INNOVATION *and the Financial System Inquiry*

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The FSI rightly has a strong focus on innovation in its recommendations on how the financial system can better meet the needs of growth in the Australian economy. This paper appraises the inquiry's recommendations in four areas: collaboration to enable innovation; crowdfunding; data access and use; and comprehensive credit reporting. The inquiry highlights that openness to innovation with regard to information sharing by government, existing participants and regulatory bodies is not strong in Australia. These policy settings will need to be addressed in order for the financial system, and the whole economy, to take full advantage of these opportunities to innovate.

At the heart of the Financial System Inquiry is the objective 'to assess, and make recommendations on, how the financial system can most effectively help the Australian economy be productive, grow and meet the financial needs of Australians.[1]

To assess this objective, the inquiry uses the criteria of stability, efficiency and fairness. Apart from evident changes over the past 16 years since the Wallis Inquiry, such as increased concentration in the banking sector, the growth of the superannuation system, and global re-regulation, a remarkable aspect of this inquiry has been its need to address the all-pervading presence of technology and digital disruption in most areas of the financial system.

The value of innovation becomes apparent in the context of industries dominated by a small number of large firms increasingly focused on core competencies and economies of scale (and subsequent cost controls) to drive profit growth. New firms can challenge incumbents by offering alternative products and services to customers, and can assist in the evolution of business processes through the development of new technologies.

Technology provides opportunities to lower barriers to entry in financial services, reduce transaction costs, address issues of information asymmetry, empower consumers and facilitate international linkages. This is evident across the payments system, in credit markets, debt and equity markets, and in retirement savings and advice.

While technology offers many benefits, especially in terms of contributing to the goals of efficiency and fairness, it also presents risk, and from the inquiry's point of view, this must have been particularly challenging as many aspects of digital disruption are yet to fully play out. Although it is estimated that as much as $27 billion of current banking industry revenue[2] is under threat from digital disruption, the Report recognises that responding in an open, timely and coordinated manner across both regulatory and industry sectors is critical if the benefits of this disruption are to be maximised.

From its inception the inquiry stressed the importance of removing unnecessary government regulation and other impediments, to preserve and strengthen price signals in financial markets. Indeed, on reading the Final Report it seems that technology has become the inquiry's greatest tool for encouraging market forces, and stimulating competition and innovation.

While the role of technology and innovation is evident throughout the Final Report, Chapter 3 specifically addresses innovation and makes seven recommendations. The remainder of this paper discusses four of these recommendations which pertain most directly to supporting innovation in financial services and funding for start-ups and the small and medium-sized enterprise (SME) sector: collaboration to enable innovation; crowdfunding; data access and use; and comprehensive credit reporting.

Collaboration to enable innovation

From a regulatory standpoint, one of the greatest challenges in terms of innovation in the financial system is deriving an appropriate balance between openness to innovation and disruptive technologies, and protecting the interests of consumers, investors and the privacy of individuals. The rapid pace of innovation in financial services requires a collaborative approach between industry bodies, regulators and innovators themselves to ensure that the benefits of digital disruption are realised, that regulators can anticipate challenges, and that risks are controlled.

Consideration also needs to be given to the extent to which the interests of existing participants should be protected, especially where they are highly regulated. In the taxi industry, for example, where traditional providers pay expensive annual licenses, the adoption of disruptive business models such as Uber has presented challenges to the system. Attempts to level the playing field by bringing these new entrants into line with industry conduct have proved fairly ineffective.

Consequently, Recommendation 14 in the FSI Report suggests the establishment of:

> a permanent public–private sector collaborative committee, the 'Innovation Collaboration', to facilitate financial system innovation and enable timely and coordinated policy and regulatory responses.

The proposed Innovation Collaboration (IC) would be comprised of financial sector innovators, consumer groups, academics, and relevant government agencies and regulators. The purpose of such a group would not only be to ensure better understanding of the potential for innovation and to allow opportunities to be examined from a system-wide perspective but, most importantly, to provide a single point of reference for innovators seeking to gain regulatory approval. Creating a greater awareness of, and openness to, innovation among regulators is critical as they represent the point of entry to the system. In the United Kingdom, the Financial Conduct Authority has established a similar network called Project Innovate which supports industry innovation to improve consumer outcomes. The UK 'fintech' industry also has its own industry body, Innovate Finance, to support technology-led financial services innovators (FSI Final Report 2014, p. 149). In Australia ASIC has recently indicated an intention to establish a fintech "hub" along similar lines, to streamline licence applications from innovative companies.

Creating openness to innovation represents the most challenging part of this proposal. In contrast to economies such as the UK, which are actively promoting innovation as a means of introducing stronger competitive forces to the financial services sector, Australian regulators have tended to retain a low-risk, conservative approach to regulation. Ultimately the ability of key agencies to adapt and adjust risk levels to accommodate disruptive technologies will impact on the international competitiveness of the sector.

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Another challenge will lie in developing a collaborative approach. Strong networks across the innovation ecosystem have been essential to successful innovation ecosystems. Ferrary and Granovetter (2009) note that the entire innovation ecosystem is less efficient if only one agent is missing, and that collaboration between all agents is crucial. In the past, a major barrier to growth in Australian innovation ecosystems has been a lack of collaboration between established corporations in Australia and other members of the innovation ecosystem. According to a 2013 report by the Department of Industry, Australian organisations are among the least collaborative of all OECD countries (OECD 2013). Greater collaboration between researchers, innovators, corporates and regulators could lay a foundation for a sustainable financial services innovation ecosystem.

Crowdfunding

One of the challenges within the Australian economy has been the inadequacy of both debt and equity funding for start-ups and SMEs. The FSI Final Report gives due recognition to these challenges and makes three related recommendations on crowdfunding, data access and use, and comprehensive credit reporting.

Lack of debt and equity funding for start-ups and SMEs is recognised in Recommendation 18, which proposes a policy change to:

> Graduate fundraising regulation to facilitate crowdfunding for both debt and equity and, over time, other forms of financing.

As the report points out, there are two crowdfunding models emerging, crowd-sourced equity funding (CSEF), and debt funding or peer-to peer-lending. These financial transactions are facilitated by a platform which links providers and users of funds. It should be noted that while crowdfunding has been around for a while, CSEF differs in that it involves the transfer of financial securities to the capital provider via this platform.

CSEF would be a welcome initiative in Australia where equity capital for start-up firms has traditionally been in short supply. As the 2013 OECD venture capital (VC) statistics show, Australian VC comprises just 0.02 per cent of GDP, one quarter less than that of Canada and only around one twentieth of the level of VC investment in Israel (OECD 2013).

The relative lack of activity by local VC funds can have implications beyond capital availability as in successful innovation ecosystems, VC funds have traditionally been the key intermediaries facilitating collaboration between the various members of innovation ecosystem. In a similar way, crowdfunding platforms could play an important role in raising local, national and potentially international awareness of early-stage investment opportunities, building networks across the innovation ecosystem and increasing the potential for syndicate investing, as well as providing an additional avenue for raising capital.

While starting from a low base, it is estimated that around $10 billion has been raised through crowdfunding over the past five years, having grown by ten times over this period (Crowd Valley Inc 2014).

The issue of adapting the regulatory framework to support and monitor these new models is challenging. Governments in the UK, Canada and New Zealand have either implemented or are finalising the implementation of regulatory regimes to support CSEF. In the US, the enactment of the Jumpstart our Business Start ups (JOBS) Act 2012, which referenced the importance of online funding for start-ups and other companies to raise capital, was pivotal for CSEF globally (Ralston and Jenkinson 2014a).

In Australia, government will consult on a proposed regulatory model for CSEF. The 2014 Corporations and Markets Advisory Committee's (CAMAC) CSEF report indicates that, for CSEFs to operate in the best interests of investors and issuers, a specific regulatory structure is required. Elements of the CAMAC proposal include:

> placing a cap on an issuer's fundraising — no more than $2 million in any 12-month period — and limited disclosure requirements

> introducing caps on investments by investors — $2,500 per issuer, and $10,000 overall, in any 12-month period — and communicating the high risks to investors

> requiring issuance to occur via a licensed intermediary that is prohibited from providing investment advice, soliciting investors and lending to investors' (FSI Final Report p. 179).

Through the process of peer-to-peer or online lending, crowdfunding can also be a source of debt funding for SMEs. This technology provides access to funding at a point when traditional SME funding globally has become increasingly constrained through long-term structural changes in credit markets.

Consolidation of banks and centralised credit assessment have increased the distance between borrowers and lenders, both geographically and in terms of relationships. With distance comes an increase in information asymmetry, resulting in higher transaction costs as larger credit corporations struggle to deal with very small but complex loans, and higher search costs for SMEs as they seek out avenues of funding (Mills and McCarthy 2014). The consequence of this long-term trend, together with shorter-term cyclical factors such as the economic conditions surrounding the global financial crisis (GFC), has seen lenders become more risk averse, impacting negatively on the availability of credit for SMEs.

The European Commission has noted the reduction in SME lending post-GFC. In conjunction with the release of a series of reforms aimed at improving access to finance for SMEs in Europe, Michael Barnier, EU commissioner for financial services noted 'we need to diversify financing sources in Europe and improve access to finance for small and medium-sized enterprises that are the backbone of the European economy' (Fontanella-Khan 2014). The package of measures being implemented by the European Commission includes strategies for strengthening the European crowdfunding sector.

In Australia, where SMEs have relied on banks for 90 per cent of their intermediated credit, innovation in online and peer-to-peer lending has the potential to lower the barriers to entry for alternative funding sources, reduce information asymmetry between SMEs and lenders, and reduce transaction costs for SME lenders.[3]

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Access to financial information on smaller companies, however, is a significant impediment. The banking sector tends to have something of a monopoly on the financial information of small firms that are not subject to the disclosure requirements of equity markets, or have a publicly available risk rating. Hence there is an information asymmetry when SMEs seek finance from alternative sources. For a new potential lender to offer credit, information needs to be collected and assessed from a range of sources, adding to the cost of a new credit assessment.

The UK has recently undertaken a detailed consultation process to assess the merits of mandated sharing of SME borrower information between banks and SME lenders (HM Treasury 2014). The motivations for the proposed mandated sharing of SME information are to increase the reliability of credit assessment for SME loans by potential lenders and increase competition amongst lenders to SME borrowers.

The proposal has met with widespread support and has been put before the UK Parliament in the *Small Business, Enterprise and Employment Bill 2014–15* (UK Parliament 2014).

The risk to investors of participating in crowdfunding has created concerns for ASIC around the potential for fraud, issuer failure and dilution, especially where CSEF platforms are concerned. However, as outlined in the CAMAC proposal, limiting the exposure of individuals, and clear disclosure of the risks involved would partly address these concerns. Structures based around a graduated form of the current Managed Investment Scheme regulation should assist regulators in facilitating a policy framework which accommodates peer-to-peer lending.

Data access and use

A critical aspect of encouraging alternative finance providers, reducing barriers to entry and lowering transaction costs lies in the ability to provide greater access to data. With increased computational power, big data solutions and powerful algorithms, such data can assist in understanding the needs of individuals and in developing appropriate solutions to service provision.

More generally, however, apart from financial data, there is a wide range of public and private data which can inform and assist individuals and businesses in a range of activities. The FSI Report notes that while national governments globally are adopting open data policies, in Australia there has been little recognition of the importance of this issue or debate about the need for change.

The FSI has pointed to these issues in Recommendation 19:

> Review the costs and benefits of increasing access to and improving the use of data, taking into account community concerns about appropriate privacy protections.

The issue of privacy protection is obviously one of the barriers to wider access of personal data in particular. The need to balance efficiency and privacy interests is central to this issue.

Several recent public reports including the *Productivity Commission Annual Report 2012–13* and the National Commission of Audit have noted the limited use of public sector data resources in Australia and that despite the low initial costs of doing so, there is a lack of recognition of the benefits of shared information for achieving better outcomes for the economy. On this point the Productivity Commission observed that '... academics, researchers, data custodian agencies, consumers and some Ministers are eager to harness the evidentiary power of administrative data, but this enthusiasm generally is not matched by policy departments'.[4]

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As a means of exploring better use of data as per Recommendation 19, the FSI has proposed that the Productivity Commission be tasked with undertaking 'an inquiry into the costs and benefits of increasing access to and improving the use of data, subject to privacy considerations', with the intention being to 'enhance consumer outcomes, better inform decision making, and facilitate greater efficiency and innovation in the financial system' (FSI Final Report p. 184).

Comprehensive credit reporting

Innovative new companies seeking to serve the SME sector need to be able to access meaningful data on companies to allow a better assessment of credit risk. In this regard, potential alternative lenders are at something of a disadvantage in Australia. First, there is no required lodging of annual data on small businesses and, second, Australia lags many nations in the availability of credit information through its long-term adherence to a negative credit reporting regime. While the latter provides some information in terms of defaults on loans, it is inadequate in helping to build a financial profile of a potential borrower.

More comprehensive credit reporting, on the other hand, presents more constructive information for a potential lender as it provides not only default information but details on the dates credit accounts are open and closed, the type of credit extended and the repayments history.

Legislation to introduce comprehensive credit reporting was drawn up for discussion in March 2012, the legislation was enacted in March 2014, but at the time of writing, the data-sharing agreement between credit providers has yet to be finalised. As the Final Report notes, even with the implementation of that agreement, significant amounts of data are not expected to be exchanged until late 2016 or early 2017.

Hence the need for Recommendation 20:

> Support industry efforts to expand credit data sharing under the new voluntary comprehensive credit reporting regime. If, over time, participation is inadequate, Government should consider legislating mandatory participation.

It is made clear in the Final Report that the inquiry has rejected the UK approach of mandating the release of such information to the market, where the SME owner is in agreement. So it remains to be seen whether there is a will among existing credit providers to accelerate this process and make data available more widely on a voluntary basis.

There is, however, more broad-based support for expanding the number of fields included in the CCR regime to support better credit decisions, and to include details such as the account balance. The latter, however, would require an amendment to the Privacy Act.

The slow pace with which the CCR regime has developed to date, and the fact that CCR imposes additional costs on lenders who already have something of a monopoly on SME information, suggests that any immediate expansion of these efforts is unlikely. Contrast that with the rapid rise in alternative online lenders and what appears to be unsatisfied demand for credit in the SME sector, and it seems that this recommendation may well be a little optimistic about the extent to which barriers to entry can be lowered in a timely manner.

Conclusion

The great advantage of undertaking periodic reviews of the financial system is that it allows time for an assessment of the stability, fairness and efficiency of a system when there is no impending crisis. Holding any system up to the spotlight and comparing it with other regimes can only be of benefit, especially for Australia with such a highly concentrated domestic financial sector.

A distinguishing feature of the FSI, when compared with its predecessors, has been the influence of technology, advances in the use of data, the growth of online platforms, and the increased internationalisation of the sector. While many aspects of these changes have yet to be fully realised, they are having a significant impact on the conduct of the financial sector and, in some areas, present a real opportunity to drive a more open and competitive approach, to the benefit of Australian consumers and businesses.

The inquiry also highlights, however, that Australia's openness to innovation and sharing of information by government, existing participants, and regulatory bodies is not strong. These policy settings will need to be addressed in order for the financial system, and the whole economy, to take full advantage of these opportunities to innovate.

Notes

1. *Financial System Inquiry Interim Report*, p. xv.
2. *Financial System Inquiry Final Report*, p. 150.
3. Discussed in Ralston and Jenkinson (2014b).
4. *Productivity Commission Annual Report 2012–13*, Chapter 1: Using administrative data to achieve better policy outcomes, p. 1.

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