operating Officer**
  Gordon McKellar
  - **Product Manager 1 FTE**
  - **Marketing and Sales 5 FTE**
  - **Operations and Service 2 FTE**
- **Chief Technology Officer**
  (vacant)
  - **Solutions Architect 1 FTE**
- **Chief Financial Officer**
  Paul Mann
- **Chief Culture Officer**
  Liz McPherson

Key
- **Existing management**
- **New role or team**

The $20m budget will cover a tech build, marketing, and three years of additional OPEX for the future fund

Budget allocation

AUD



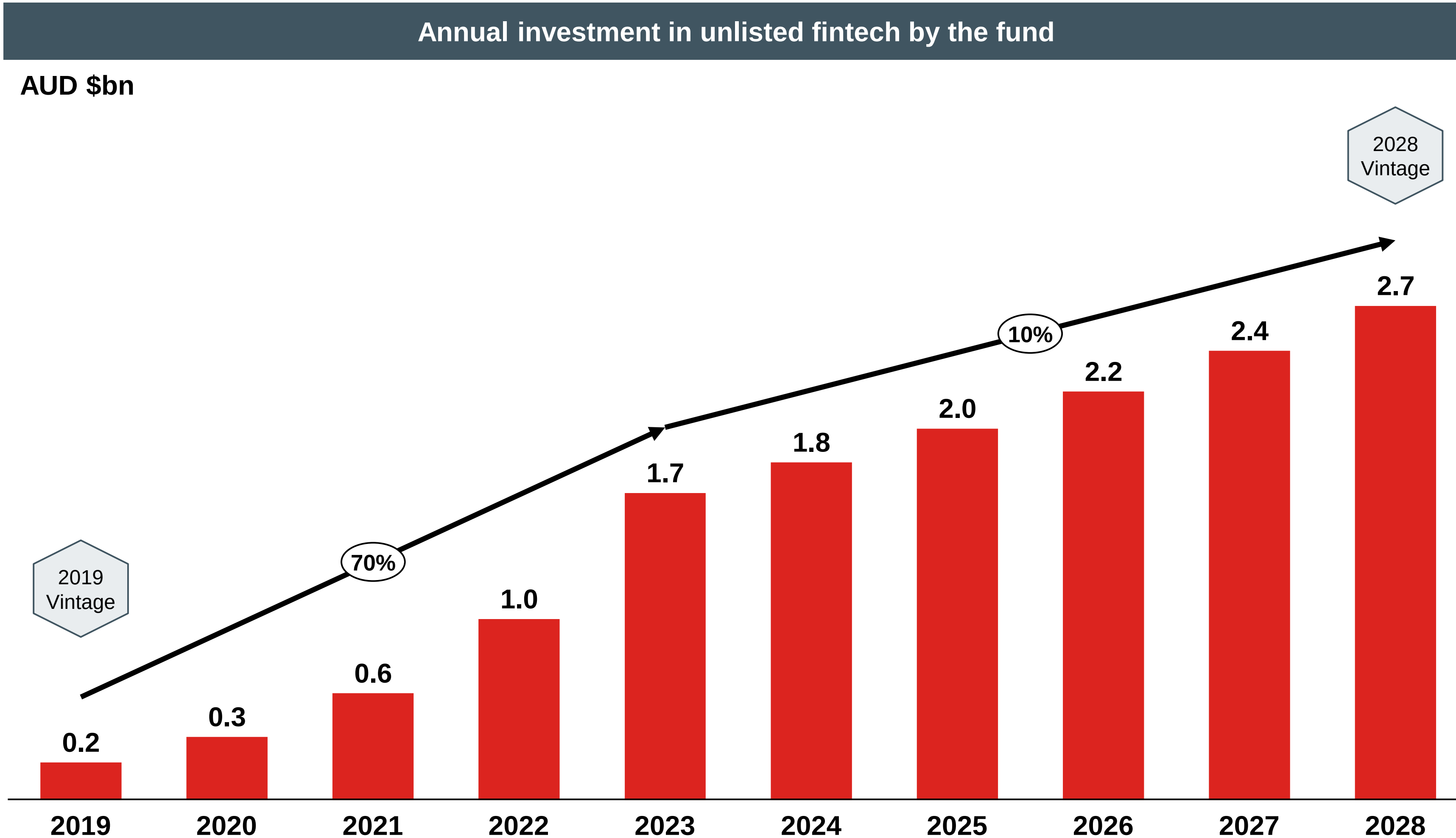
Technology vendors

InvestDigital

International

TOKENSOFT
Republic
COINTOPIA
ICO engine
COINLIST
INDIEGOGO
BLOCK EX
Digital Asset Exchange Platform

The Fintech Investment Fund will inject billions annually into Australian fintechs



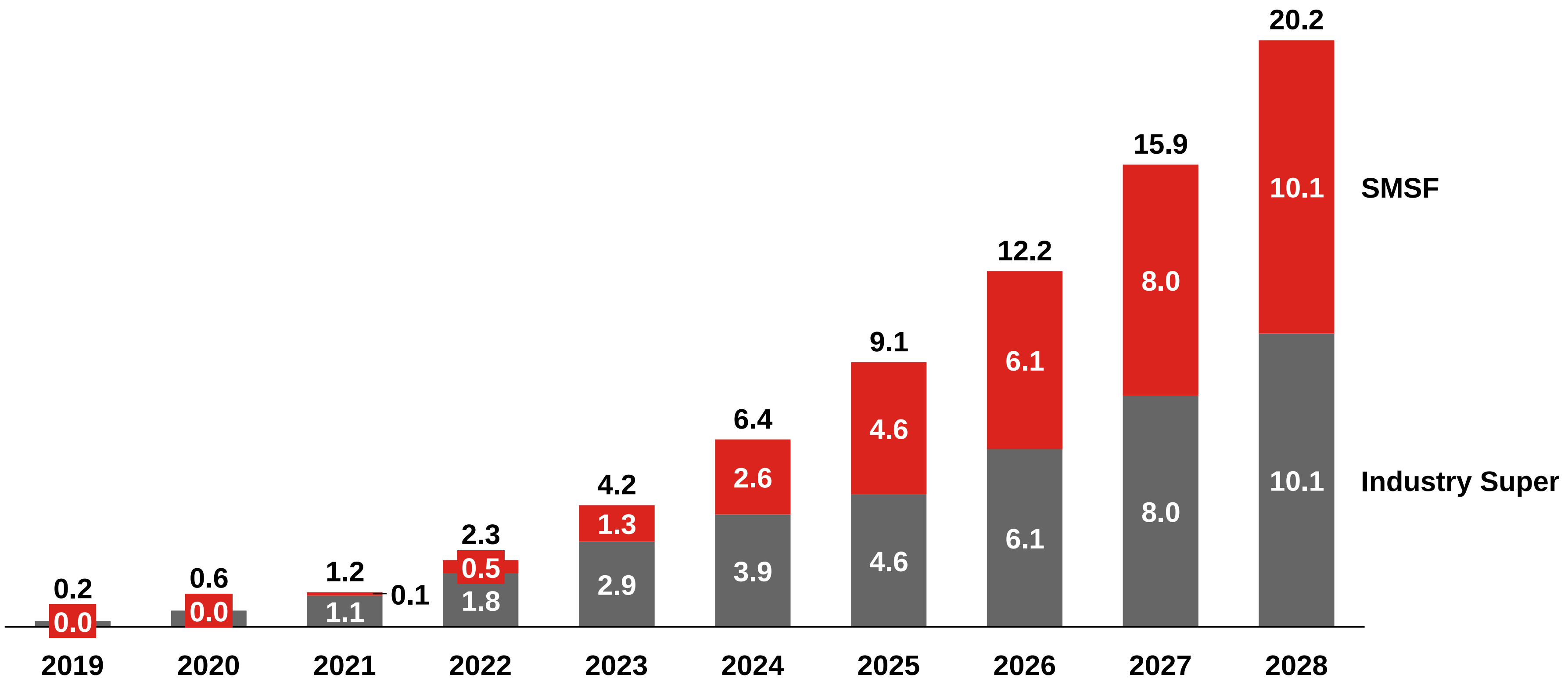
Source: author’s analysis; KPMG and IBIS World forecasts; Strategic insights and ATO data

Implied FUM targets for the fund are achievable

Total FUM in the fund by year

AUD $bn

	2019	2028
Market share of ISF allocation to alternatives	2.7%	4.9%
Market share of total assets for SMSFs >$1m	0.2%	0.97%

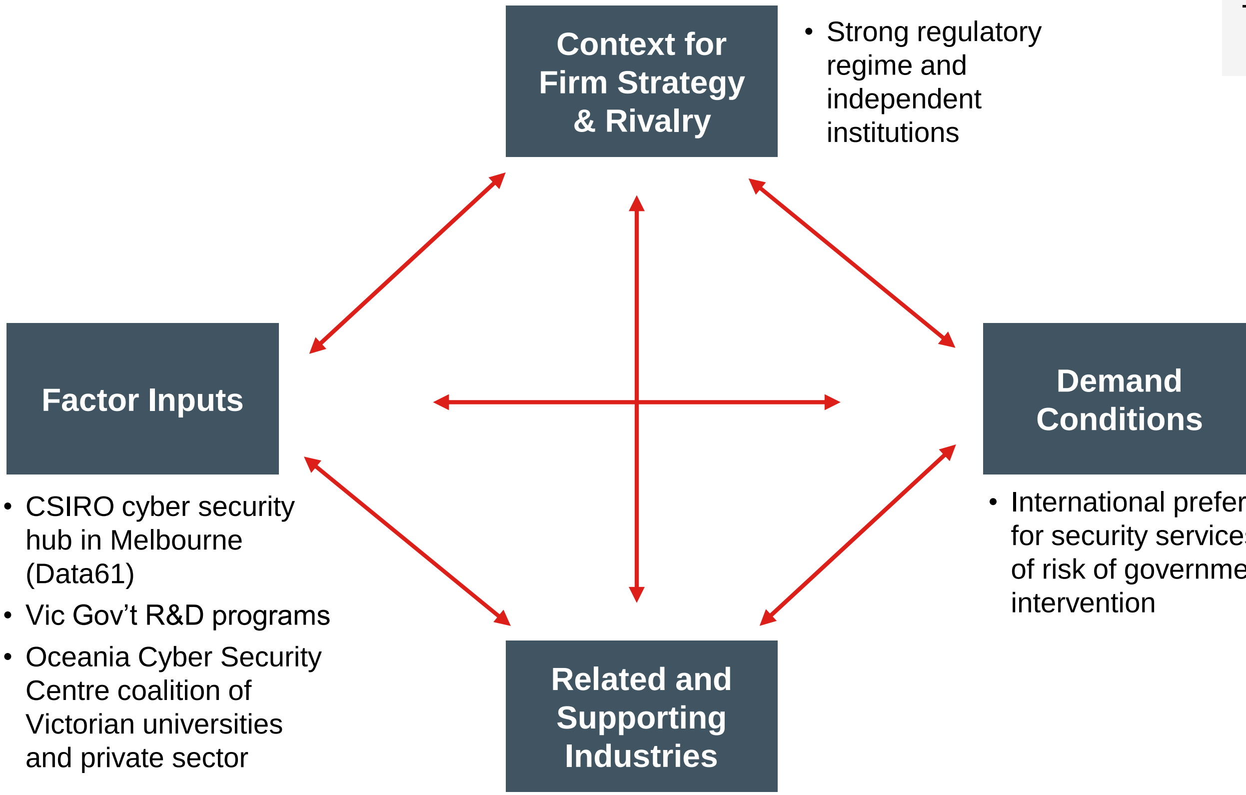


Source: author's analysis; KPMG and IBIS World forecasts; Strategic insights and ATO data

Focusing the impact of the Fintech Investment Fund into clusters of competitive advantage

Porter's cluster framework: financial cyber security in Melbourne example

Other cluster examples
- Regtech in Sydney
- Digital security exchange in Sydney



Context for Firm Strategy & Rivalry:
- Strong regulatory regime and independent institutions

Factor Inputs:
- CSIRO cyber security hub in Melbourne (Data61)
- Vic Gov't R&D programs
- Oceania Cyber Security Centre coalition of Victorian universities and private sector

Demand Conditions:
- International preference for security services free of risk of government intervention

Related and Supporting Industries:
- Quantum computing research (including UNSW quantum labs)
- Federal Government R&D contract with IBM through Melbourne hub

Framework source: Michael Porter, Harvard Business School

$20bn of fintech investment will transform Australia into a great financial centre of the future

- Protect Australian jobs and tax revenues
- Engage Super members through nation-building investments
- $20m outlay > drives $20bn+ investment in fintech > creates new sector of Australian economy