FINANCIAL SYSTEM INQUIRY

CHAPTER TWO

FINANCIAL SYSTEM USERS

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This chapter considers how users interact with the financial system. We focus largely on Australian consumers and businesses. Other chapters focus on particular elements of the financial system as an industry or the regulatory structure in which we operate. This chapter squarely deals with the system from an external perspective.

We canvas three major issues faced by users of the financial system:

1. consumers and technology: evolution and how the system remains fit for purpose;
2. indigenous engagement; and
3. financing needs of Australian businesses.

Our findings are supported by independent, external research.

CONSUMERS

The regulatory framework underpinning Australia's financial system must meet the needs of consumers today and be flexible enough to accommodate innovation which meets expectations of users tomorrow.

A key consideration that influenced the outcome of the Wallis inquiry was the acceptance of the fact that technological innovation had been a major force in shaping the delivery of financial services in the past decades and that it would continue on an even greater scale in future.[1]

Similarly, an objective of the Financial System Inquiry of 2014 is to make recommendations that foster an efficient, competitive and flexible financial system, consistent with financial stability, prudence, public confidence and capacity to meet the needs of users in light of the role and impact of new technologies, market innovations and changing consumer preferences and demography.

[1] The Financial System: Towards 2010 – Overview, Financial System Inquiry Final Report (Wallis), released March 1997.

In order to inform the FSC's recommendations that are necessary to drive the growth of a digital financial services sector that meets the needs of its consumers, research house GfK were commissioned to undertake research including consumer polling completed in February 2014,[2] to understand:

1. current levels of consumer financial literacy;
2. attitudes towards the use of technology for financial services research, products and services; and
3. propensity to engage with digital technology for the purposes of wealth management and protection in the future.

A copy of the complete research has been included as an appendix to this chapter.

DIGITAL TECHNOLOGY ENGAGEMENT

To demonstrate the exponential growth in digital engagement in Australia, the Financial System Inquiry Final Report stated that in 1995, 47% of Australians owned a personal computer (PC) and just 15% of households had a modem.

In less than a decade, digital engagement in Australia is almost universal with most Australians having access to a digital, internet-able device (94%) including 84% of households having access to the internet at home and 72% of Australians owning a smartphone.

Additionally, 74% of Australians access the internet on a daily basis, for the equivalent of a full day per week. Device ownership is also projected to grow and in particular, tablet ownership is expected to grow by 15% by 2015 to 55% of the population. The level of engagement online is consistent across the adult population, including the fact that 37% of internet users in Australia are over the age of 50, which is the equivalent of 86% of that demographic.

Given such rapid growth and the ongoing emergence of new technology, it is possible that technology considered as new and innovative today could become out-dated in a relatively short period of time.

For many years, technology has left regulation behind. As a result, the financial sector has been unable to meet the changing needs of consumers.

[2] Consumers and Technology: openness to technology in wealth management, undertaken for the FSC by GfK Australia, February 2014.

Consequently, the FSC submits that it is critical that the regulatory framework underpinning the delivery of financial services to consumers is drafted in such a way as to accommodate the rapid developments in technology.

The financial system must keep pace with the changing needs and expectations of consumers and preferences as to how they engage with the products and services of the financial services industry.

It is essential that legislation is drafted in a way that remains 'technology-neutral' to ensure that innovation by financial services providers is encouraged to drive competition, efficiency and accessibility whilst maintaining appropriate and effective consumer protection.

Although there are examples of legislation and regulation which have attempted to grapple with this concept (such as the Electronic Transaction Act), these efforts have been largely piecemeal and do not pervade the wider corporations and financial services legislation.

There have been examples in recent years where exemptions have been granted through ASIC Class Orders for providers where digital interaction with consumers has been been sought but was not possible. For example, in January 2014 this year, ASIC issued Class Order 13/6121 which waived the Corporations Act requirement for Responsible Entities to receive a paper-based signed application form from consumers wanting to purchase a managed fund.[3]

In an age of online purchase and delivery of goods and services, the regulator should not be required to undertake a laborious process of issuing subordinate legislation for digital delivery of disclosure documents. Rather, the default should be a technologically neutral legislative framework.

RECOMMENDATION

The FSC recommends the Inquiry ensures that financial services regulation is technologically neutral to allow evolution as technology changes.

[3] See for example C/O 13/1621 http://www.asic.gov.au/asic/asic.nsf/byheadline/14-002MR+ASIC+issues+class+order+providing+relief+for+the+mFund+service?openDocument

RETAIL AND FINANCIAL HABITS ONLINE

According to the research completed by GfK for the FSC, nine out of 10 Australians (i.e. almost all internet users) have shopped online in the past six months, with the most common e-commerce activity undertaken being banking and/or paying bills.

Over and above using online technology to undertake financial services transactions, the use of digital technology to research and search for products and services is common and increasing. According to the FSC research, 50% of those polled indicated that they were increasingly using the internet to search for products (in all categories).

The research also tested current consumer attitudes to engaging in wealth management and protection-related activities online. The research demonstrates that a majority of adult Australians are comfortable engaging with traditional financial services such as banking or credit card transactions online, with 80% indicating they had undertaken banking-related activities online in the past 12 months and 67% having purchased online using a credit card.

The research also revealed that in general, adult Australians are also just as likely to conduct wealth management online as offline. This was reflected in the changing nature of engagement with superannuation, 84% of those polled have superannuation, and of those, more had checked their balance online (39%) in the previous 12 months than offline (25%).

Similarly, of the 19% of respondents who indicated they owned a professionally managed investment, more than half had checked or modified their investment and 34% of those did so online compared with 28% offline.

However, it is clear that barriers remain in relation to the level of online engagement with other wealth management activities, including financial advice (just 13% sought financial online) and life insurance (just 7% had sought online).

FUTURE DIGITAL WEALTH MANAGEMENT: INTENTIONS AND HURDLES

The research clearly demonstrates there is a significant level of existing online consumer engagement with wealth management and a propensity to engage with the industry in the future. It is clear that barriers remain that may be addressed through reforms to the current regulatory framework through an ongoing, consistent approach to improving consumer financial literacy and understanding.

Significantly, three in four adult Australians are open to conducting at least one wealth management activity online, and one in two are currently doing so. This is further reduced to just 34% per cent if checking existing products is excluded.

This means that one in four Australians would conduct wealth management online, but currently identify barriers to doing so.

Mistrust and fear about online security

According to the research, just under one third of adult Australians have confidence in their financial knowledge when it comes to wealth management, and less than half are comfortable with conducting wealth management online.

This sentiment also translated to the propensity to engage with wealth management online – a greater proportion (45%) of those who considered themselves to be financially savvy were also happy to conduct activities online compared to just 32% of those who were less confident.

However, rather than a lack of confidence in the products and services, from the research that the main barrier to a greater level of engagement with wealth management online is anchored on a mistrust in or fears about online security – almost 70% of respondents indicated they had reservations about online and of these, almost 70% identified mistrust/fear as the greatest barrier.

This is inconsistent with consumer attitudes towards security in relation to everyday banking activities.

We believe that financial education is needed to alleviate these fears and to engender trust in digital financial advice.

The FSC strongly supports the important role that can be played by government and the industry to raise the level of financial literacy and education amongst the community.

Lack of knowledge and understanding

A secondary barrier was a lack of knowledge about how to go about wealth management and protection activities online. Again, the FSC submits that there is an important role for financial education and greater accessibility to 'scaled' financial advice in order to overcome this barrier.

We also note that reforms that support improved accessibility of financial advice in general are likely to result in its increased use through both traditional and digital means.

Simplification of disclosure

A final barrier to greater online engagement with wealth management identified through the research was the perceived difficulty of the process. FSC supports consumers being able to receive comprehensive disclosure about financial products and providers. However disclosure has become complex and difficult to digest.

Two in five who are not open to conducting wealth management online say the process is too hard, including almost 18% believing the volume of documentation to be read was a barrier to engagement.

Just one per cent of those who were not open to online access felt that way because of a preference for face to face engagement.

We submits that the existing disclosure regime is out-dated and is no longer meeting the needs of consumers in an increasingly digital age.

Existing disclosure methods prescribed by regulations, particularly for existing customers for example, typically require the prior express consent of the customer, which in itself is a requirement that exhibits a bias towards existing paper-based or other forms of disclosure.

At the same time, innovative uses of new technology have allowed better reporting, security and identity checks to be undertaken, particularly where transactions are involved in a far more timely and cost effective manner.

At present:

- there is no uniform approach to disclosure. Disclosure requirements differ depending on the financial products and services offered; and
- disclosure does not properly reflect a technology neutral approach.

We submit that the findings of the FSC's research highlight the fact that increasingly, consumers are actively searching online for information about products and services and as such, may not want it "pushed" to them but rather would prefer to "pull" particular pieces of information and only be told how, where or when it is available.

An example of this is that of the 30% who had read a Product Disclosure Statement (PDS) in the previous 12 months, more (21%) had done so online rather than offline (15%).

Online PDS documentation is simply available in the form of an online version of a paper-based document. PDSs are typically voluminous. Although there have been short-form PDSs in the market for some time, the PDS remains a blunt tool which provides consumers with enormous amounts of information without the possibility of it being broken down into chapters.

RECOMMENDATION

The FSC recommends the Inquiry find that the current disclosure regime is not taking changing consumer preferences into account and is hampering consumer engagement.

We further recommend a new disclosure regime be implemented which recognises consumers have a preference for digital engagement and the ability to access "piece by piece" information.

For example, consumers may be seeking information solely on a particular element of a financial product such as fees or asset allocation.

There is no mechanism to unbundle this information to provide "bite-sized" information.

Therefore, we submit that reform should be forthcoming to provide greater flexibility for consumers and providers to send or make relevant information available in an effective and efficient manner.

Further detail in relation to the FSC's recommendations about disclosure can be found in the Regulatory Architecture Chapter of FSC's submissions to the Inquiry.

INDIGENOUS AUSTRALIANS AND FINANCIAL SERVICES

INTRODUCTION

Access to and engagement in financial products designed to protect people's lives and provide retirement savings is highly desirable. Unfortunately there are a range of barriers which prevent certain communities, such as Indigenous Australians, from accessing and engaging in financial products, such as superannuation and life insurance.

A high level of disengagement and confusion among some groups of Australians is particularly troubling, given that superannuation and life insurance have become compulsory financial products for all working Australians. Life insurance protection has been provided for under the recent MySuper reforms and will therefore become increasingly significant to all working Australians.

We appreciate that many of the problems associated with access to and engagement in these products may be a function of certain cultural factors or barriers, rather than, necessarily, the strict operation of the Anti-Money Laundering (AML) / Counter Terrorism Financing (CTF) regime.

However, there are legal and regulatory factors which inadvertently exacerbate these problems and which should be considered if we are to promote access to and engagement in financial products for all Australians, including the Indigenous community.

The AML regime has made it challenging for superannuation funds and life insurance companies to identify Indigenous Australians for the purpose of providing them with access to superannuation and life insurance products. We understand that one of the objects of the AML regime is to ensure that persons seeking to acquire financial products are appropriately identified. However, we believe there is scope to permit flexibility in the application of the AML regime so as to recognise the unique needs of certain cultural groups, such as Indigenous Australians.

We note the following problems with identification of Indigenous Australians:

1. Regular loss of contact or incomplete information leading to information gaps;
2. Inability to utilise uncertified documents for AML purposes, such as community identification cards (for example Larrakia ID cards);
3. Multiple name changes ("name conventions") which are inconsistent (and therefore not recognisable for AML purposes) from the original name provided upon acquiring a financial product; and
4. Name conventions that affect beneficiaries of life insurance policies when making insurance claims following the death of a family member.

The inability to identify someone under the AML regime may cause the person confusion and may result in them being unable to access their superannuation or life insurance. This problem is particularly pronounced in remote Indigenous communities where identification problems are most prevalent.

Based on a survey of over 20 superannuation funds conducted in late 2013, the FSC is aware that at least 31% of superannuation funds have had problems processing life insurance claims, with 10% of these being directly related to Indigenous in information provided at the time of acquiring the product and the information available at the time a claim is made.[4]

We therefore believe that it is appropriate to consider some targeted flexibility in the application of the AML regime which recognises that the regime may have unintended and undesirable outcomes for Indigenous Australians. We set out below our further suggestions on how this might be achieved.

We understand that the AML regime establishes a risk-based approach to regulation and that the key principle which underpins the risk-based approach is to implement measures that prevent or mitigate money laundering and terrorism financing which are also proportionate to the identified risks.

Further, we understand that the Government is committed to reducing the dead weight of regulation which can be counter productive.

[4] Anonymous survey of over 20 superannuation funds undertaken by industry associations in 2013.

We suggest that in addition to the broader industry, the Inquiry should also be concerned with reducing the unintended and undesirable outcomes of the AML regime for Indigenous Australians.

The risk associated with Indigenous Australians' access to superannuation and life insurance products is in our view low in relation to the significant financial crime risks that the AML regime seeks to address.

As such, in line with the risk-based approach to regulation, we submit that a more flexible approach to due diligence/customer identification is desirable in relation to Indigenous Australians and their access to certain financial products. This is especially so, given the compulsory nature of superannuation and life insurance products and the fact that Indigenous Australians, like all other Australians, are compelled to invest a proportion of their earnings in superannuation.

FLEXIBILITY

The existing AML regime includes provisions which enable the AUSTRAC CEO to provide relief from the identification problems facing Indigenous people by:

I. making Rules that exempt a reporting entity from complying with provisions under the Act (s 247); or
II. by modifying the operation of provisions of the Act in relation to reporting entities (s 248).

However we do not believe these powers have been used to address identification or cultural issues facing Indigenous people.

Accordingly we seek legislative change.

RECOMMENDATION

The AML and CTF Act should be amended to provide an exemption from certain applicable customer identification requirements which could be applied for certain localities, cultural backgrounds or for particular documents, of relevance to the Indigenous community.

In our view, this approach would ensure better access to the benefits of in these financial products by Indigenous Australians and alleviate the compliance burden on financial institutions that provide superannuation and life insurance products to Indigenous Australians.

We believe that this can be achieved in harmony with the risk-based approach to regulation in this area and without compromising the broad financial crime prevention objectives of the AML regime. An additional provision could be inserted in the legislation following consultation with the Indigenous community and the financial services industry.

BUSINESS FINANCING

Capital markets should act to service and provide the corporate financing needs of businesses so as to establish and grow. It is important that Australian businesses of all sizes can access capital to finance their operations.

To better understand the way Australia's financial system finances Australian businesses on a comparable basis, the FSC commissioned the Capital Markets Cooperative Research Centre (CRC) to examine the capital market structure in Australia and make comparisons to three relevant markets: Canada, the United Kingdom, and South Korea.

The research reviewed the corporate financing options available to companies in each country. It analysed the capital mix of companies and size of debt and equity markets. The paper considered both financing options for large but also small and medium enterprises (SMEs).

This research paper forms the basis of this part of the FSC's submission. In commissioning the research, the FSC and the CRC considered appropriate markets to compare. The countries chosen and the reasons were:

- the UK - global benchmark;
- Canada - scale comparable market; and
- South Korea regional comparable market.

FORMS OF FINANCING

Companies face many decisions regarding the method by which they finance their operations. The initial choice is between external and internal financing. Where internal financing is largely sourced through retained earnings, external financing requires further decisions regarding the composition and source of debt and equity financing.

Other factors influencing the capital market structure of an economy are taxation policy and regulation.

Debt and equity

The total size of the debt market in Australia is comparable to the Australian listed equities market (approximately $1,210 billion v $1,400 billion). However, this figure includes government bonds and short-term interbank lending which account for 80% of the Australian debt market. After filtering out these securities, the total value of corporate bonds outstanding in Australia is approximately $209 billion (equal to around 20% of GDP), of which non-financial corporations represent less than 20% of the market.

In itself this represents significant growth in the size of the market; in 1997 the market value of corporate bonds was approximately $30 billion (equal to approximately 5% of GDP).

Figure 1. Outstanding value of corporate bonds issued by corporates within each market ($US billion)

	DOMESTIC CORPORATE BONDS		INTERNATIONAL CORPORATE BONDS
	TOTAL	NON FINANCIAL	
AUSTRALIA	209	45	51
UK	328	170	376
CANADA	330	202	213
SOUTH KOREA	847	491	49

Source: Bank for International Settlements, AsianBondsOnline, ABS

The corporate bond market in Australia is therefore comparatively small, particularly in the non-financial industry sectors.

Several factors have dictated the fate of Australia's corporate bond market.

- Banks typically offer better borrowing rates to businesses than they could achieve through corporate bond markets.
- Secondary market liquidity is limited. While annual turnover in the Australian corporate bond market has increased 31.2% to $777 billion in 2012-13 from 2011-12, this is a fraction of the exchange equity market turnover in Australia ($1,151 billion) and equity derivatives market ($3,327 billion).
- The strength of the government bond market in Australia, while providing a number of benefits to the development of broader capital markets, may also have done a disservice to corporate bonds which, in effect, are "crowded-out" of the fixed-interest demand space.
- Retail investors prefer higher yielding assets than most corporate bonds offer (which may be a result of the dividend imputation system). Bond issuers are unwilling to pay an additional premium, and retail investors instead hold hybrid securities as an alternative to meet their return demand.
- Conversely, companies are able to access a range of innovative subordinated and mezzanine financing alternatives.
- Investors are also less likely to prefer to hold corporate bonds over a range of other investors given the low and inconsistent historical issuance of volumes.
- Bondholder rights are limited in Australia as corporate issuers are reluctant to give many covenants. In part, this may improve as the education and culture surrounding corporate bond investments improves in Australia.

RECOMMENDATION

It is recommended that the inquiry find:

- The bond market in Australia is small but growing; and
- The size of the corporate bond market is the result of market outcomes in Australia rather than any particular distortion arising from financial system regulation;
- There is no need to create an artificial bond market.

Ratios

Debt to equity ratios in Australia are in-line with those experienced in comparable markets. This is the case at the small, medium and large firm level.

Figure 2 below shows the average debt-equity ratio and debt-value ratio for listed companies in each of the four markets considered.

Figure 2. Average Debt-Equity Ratios for Large, Medium and Small firms

	LARGE	MEDIUM	SMALL
AUSTRALIA	1.417	0.927	0.459
CANADA	1.181	0.963	0.152
UK	1.246	0.796	0.220
SOUTH KOREA	3.746	0.710	0.676

Source: Datascope

Firms in Canada (0.844) Australia (0.835) and South Korea (1.25) have the higher average debt-equity ratio of the countries considered.

This could partly be due to the rapid movement to de-leverage among corporates in the UK post-GFC relative to the less-affected markets of Australia and South Korea. **Figure 3** shows the average debt-equity ratios for companies of different size in each of the markets considered.

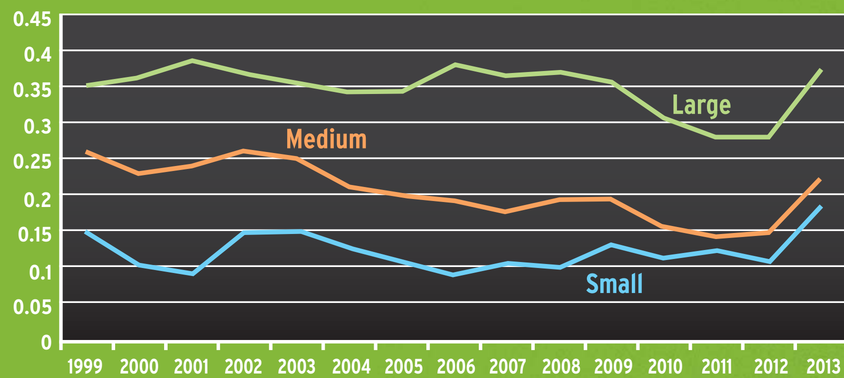
Figure 3. Debt Ratio, Australian Companies by Value

	LARGE	MEDIUM	SMALL
AUSTRALIA	1.417	0.927	0.459
CANADA	1.181	0.963	0.152
UK	1.246	0.796	0.220
SOUTH KOREA	3.746	0.710	0.676

Source: Datascope

On average, the debt-to-equity ratio is lower for small companies than for large companies. This result is in line with expectations set. Furthermore, this pattern has been relatively consistent over time. Overall it suggests that companies in Australia do not find it difficult to access debt on a comparative basis.

Figure 4. Superannuation assets and superannuation accumulator



Sources: 2012-13 Commonwealth Budget, Statement 4

Debt-to-equity for SMEs in Australia is high compared to UK, indicating that there is no "financing gap" in our markets as SMEs are able to source debt from banks. Bank financing is typically cheaper for SMEs than accessing finance via the capital market.

RECOMMENDATION

It is recommended that the Inquiry find:

- There are no significant distortions to capital flows in Australia when compared to comparable capital markets; and
- Australian small, medium and large sized businesses do not experience a debt financing gap.

Dividend imputation

The uptake of external financing options is affected by taxation and regulatory environments.

Dividend imputation lowers the cost of capital for companies with shareholders that value franking credits. As such, imputation systems may encourage business investment and grow supporting financial markets. The FSC supports dividend imputation.

These benefits notwithstanding, there are confounding biases arising from dividend imputation which affect the market's capital structure. Firstly, some investors will prefer equity over debt if they can access the tax offset benefit. These will generally be higher-income earning

residents in the same country as the company (as access to imputation credits is often restricted to residents). This may, in part, explain the relatively large off-shore issuance of corporate bonds compared to domestic issuance.

Secondly, those investors who attach a value to franking credits will prefer to hold companies which have operations primarily in Australia. This is because the Australian government regulation on franking credit treatment limits creditability of earnings that have paid foreign taxes. This consideration, however, needs to be weighed up against the comparative tax rates of the foreign markets.

Finally, the dividend imputation system can be seen to disproportionately benefit large companies over small companies. The cost of capital under imputation is lowered only when there is franking credit value. Many small companies reinvest their earnings (as noted earlier in this report, retained earnings is a significant part of small business financing), which dictates a low or non-existent dividend policy. Individuals who value franking credits will prefer to hold companies paying large dividends, and thus prefer to direct their investments away from small companies.

Dividend imputation provides an incentive for large corporations to use equity rather than debt as this system lowers the net cost of financing to the firm and matches the aggregate preferences of the investors within the market. This makes dividend imputation both a demand and supply phenomenon.

CHAPTER 2 RECOMMENDATIONS:

The FSC recommends the Inquiry :

1. The FSC recommends the Inquiry ensures that financial services regulation is technologically neutral to allow evolution as technology changes.
2. The FSC recommends the Inquiry find that the current disclosure regime is not taking changing consumer preferences into account and is hampering consumer engagement.
3. We further recommend a new disclosure regime be implemented which recognises consumers have a preference for digital engagement and the ability to access "piece by piece" information.
4. The AML and CTF Act should be amended to provide an exemption from certain applicable customer identification requirements which could be applied for certain localities, cultural backgrounds or for particular documents, of relevance to the Indigenous community.
5. It is recommended that the inquiry find:
   - The bond market in Australia is small but growing; and
   - The size of the corporate bond market is the result of market outcomes in Australia rather than any particular distortion arising from financial system regulation;
   - There is no need to create an artificial bond market.
6. It is recommended that the Inquiry find:
   - There are no significant distortions to capital flows in Australia when compared to comparable capital markets; and
   - Australian small, medium and large sized businesses do not experience a debt financing gap.