Balancing innovation and governance

Presentation to Institute of Internal Auditors

Wednesday 15 November

Good morning and thank you for the invitation to talk to you today.

Thank you particularly to Peter, Charlie and John for inviting me to speak to you.

I would also like to acknowledge and pay my respects to the traditional owners of the land on which we meet – the Gadigal people of the Eora Nation.

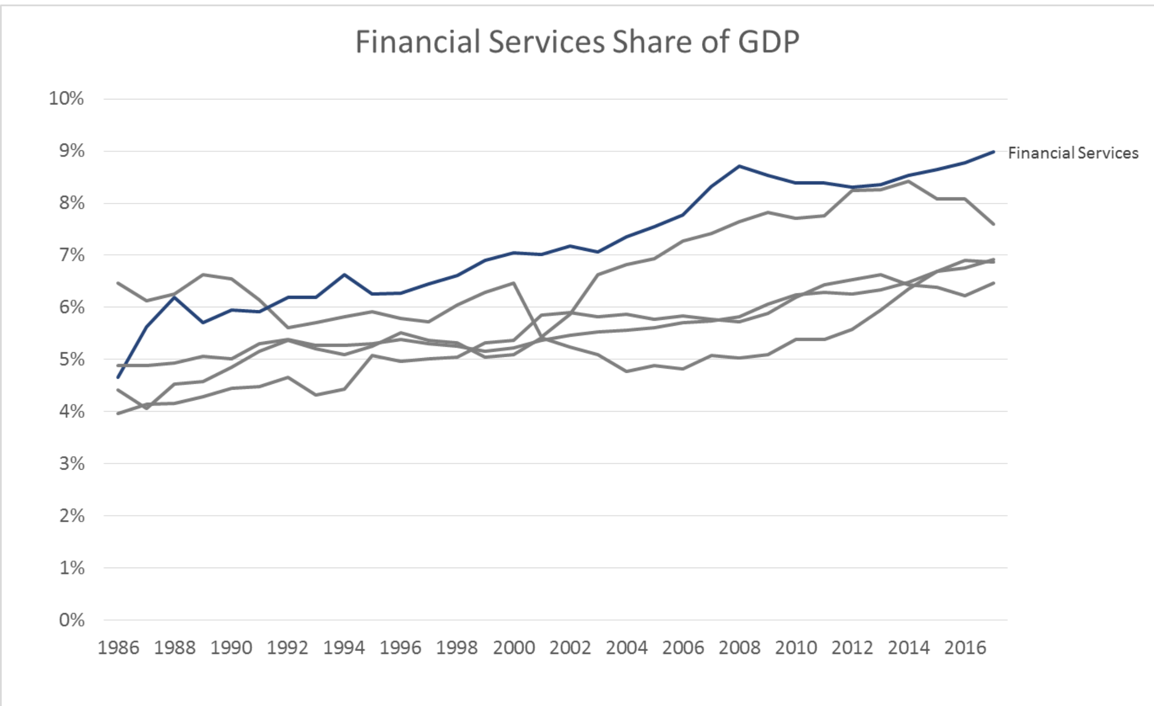
Today I will be talking to you about the issue of balancing innovation and governance in the Australian Financial Services Sector.

My central theme is that innovation and governance often go hand in hand — in many cases good governance will promote and enhance innovation.

But first I will discuss the state of the industry, both the good bits and areas for improvement.

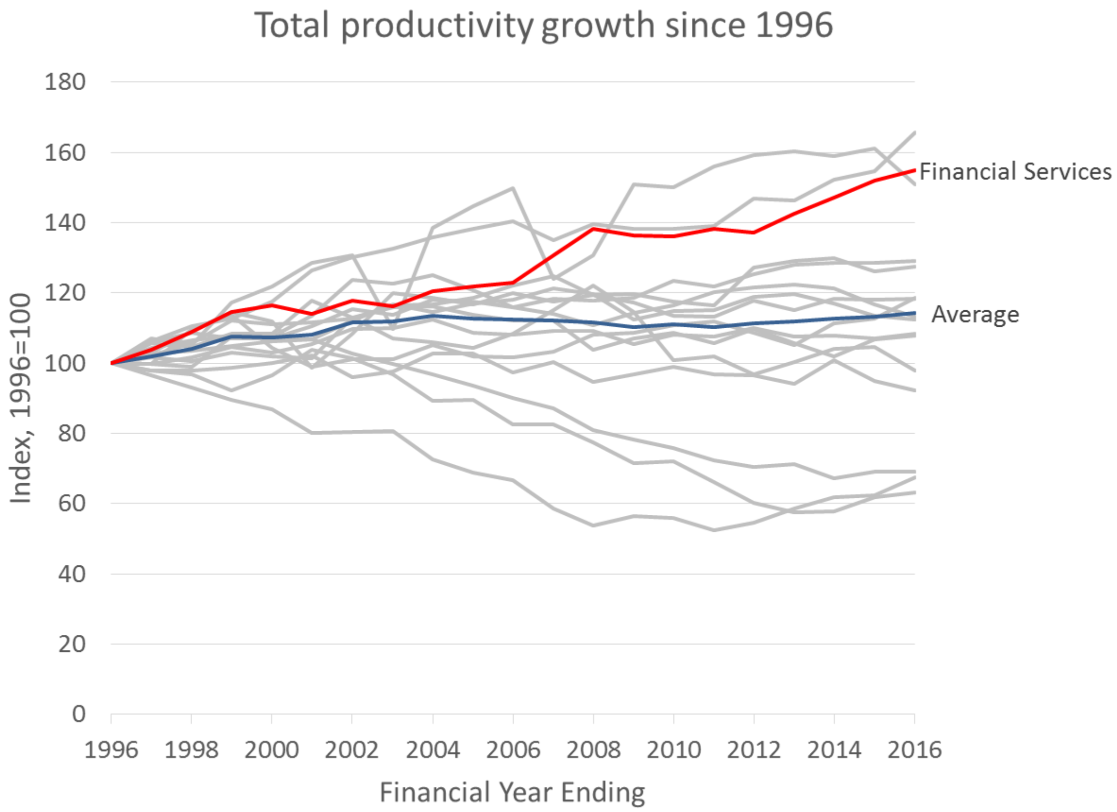
On several important measures, our industry is performing pretty well. Financial services is now the largest industry in Australia. Almost 10% of Australia's economy consists of the financial services sector — banking, insurance, superannuation, funds management, financial advice, and related businesses. This growth is shown in the graph.

SLIDE 1 (Financial services share of GDP).



Our industry is also one of the best performers for productivity, which is basically how efficient the industry is at using inputs such as workers and technology to generate outputs. Total productivity in financial services grew by 55% since 1996, the second best performance out of 16 industries and well above the average productivity growth of only 14%. This is shown in the graph.

SLIDE 2: (total productivity growth since 1996)



Furthermore, a recent review by the Productivity Commission found our sector was equal best in terms of long-term productivity growth.

Social value

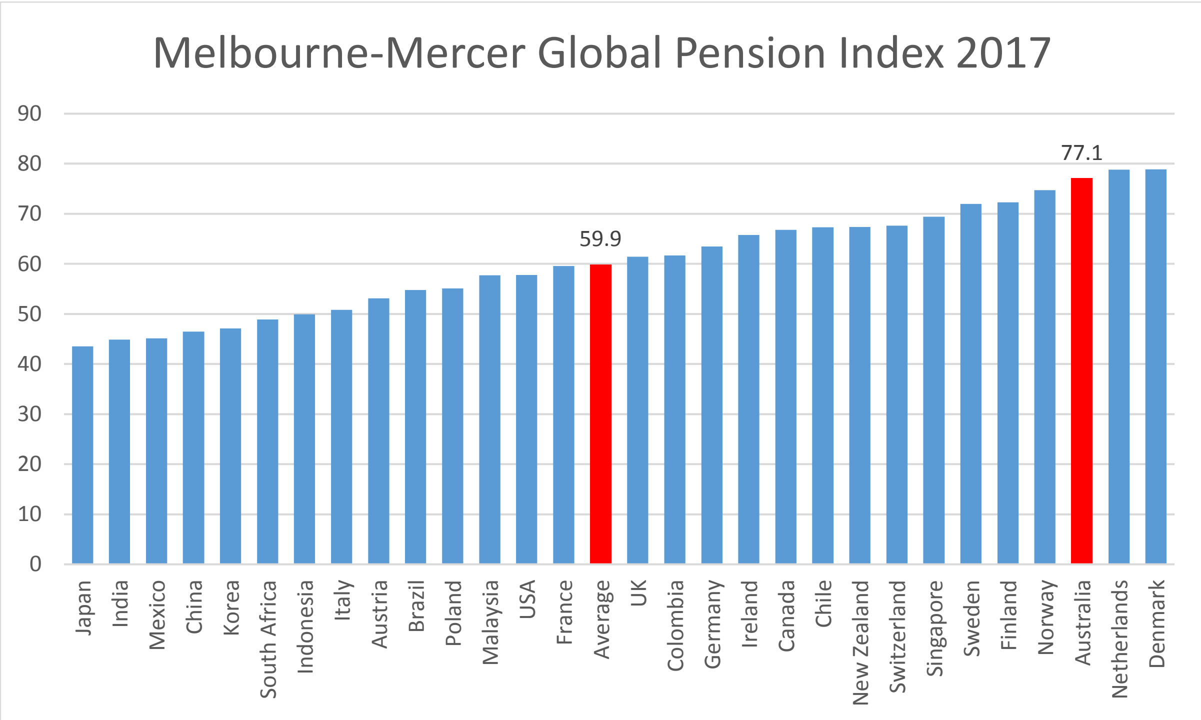
The social value of our industry is important as well.

- Our life insurance companies paid out $9.2 billion in claims last financial year, critical support to families suffering trauma, illness, death or loss of employment.
- Research for the FSC by the University of Western Australia, University of Adelaide and University of Technology Sydney shows clients of financial planners place a high level of trust in their advisers, and find real value in advice.
- Companies in our industry donated almost $700m to charities and foundations during last financial year.
- Our industry contributed $24.6 billion in company tax in 2014–15, the latest year available, which was 37% of all company tax paid in that year.
- The financial services sector manages just under $3 trillion under investment, mainly through superannuation. Australia's funds managers are providing increased security and financial independence in retirement for millions of Australians.
- On July 1, the life insurance industry's first ever Code of Practice commenced, providing new self-regulatory minimum standards of protection to consumers that lifts the bar above what is already in law.
- We're engaging with valued stakeholders, including mental health groups and geneticists to achieve a mutual understanding of issues and concerns so we can make insurance more accessible and sustainable.

- The FSC supports social justice cause, including Wayside Chapel's Side by Side event to look at new ways of closing the equality gap with social bonds and impact investing.
- Our recent roundtable on elder financial abuse has prompted the development of a new guide for financial services institutions to provide them with tools to identify abusers.
- The FSC and our members have contributed $1 million to First Nations Foundation over the past 5 years which is being spent on improving Indigenous financial literacy.

The Australian superannuation system also performs well against the rest of the world. The FSC recently hosted the launch of the 2017 Melbourne Mercer Global Pension Index, which ranked Australia as third best funds manager out of 30 countries surveyed as shown in this graph.

SLIDE 3: Melbourne-Mercer Global Pension Index 2017.



This doesn't mean our superannuation system is perfect, this index only rates Australia as B+. We could do better.

So where are some of the areas of weakness for our industry?

Exports

We are behind the game when it comes to financial services exports. Offshore funds only make up about 3.6% of our funds under management — so we are operating well behind our export potential.

By comparison Singapore and Hong Kong are way ahead of us. Offshore funds make up about 70% to 80% of their funds management industries. They have much more competitive tax settings — in particular corporate tax rates are well below ours, and they enjoy withholding taxes on non-residents that are generally zero.

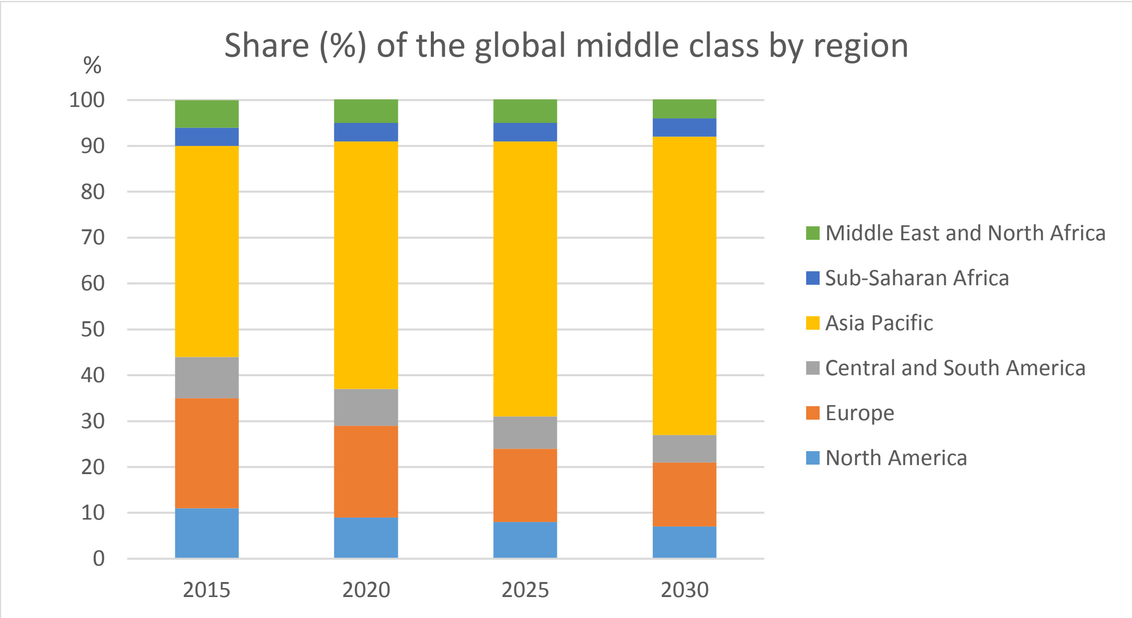
Some of the largest, and fastest growing economies are on our doorstep.

China is the world's largest economy, while India is third largest, Japan fourth, Indonesia eighth and South Korea fourteenth. And China and India combined have generated about half of total world economic growth in recent years.

With this overall growth, growth in the middle class is occurring - and consequently, so is demand for funds management and other financial services products like life insurance and retirement income products.

The graph shows the share of the middle class by region: Asia currently has 46% of the global middle class; this figure is set to soar to 65% by 2030.

<u>SLIDE 4: Share of the Global Middle Class by Region</u>



The scope for Australia to improve is clear.

The FSC has commissioned research showing that doubling our funds management export revenue would increase GDP by $330m by 2030. This would in turn support higher employment, wages and household incomes.

But we need to be mindful that other countries won't be standing still. Look at the United Kingdom for example: with Brexit, they will find it harder to export financial services to Europe and will look elsewhere. They are likely to see Asia as a destination for financial services exports. The UK is after a 'super competitive economy' with low taxes and a global focus.

As a result, London post-Brexit is likely to be a larger competitor in our own region. London is closer to Beijing than we are.

<u>However - we have been working on ways to help with improving the competitiveness of our industry.</u>

We've been working for several years with other countries in our region – initially Japan, Korea, New Zealand and Thailand - to create the Asian Region Funds Passport. This will enable regulatory harmonisation to make it easier for people – mum and dad retail investors in these jurisdictions - to invest in Australian investment products and gain access to investments not available in their home jurisdiction.

The reciprocal benefits for the vehicle we've dubbed the "UCITS of Asia" will also be available to Australian investors in the other Passport countries. The Passport is due to be launched next year – we took a group of fund managers to visit Tokyo and Seoul last month, and found growing interest in the opportunities.

Innovation state of play

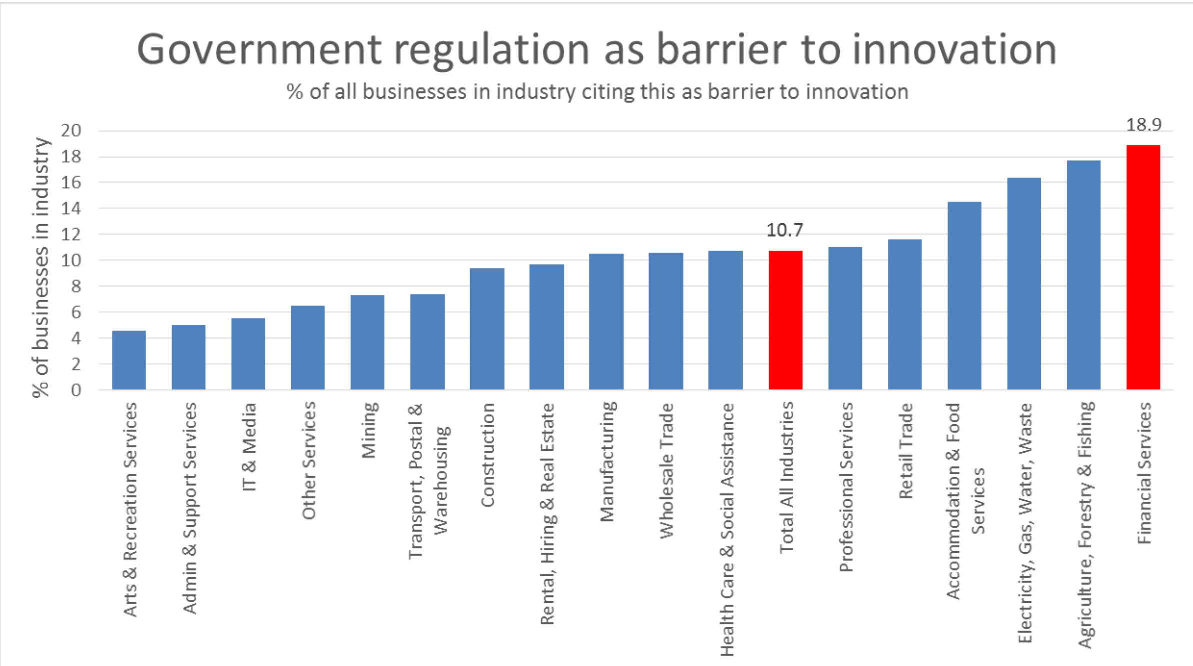
Are financial services innovative? In some parts. Those of you who use apps to bank, trade shares, claim health funds and add to your super fund balance via change rounding tools will know the power of digital technology. We are early adopters of tech in Australia and the leaders in this field in financial services are enjoying growing market share.

The fact is that we are above average: 53% of financial service businesses were innovative in 2015−16 compared to an average for all industries of 49%.

But there is clear room for improvement.

What are the barriers to innovation in financial services? There are a variety of obstacles, but the standout is government regulation. Our industry, more than any other, cites government regulation as the barrier to innovation, as shown in the graph below.

SLIDE 5: Government regulation as a barrier to innovation.



In addition, the negative effect of government regulations on financial services has increased most over the five years to 2014–15 - whereas most other sectors actually believed it has declined.

Regulation

The adverse impact of the significant regulatory burden on our industry is a message we hear frequently.

Our annual financial services CEO survey showed the costs of regulatory change. The 2017 results show 40% of CEOs are concerned that rapid regulatory change increases the risk of their organisation not complying with relevant laws and regulations, and that constant regulatory changes were raising costs. And many CEOs also indicate the new regulations are not delivering value or trust for consumers and the industry.

We also released research by Tria Partners earlier this year showing the past five years of regulatory change have cost the industry $2.75 billion, estimated to reach $3 billion when current reforms are fully implemented. This creates a real cost to consumers, estimated at $105 per superannuation account over the past five years: this is equivalent to 25% of the typical fixed fee charged to members.

This increasing regulatory burden hasn't appeared out of nowhere, it is partly a result of the current climate of political and economic uncertainty which started with the GFC.

Populism is also on the ascendancy here and overseas, and this is leading to policies that hinder trade. These policies are harmful to global growth and household incomes — and will also harm the financial services industry.

The uncertain political climate has meant governments find it more difficult to pass reforms that are beneficial for consumers and the industry, and a rise in populist proposals.

More broadly, we have also seen a drought of useful broader economic reforms. Over the past decade, we've seen two substantial reviews of our tax system, and they were both largely shelved.

Australia does have a strong commitment to free trade, a strong rule of law and strong regulators which has helped support our economy and engender trust from potential overseas investors – but we do need to be more competitive and innovative.

Public views & our response

The poor political climate is also feeding into views of our industry. We aren't the most popular business sector in the country. In addition, larger businesses are generically unpopular. So in combination, larger financial services businesses are the target of much criticism.

When he spoke at our Leaders Summit in July, former Treasurer Peter Costello pointed out that the four banks make up 25% of the ASX200. That means "an investment in Australian equities is an investment in Australian banks." He went on to ask an important question: Despite Australian "financial institutions proving more resilient than those in any other country coming out of the financial crisis in 2008, at the end of that are the banks held in higher esteem? No. What went wrong?"

Some of the criticism faced by financial services providers is fair, but not all of it. Regardless, financial service businesses are being held to high standards by the public, and we need to improve our game. The Financial Services Council has been encouraging many steps to improve governance in financial services.

In particular, the FSC has taken a leadership role in developing standards for our members. We are the only industry organisation with mandatory standards that all members must attest to annually. If they cannot meet these standards, they leave.

We have lost members as a result of the standards - and some companies have not been able to become FSC members because of the standards. But we see this as a positive not a negative.

We can say our members reach a higher bar on issues as diverse as mental health training, to stewardship standard for funds managers.

We didn't need government or regulators to impose a solution: we did it ourselves. The industry-led solution wasn't compromised by the political process, and it was developed by people with detailed knowledge of the industry.

The FSC's Code of Practice for Life Insurance has raised standards in the industry. The Code is binding on the FSC's life insurance members. It is delivering plain English disclosure, a timetable for claims decisions and a more transparent claims process, enhanced consumer protections during claims investigations, and additional support for vulnerable consumers.

This standard, along with many other standards set by the FSC are innovative responses to genuine concerns.

Even though the code has only recently started, we are already thinking about how it can be improved and we have started drafting the next version, called Code 2.0.

While the FSC has developed its own industry standards, we've also held back some calls for various excessive and unwarranted regulatory interventions. This includes proposals for a financial compensation scheme of last resort. Such a scheme would cost up to $300m per year and would effectively be another levy on top of the heavy burden the industry already bears as well as presenting a significant moral hazard.

Superannuation governance

However, sometimes an industry-led solution needs assistance from the government or regulators. A case in point is the legislation currently before Parliament to improve the superannuation system for consumers.

Included among a package of reforms is a proposal to raise the governance standards of super funds so that at least a third of board directors are independent.

FSC's standards require our members to have a majority of independent directors for the governance of super funds. Minister O'Dwyer's reforms should encourage innovation in superannuation. It will encourage innovative thinking in the parts of the super industry that are sticking with old approaches.

For example, an increase in independent directors would encourage some sub-scale funds to merge. Requiring more independents will likely improve the diversity of many fund boards, reduce the number of board members with very long tenure, and increase the number of board members with expertise in technology. All these changes are likely to drive innovation in the sector.

The reform package, which will also require funds to hold annual general meetings for members to attend, publish information about fees and be clearer about where they spend members' money, could easily result in significant gains to super fund members. In September, we released a report showing innovative product design in super could improve retirement balances by around 35% for people using MySuper products.

This report, jointly released with Trustee Tailored Superannuation Solutions, argued the reform could increase total super balances by up to $5 billion across the economy. The report also argued this product design innovation would be assisted by the super reforms mentioned earlier. Another case where governance improvements can encourage innovation.

Against the backdrop of an on-going Productivity Commission inquiry into the competiveness and efficiency of the default superannuation system, we are also calling for other superannuation reforms that will bolster both innovation and governance, in particular by increasing competition between super funds. Currently the employees of many super funds are prevented from exercising choice of fund as a result of their collective workplace agreements. Minister O'Dwyer recently stated that about two million Australians don't have choice because of legacy enterprise agreements.

These Australians would be permitted to have choice of fund if legislation currently before Parliament is passed. The current law protects some super funds from competition, which unsurprisingly discourages innovation. It also hinders the incentives for super funds to meet consumer demands.

Our research also shows that dismantling the barriers to choice and competition could reduce super fees by around $292m per year, a 13% decrease.

Other FSC analysis shows as much as $94 billion is trapped in 33 subscale funds. More worrying is that these funds make up 153 modern award listings, or 30% of all award listings.

Consumers deserve a competitive default super model that encourages engagement and is decoupled from politics. Our current system with its outdated industrial barriers that stifle competition between superannuation providers must be modernised to meet the 21st century. We call a new, flexible, competitive and open system Super 2.0.

If you give people information, choice and innovative products, they will engage.

A recent Mercer Super Fund Executive Survey which found that almost 90% of super fund executives don't seriously consider the treat from disruptors or technology; and two thirds were unconvinced that technology, digitisation and ease of interaction were important.

I think this reveals wither complacency or lack of understanding of what technology will bring to the industry by way of consumer benefits.

The funds protected from competition don't have to meet consumer demands, don't have to innovate, and don't have to grow more efficient.

New entrants are seeking to transform the industry using current technology. You might be aware of Grow Super, Spaceship, Zuper, Good Super and others. They are showing the incumbent funds that it is possible to overhaul the user experience with new, attractive and easy-to-use apps. They avoid industry jargon and speak to their members in language they can understand and engage with; they tap into the new technology of single touch payroll system; and they keeping their members informed when super contributions haven't been received.

If these new players can bring about these innovations in an uncompetitive operating market, imagine what the other players would be able to do — or need to do — if there was an open competitive market.

Competitive markets work best when engaged, informed consumers can choose a product offering that best suits their personal needs. This principle holds true for superannuation, as it does with any other product or service in our economy.

Engaged consumers in the superannuation market not only choose a product that is best suited to their needs, but their engagement also increases pressure on funds and their trustees to raise the standard of their products and reduce their costs to attract and retain members.

There is no reason why any efficient, well-performing fund – whatever its ownership structure – should fear open competition. Opening up super's default system to competition and choice will kick start an arms race in innovation to the benefit of all Australians.

Legacy products

There are other areas where regulatory change can remove barriers to innovation.

Of concern are the laws restricting or preventing the rationalisation of legacy products. Our current laws effectively mean we can't transition customers out of outdated or uneconomic financial products. As a result many businesses in our industry are stuck with outdated technology systems that are increasingly difficult to support. The barriers to innovation caused by this legacy are clear.

We've noted this causes some absurd problems for our industry:

- One life insurer needed to hire a computer programmer fluent in FORTRAN — a largely defunct programming language developed in the 1950s — to implement a regulatory system change
- Another has customer records stored on microfiche
- While a super fund had to buy a spare part on eBay for one of its legacy systems because the manufacturer doesn't make or supply it anymore.

If nothing is done, our industry will continue to be discouraged from innovation – for every time we innovate, there is an inevitable tail of legacy products. More legacy products means higher costs; higher costs from innovation clearly means less innovation.

So removing the barriers to rationalisation remains an important policy goal for the FSC.

Innovation

There are many other areas where the FSC is advocating changes to promote innovation — and in we're not talking here about reforms that involve a tradeoff for worsening governance.

We are enthusiastic about the potential for innovation in our sector. We've made a deliberate decision at the FSC to increase our focus on this area. It covers things such as Robo advice which is the automated provision of financial advice by algorithms and technology. While I will always advocate for expert financial advisers to be the first choice for people seeking the best possible financial advice, robo advice has the potential to increase consumer demand for advice.

Some other areas we'll be working on include RegTech, which is the use of technology for automating compliance with financial regulations. This can improve compliance with regulations, while reducing the costs to our industry of compliance. A win-win for consumers and the industry.

We're also exploring issues relating to digital Identity and a 'Regulatory Sandbox' which permits some exemptions from regulations for certain financial service innovations. We argue it is essential that regulatory barriers do not hamper product and service innovation by start-ups and incumbent businesses alike.

These areas of innovation should not hamper good governance. For RegTech, there is good potential that innovation will improve governance over time, for example by ensuring companies can identify breaches of governance standards on a near real-time basis.

However, it is far too early to say the benefits of innovation are guaranteed. As I've indicated earlier, there are substantial barriers to innovation, and poor policy could prevent beneficial changes.

An industry Royal Commission

I might end by looking at one idea we frequently hear: calls for a broader inquiry or Royal Commission into financial services. This would be a distraction from the work we are already doing to bolster the performance of the industry.

A Commission would put ongoing reforms on hold. We would have years of lost progress on industry reform; little or nothing would be done while the Commission is underway. Little or no governance reforms, disclosure reforms, competition reforms or reforms to regulators. The focus of industry and regulators would overwhelmingly be on the Commission.

This is not to say there aren't issues in the financial services sector. But existing regulators are well placed to deal with these issues.

Since the GFC, our industry, financial services, has faced more than 18 major reviews and inquiries, including the Financial System Inquiry, and many inquiries are ongoing. It isn't clear how a Royal Commission would add to these extensive inquiries.

And returning to the topic of innovation, it seems pretty clear that a Royal Commission would delay or halt significant innovation in our sector. It would put a handbrake on efforts to improve the industry's performance, productivity and consumer focus as we would become largely inwardly focussed and risk adverse for years.

Conclusion

In conclusion, there are many things our sector does well, but many where we could improve. There are too many issues holding back innovation in our sector, and the FSC has been calling for reforms in a wide range of areas to remove these barriers.

And in many cases, we are talking about reforms that encourage innovation and governance improvements at the same time. Mandating more independent directors for super should help both; as will extending super choice to many more Australians.

These two issues often go hand in hand.

Thank you for the opportunities to discuss these issues with you today.