

Submission to the Financial System Inquiry

A. Introduction

Digital Finance Analytics (DFA) welcomes the current Financial System Inquiry. We wish to make the following submission.

1. DFA is a boutique consulting and research company, specializing in the financial services industry. We execute primary consumer research, segmentation and industry modelling. As well as completing research for our clients, we post regularly to our blog¹.
2. We believe that whilst the current financial system in Australia is robust and well regulated, there are a number of factors which means it is having a significant negative impact on the economic performance of the country.
3. Banks have grown their balance sheets in-line with growth in demand – especially supporting high levels of investment loans, and as a result they are not adequately providing reasonable lending services to a considerable number of small and medium enterprises, who could create economic value to the country. This is influenced by the relative capital costs of housing lending versus commercial lending under the Basel rules. (Many smaller ADI's are unable to take advantage of the advanced methods, therefore smaller players require more capital per loan than the big four). Lending ever more loans to households to purchase property does not create real growth, it just inflates prices. Our surveys of Small and Medium Enterprise Businesses (SME's) indicates that since 2007, and after the GFC, availability of finance options has diminished, the costs of borrowing are significantly higher, and the compliance demands placed on them by lenders has increased significantly.
4. Whilst competition amongst the big four is genuine, the range of products and pricing is more homogenous than before the recent consolidation of regional players including Bank West and St George into the majors. Smaller regional banks, building societies and credit unions are unable or unwilling to compete, so we have "the rest" of the market losing share and concentration increasing. Non-Banks remain under pressure post the GFC. Lower levels competition leads to higher prices and less need for innovation.
5. In addition, the big four have extended their business footprint, to include wealth management, investment platforms, insurance, commercial banking and other areas. This concentration is not necessarily best for Australia, as it creates a structure where individual large players are able to control too much of the market, and may become too big to fail. Whilst they may trade under an umbrella of different brands, such concentration has the potential to reduce competition and exclude new or smaller players from the market. Whilst the regulators report piecemeal on elements across the financial services landscape, there is no holistic measure of total market influence of any one of the large players.

¹ <http://www.digitalfinanceanalytics.com/blog/>

6. All banks are being confronted by a tsunami of new technology, which is driven by consumers now familiar with smartphones and tablets expecting ever more services delivered direct to them. This migration is not uniform, so some older less profitable customers are still reliant on branches, but overall distribution economics are changing fast. We could see a “last man standing” problem as banks close branches and invest more online. The most profitable customers are ahead of the banks in their online expectations.
7. The potential for new technology based competitors to enter the financial services market is significant. In a recent piece of research, DFA undertook a thought experiment, which highlighted that some of the more digitally aware bank customers have stronger loyalty to technology companies than for traditional banks.
8. Peer-to-peer lending has the potential to offer new solutions. We believe that P2P Lending has the potential to become a significant and disruptive force in banking, for unsecured credit and as an alternative to credit card debt. However, as this is a relatively small share of total borrowing (~\$150bn), the overall impact on the banking system is likely to be quite small initially. We should expect new-to-world models of lending to proliferate, and this should be seen as a positive opportunity, not a threat. We note that the UK Government has placed funds via peer-to-peer lenders to assist small business there.
9. Shadow Banking in Australia may not be as contained or isolated as regulators portray. The wider question is the extent to which the prudentially regulated entities and the non-prudentially regulated entities are connected (either locally or globally). The data is hard to pin down. Perhaps 5% of Australian bank assets are exposed to shadow bank intermediaries, and 18% of shadow banking assets in Australia are exposed to the banks. The challenge is to better understand these connection, and begin to tease apart the links and risks.

Details of our research have been published in our report “The Quiet Revolution” which is attached as appendix 1. There we go into significant detail by customer segment, leveraging our primary research. We focus specifically on digital banking, and how consumers are responding. Appendix 2 covers our recent research on peer-to-peer lending. Appendix 3 covers Shadow Banking in Australia.

B. Suggested Policy Options

DFA recommends the consideration of the following to help ensure Australia benefits from the Financial Sector into the future.

1. Banks need to be encouraged to lending more willingly to businesses, especially SME's. In an environment in which on most measures, housing is less affordable than it should be, and where interest rates are low, we need mechanisms to redirect lending away from inflated housing towards productive investment in the commercial sector. The options to do this are to change the capital adequacy rules under Basel III, or implement macroprudential strategies; or both.
2. The Bank of International Settlements (BIS), using research analysis covering multiple markets², reached an interesting conclusion. Whilst there may be some benefits in capping Loan-To-Value ratios (as New Zealand has done, and the IMF advocated), the best mechanism to manage house prices is to target debt service to income ratios. The logic is because LVR controls won't impact borrowing in a rising market, (as house prices rise, borrowing can grow). On the other hand a debt service to income ratio is not impacted by rising house prices, so consumers would not be in a position to borrow any more even if house prices did rise. Therefore it is a more effective control.
3. Smaller players are disadvantaged, and it is hard to see an easy way to change this. However, one mechanism which might prove interesting is for the government to offer funding available only via smaller banks for SME lending. This could be run on a commercial basis, at no net costs to government, and would provide a platform for smaller players to grow. It would also increase competition on this important sector. Possibly this could be linked with peer-to-peer lending innovation.
4. We recommend the development by the regulators of a cross-business unit assessment of the footprint of our major banks. This should chart, in one place their total market influence and report trends over time. In addition, we recommend limits be designed to protect against "too big to fail". APRA's D-SIB's assessment³ recognizes domestic systemically important banks, but does not seek to measure the overall influence of any particular bank, and whether any one player has too much influence across the market. ACCC seems to focus on specific transactions or acquisitions. There is therefore a gap in the regulatory framework. Reporting would be a good first step.
5. Provision of a branch outlet will become less a strategic asset, more a social requirement as digital adoption continues. Consideration should be given to creating a bank branch utility, to ensure that socially important aspects of branch banking remain. This might be provided by Australia Post or some other entity. This would avoid the "last man standing" problem.

² <http://www.bis.org/publ/work433.pdf>

³ http://www.apra.gov.au/mediareleases/pages/13_40.aspx

Digital Finance Analytics

The Quiet Revolution

Households and Their Banking Channel Preferences 2014



Martin North
Principal
Digital Finance Analytics (DFA)

DFA – “Intelligent Insight”

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The Quiet Revolution

1 Summary

DFA has just updated the 26,000 strong household survey examining their channel preferences. This report summarizes the main findings.

We conclude that the move towards digital channels continues apace, facilitated by new devices including smartphones and tablets, and the rise of “digital natives” – people who are naturally connected.

We outline the findings across each of our household segments, and also introduce our thought experiment, where we tested household's attitudes to the various existing and emerging brands in the context of digital banking. We found a strong affinity between digital natives and the emerging electronic brands, and a relative swing away from the traditional terrestrial bank players.

These trends create both threat and opportunity. The threat is that traditional channels, especially the branch, become less relevant to digital natives, and becomes the ghetto of older, less connected, less profitable customers. The future lays in the digital channels, where the more profitable and digitally aware already live. Players need to migrate fast, or they will be overtaken by the next generation of digital brands who are looking towards becoming players in financial services. The game is on!

2 The Research Method

DFA executes weekly omnibus surveys which cover a statistically representative set of households nationally. We collect data from 500 each week, and maintain a national database of 26,000 households. The data is then collated and analyzed by segment.

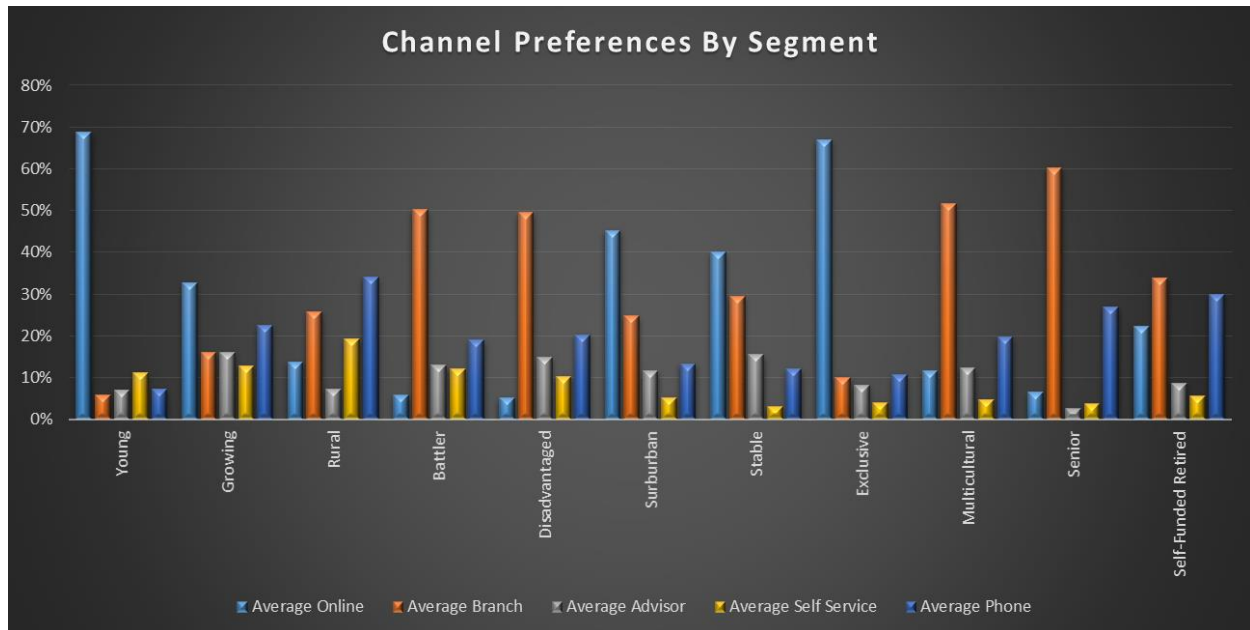
The channel aspects of the research look across the search, apply, buy, transact and service value chains. We are also able to examine trends over time, as well as device preferences.

We score channel preference using an algorithm which combines what the consumer has been doing in the last, and an assessment of their preference for channels, if they were available. For example, for mortgages, much of the initial research is via blogs, web sites and social media, then bank web sites, but applications are normally broker or branch based because a complete online application experience for mortgages does not really exist yet. We would take account of this preference in our scoring.

This report contains a summary of the findings, more detailed material, which is at a product level is available on a commercial basis.

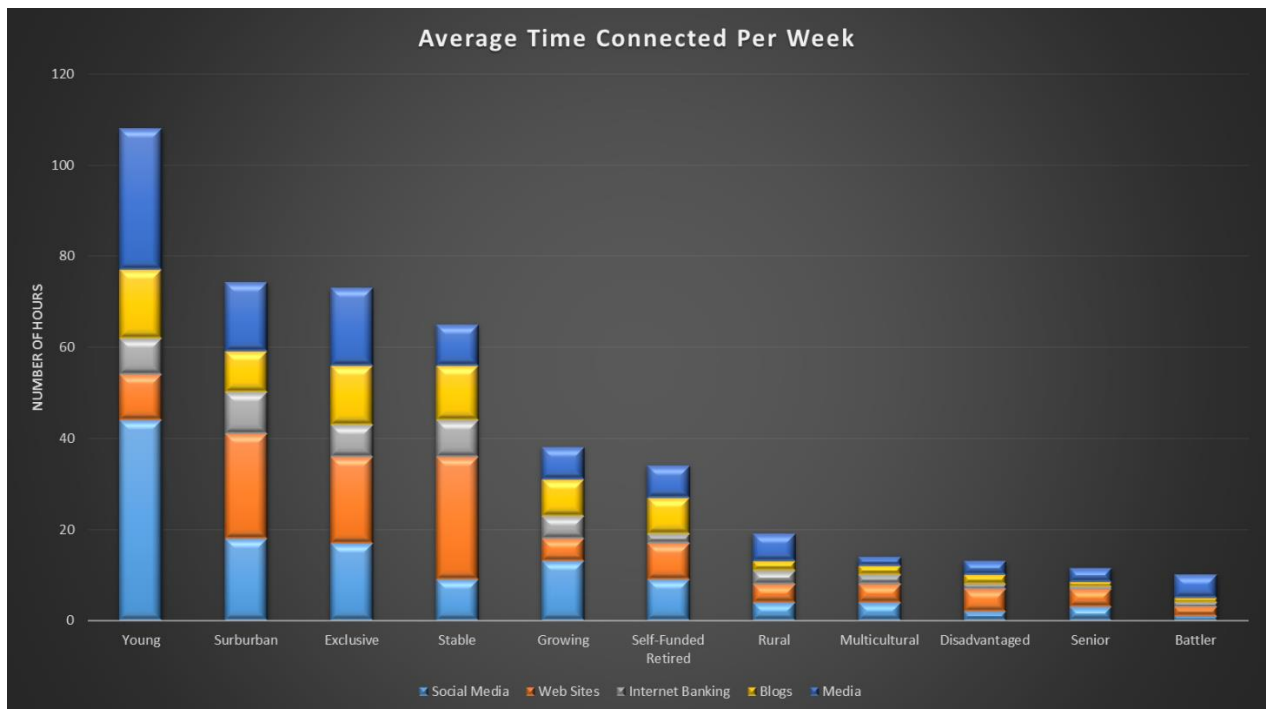
3 Overall Trends

The overall results from the survey are shown below by segment and channel.

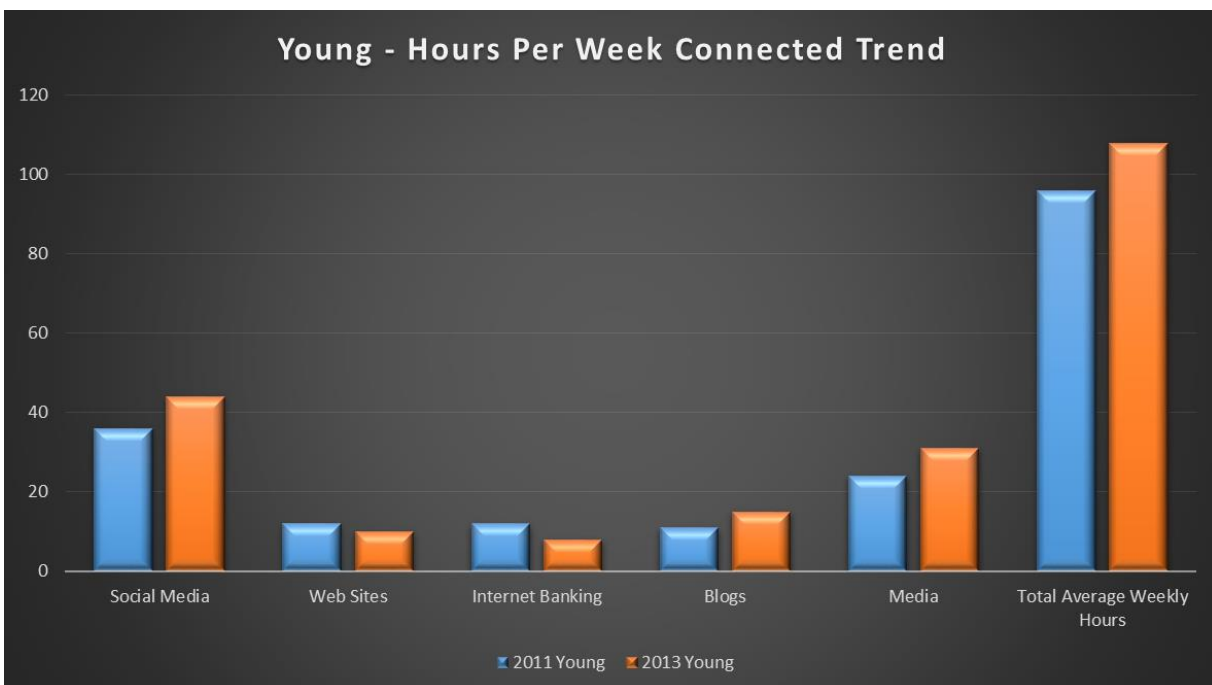
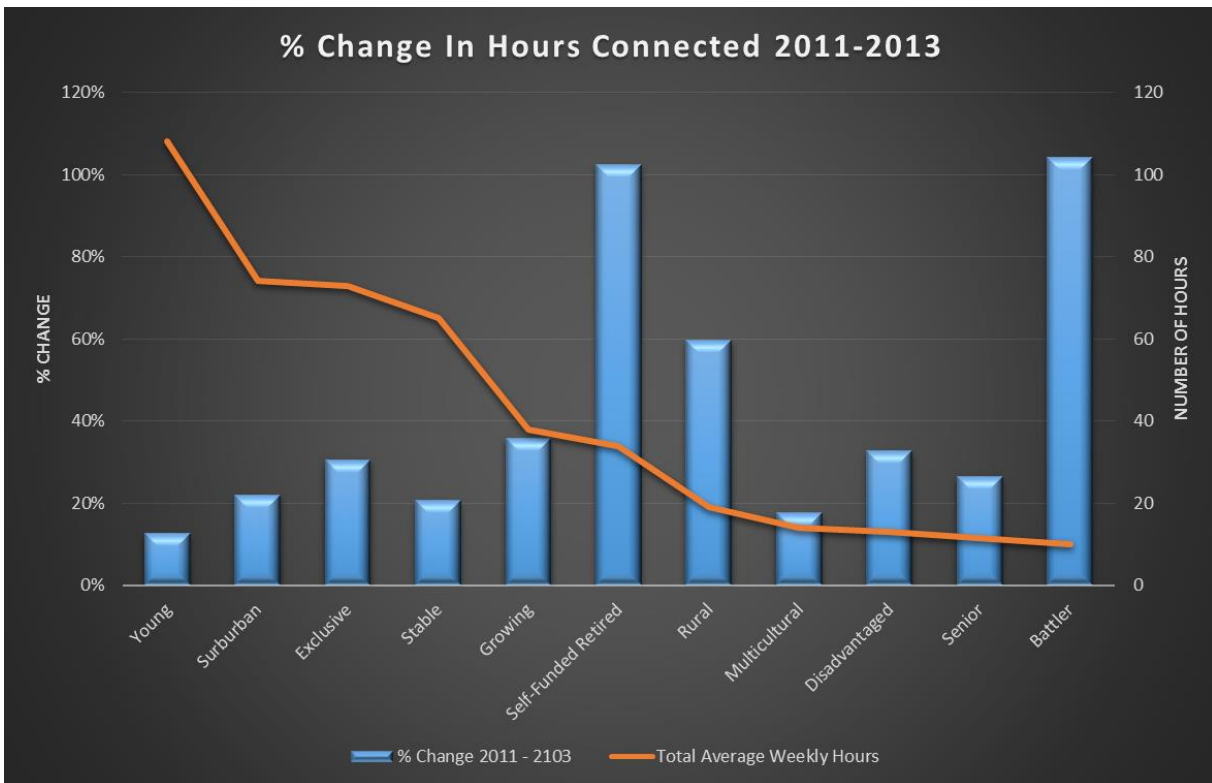


Younger households are strongly aligned to online, whereas battlers and disadvantaged groups are more branch centric. Older wealthier groups are online aligned, whereas older seniors and multicultural groups are branch orientated.

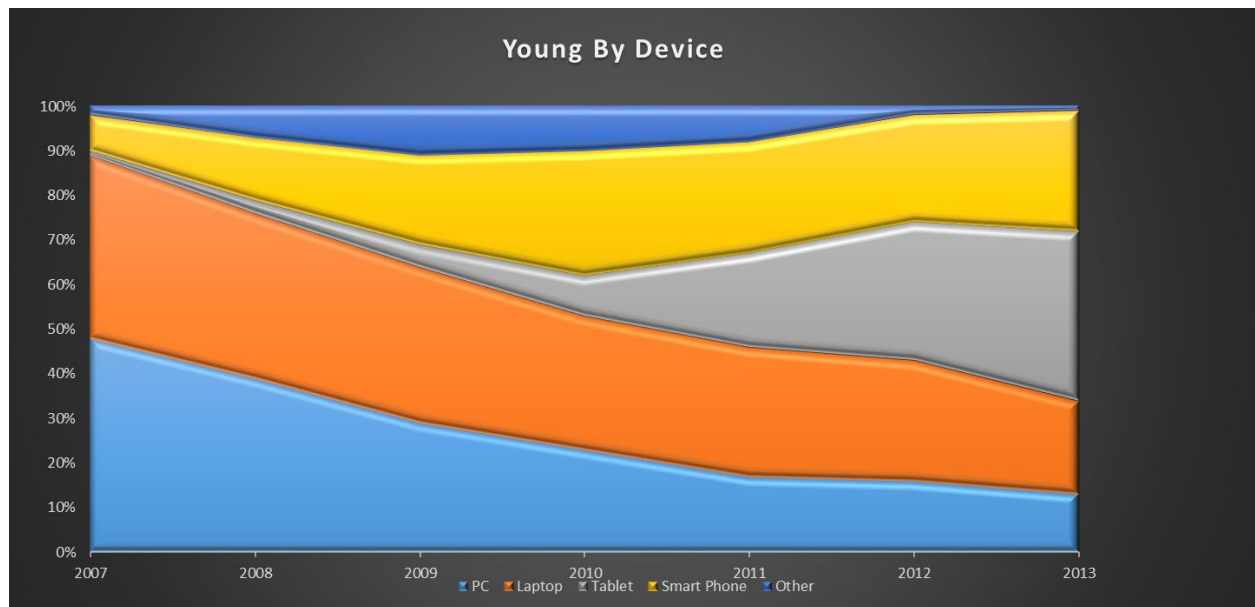
The average time spent connected (i.e. contactable via smartphone, tablet or pc) varies by group.



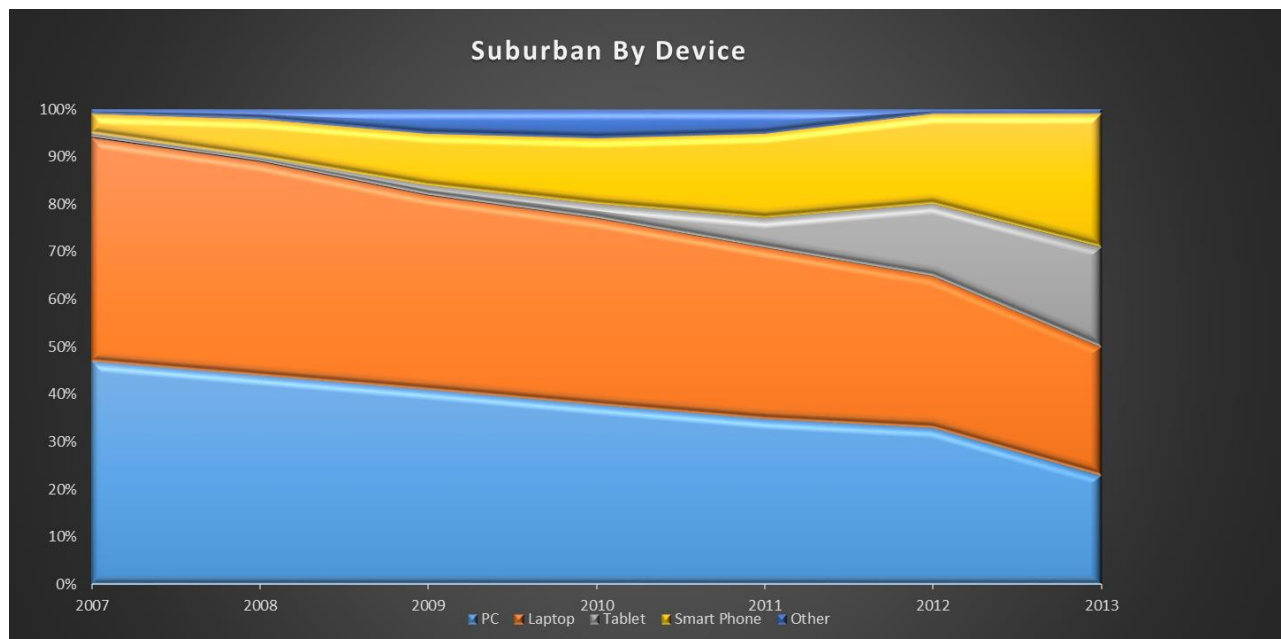
Young consumers are connected on average for 110 hours each week, and nearly half the time is spent with social media, video or other media and blogs. Web sites and internet banking only take a small amount of their time. Compare this with battlers, who are mainly connected for internet banking and web sites. There have been significant increases in time online between 2011 and 2013.



Device preference is changing fast, especially amongst the Young.



Smartphones and tablets have displaced other device types. By contrast, Suburban households are more reliant on pc's and laptops, but we are beginning to see a migration, if more slowly to tablets and smart phones. They appear to be moving two or three years behind the young.

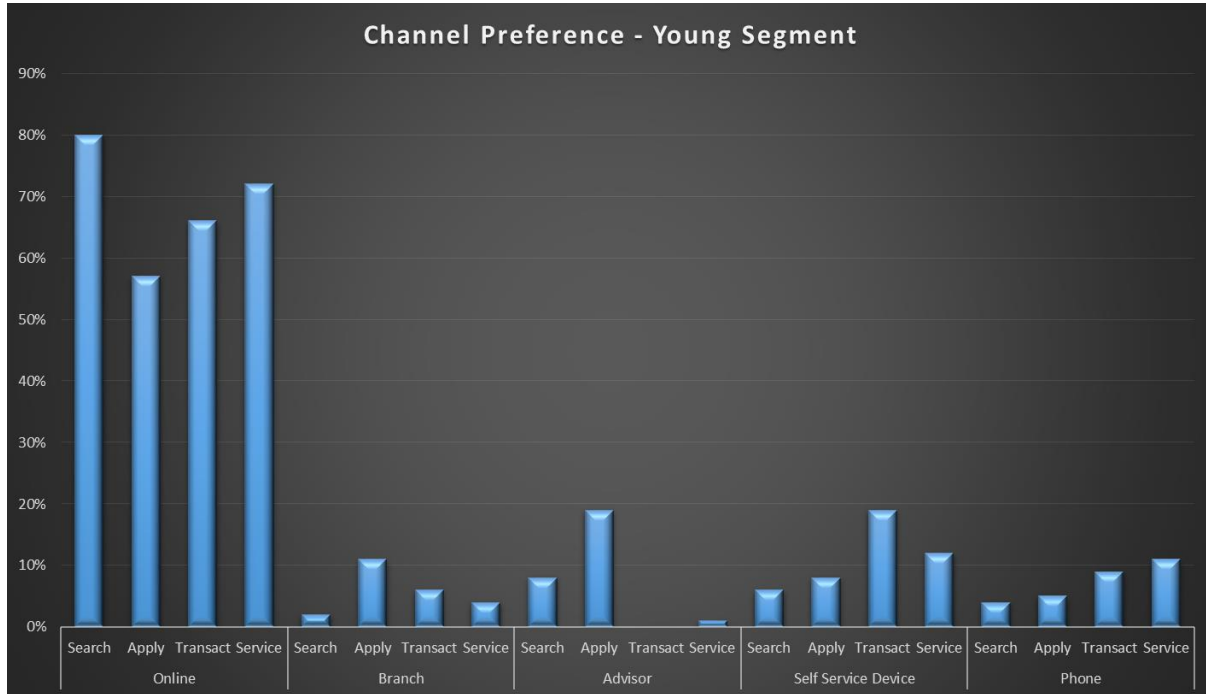


We will now examine each segment in more detail.

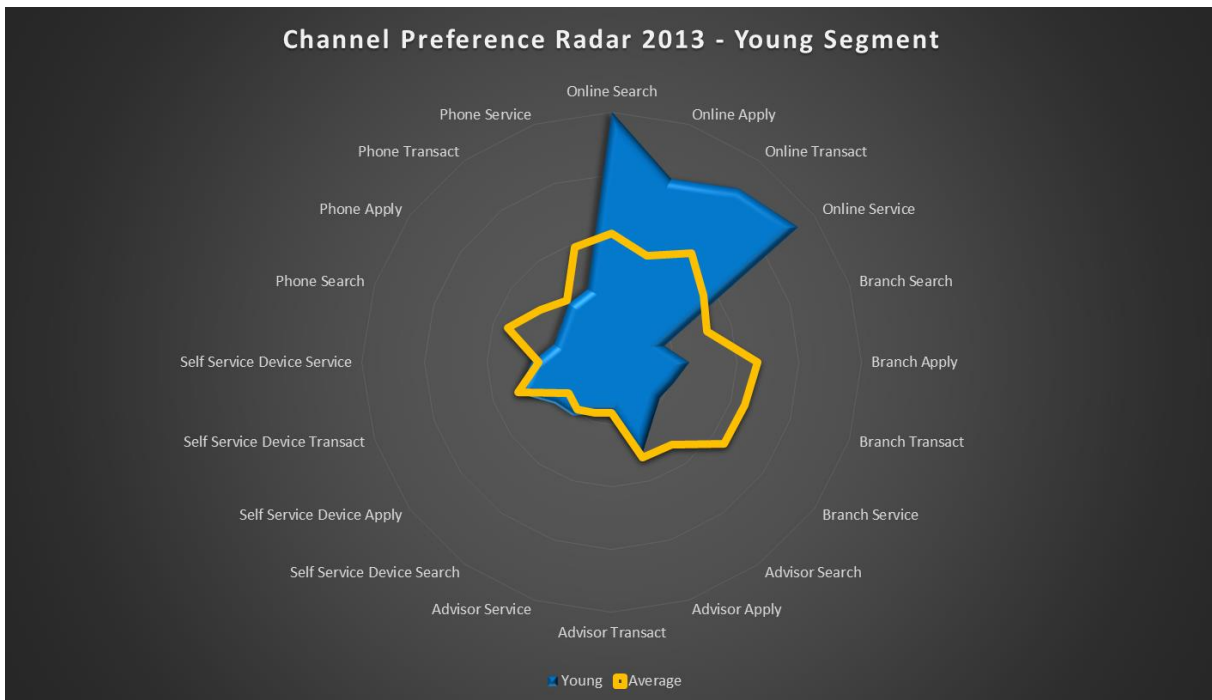
4 Segment Specific Analysis

4.1 The Young

This segment, with an average age of 27 years has a strong preference for online services.

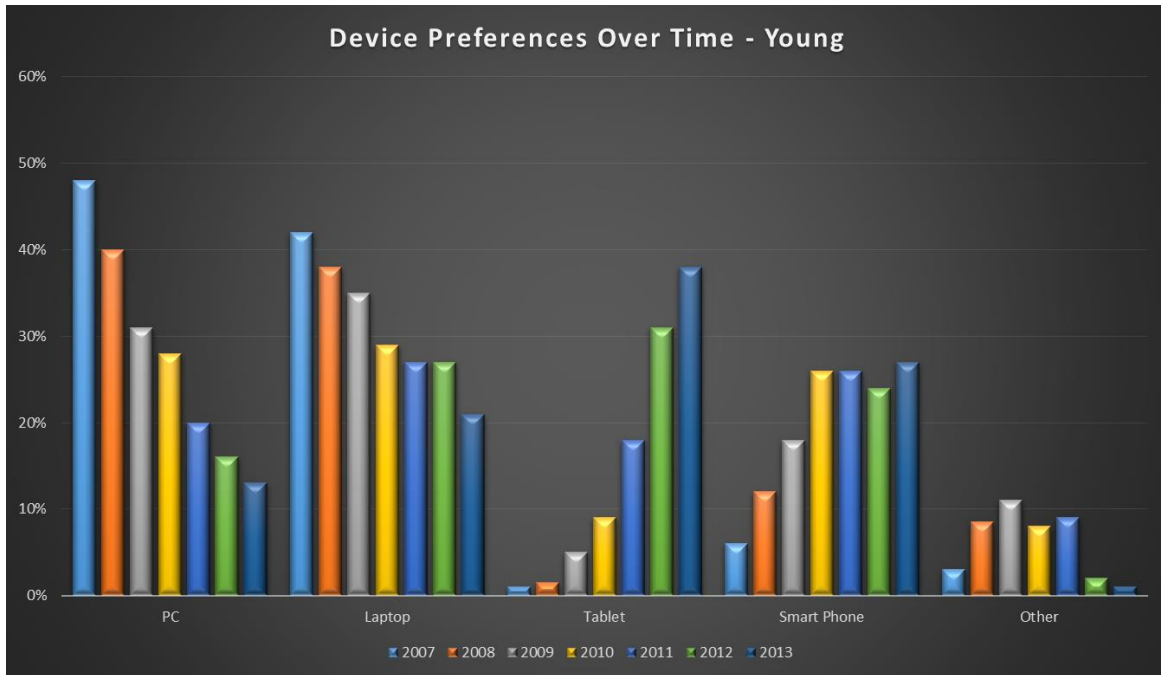


We can display the data on our channel preference radar to compare this segment with the average.



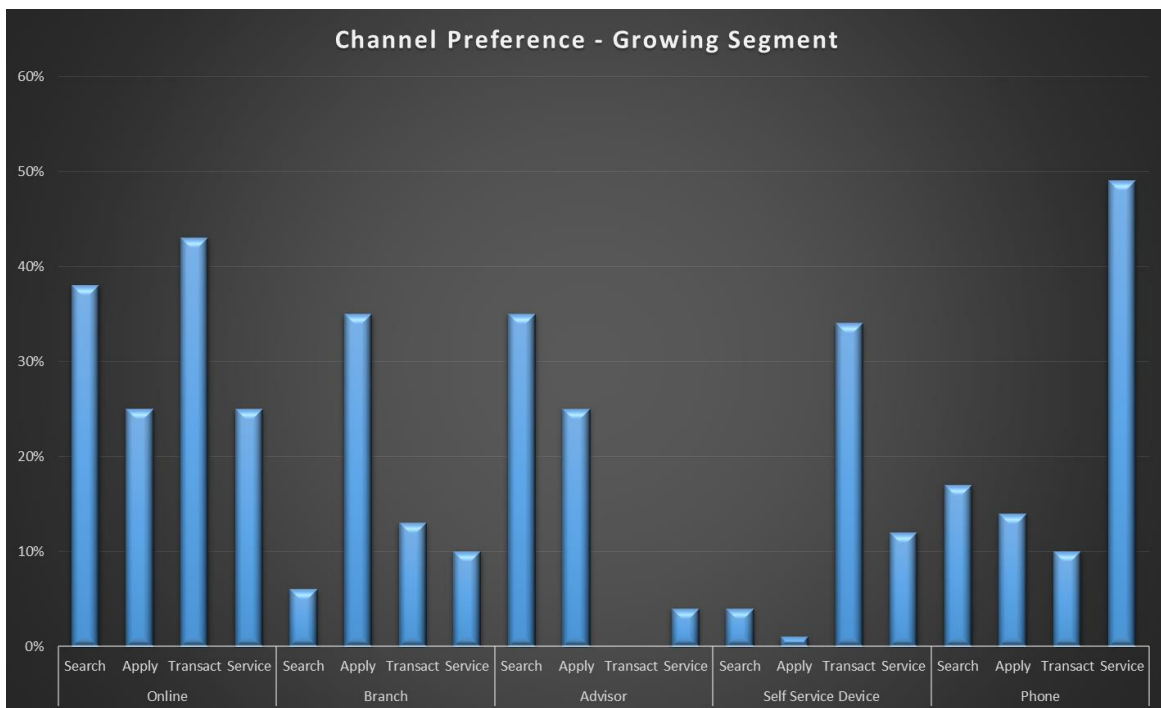
This segment is disappointed that existing players in financial services are not moving as fast as they wish.

Device preference is clear. Smartphone and tablets are the device of choice.

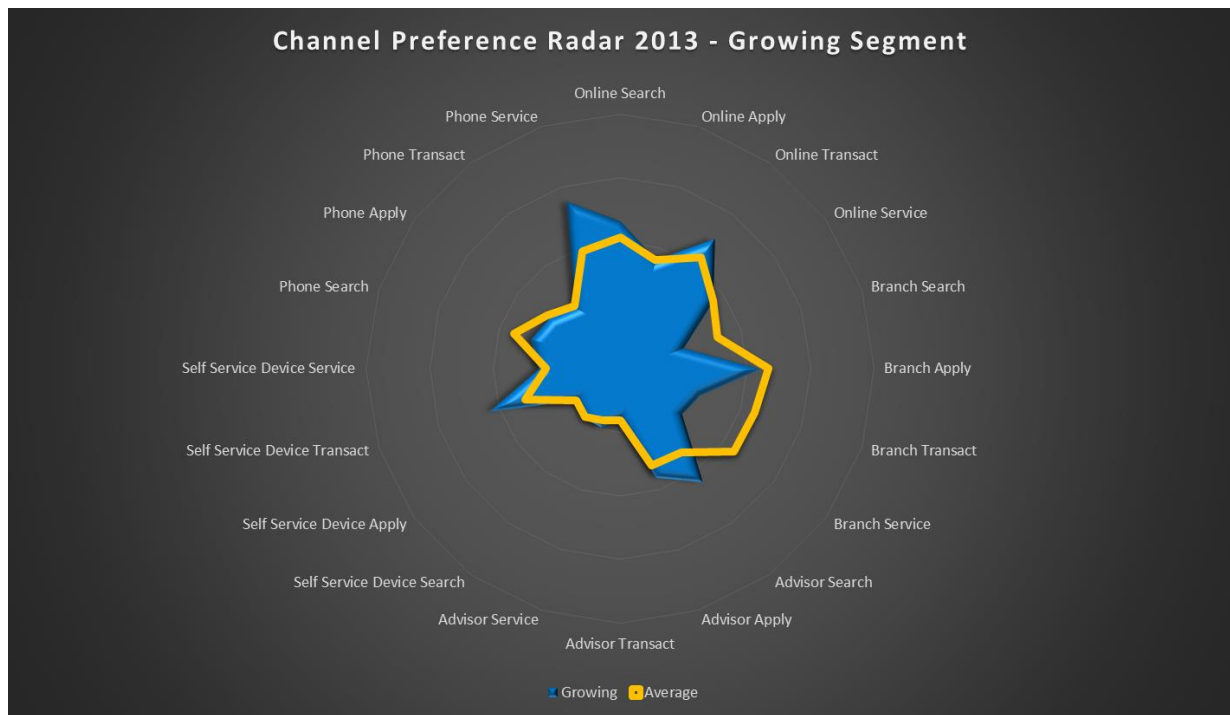


4.2 The Growing

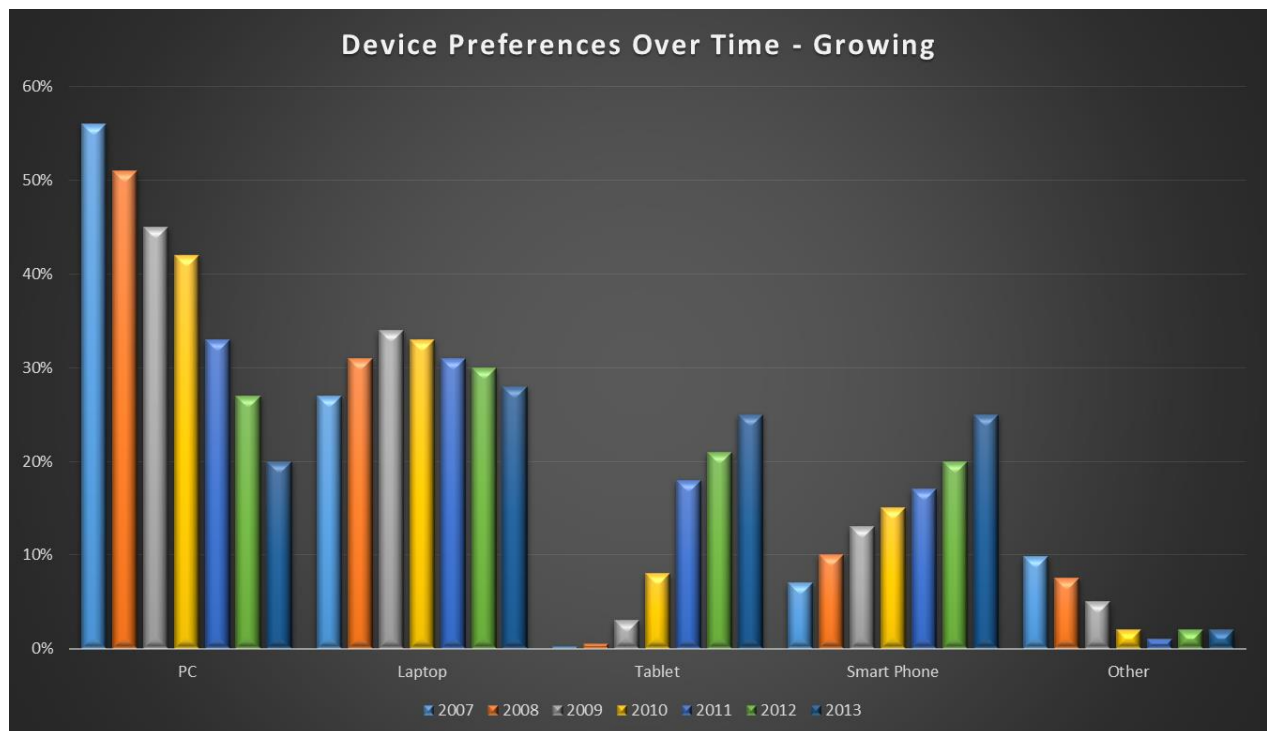
This group comprises mostly of young families, average aged 34 years.



Channel preference is more evenly spread. The channel preference radar illustrates this nicely.

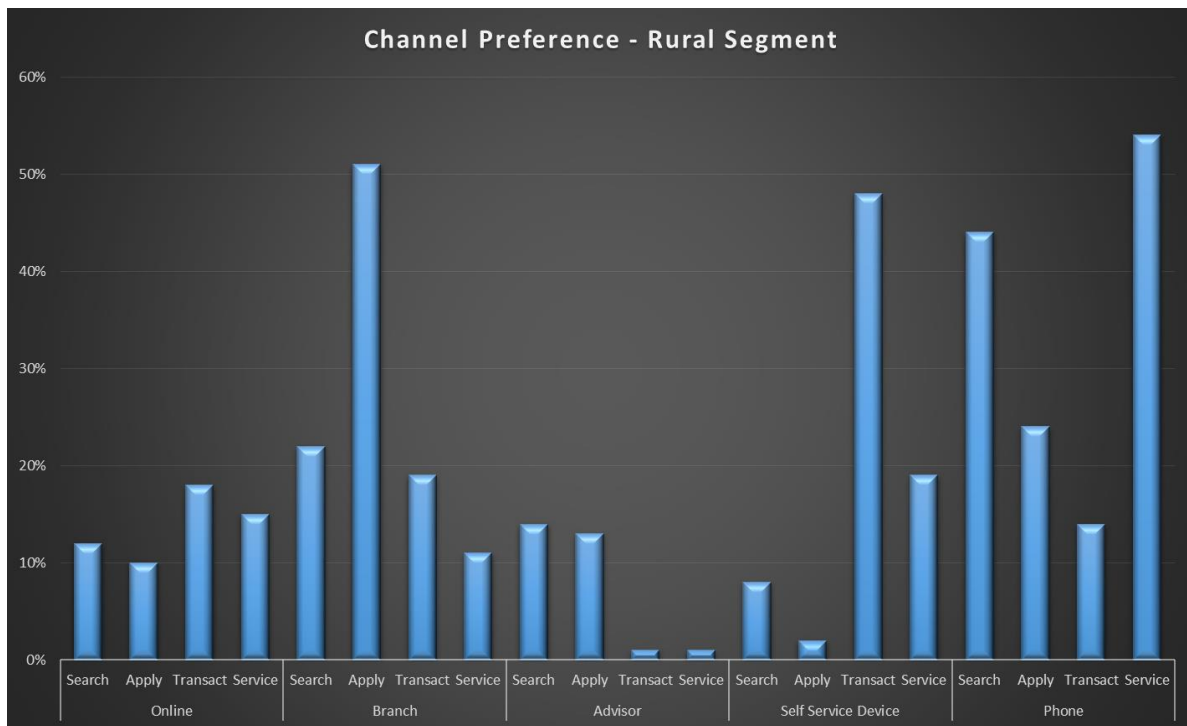


Device preference is changing, with PC and laptop replaced by smart devices.

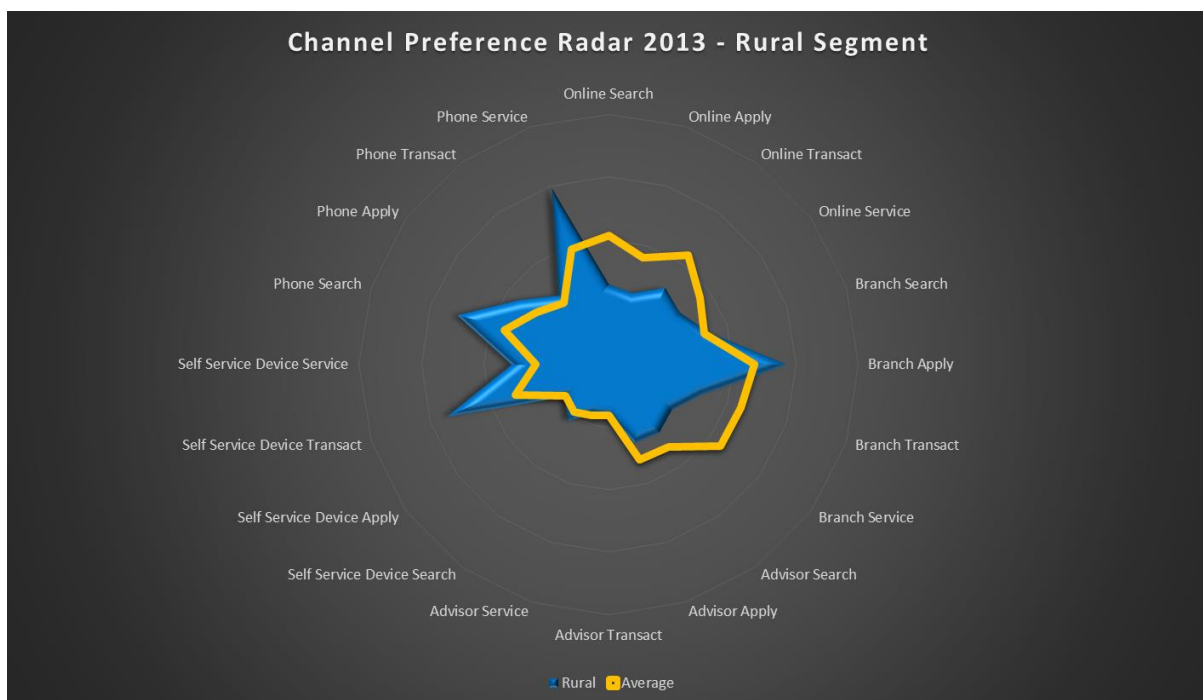


4.3 The Rural

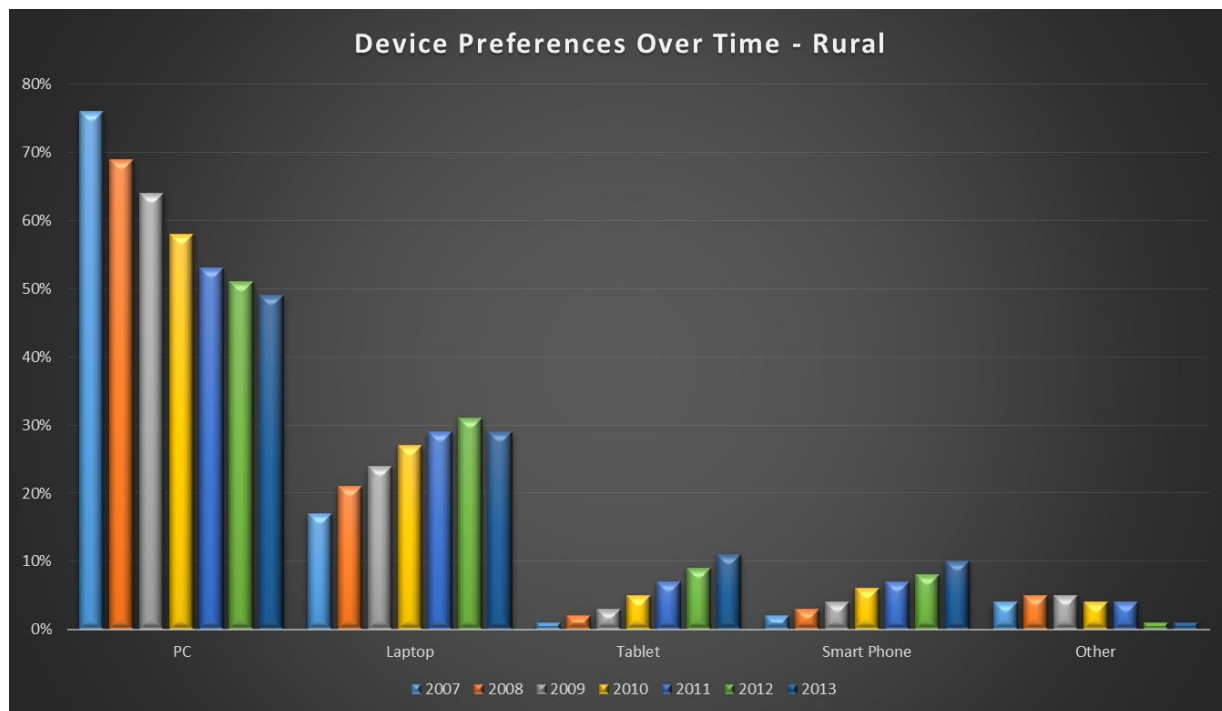
This segment reflects those away from the main urban centres, often mature households connected with agriculture or mining.



Branch and phone features in terms of preference. We noted that difficulty in getting reliable internet connectivity was a significant issue for this group. The preference radar shows the channel preferences.

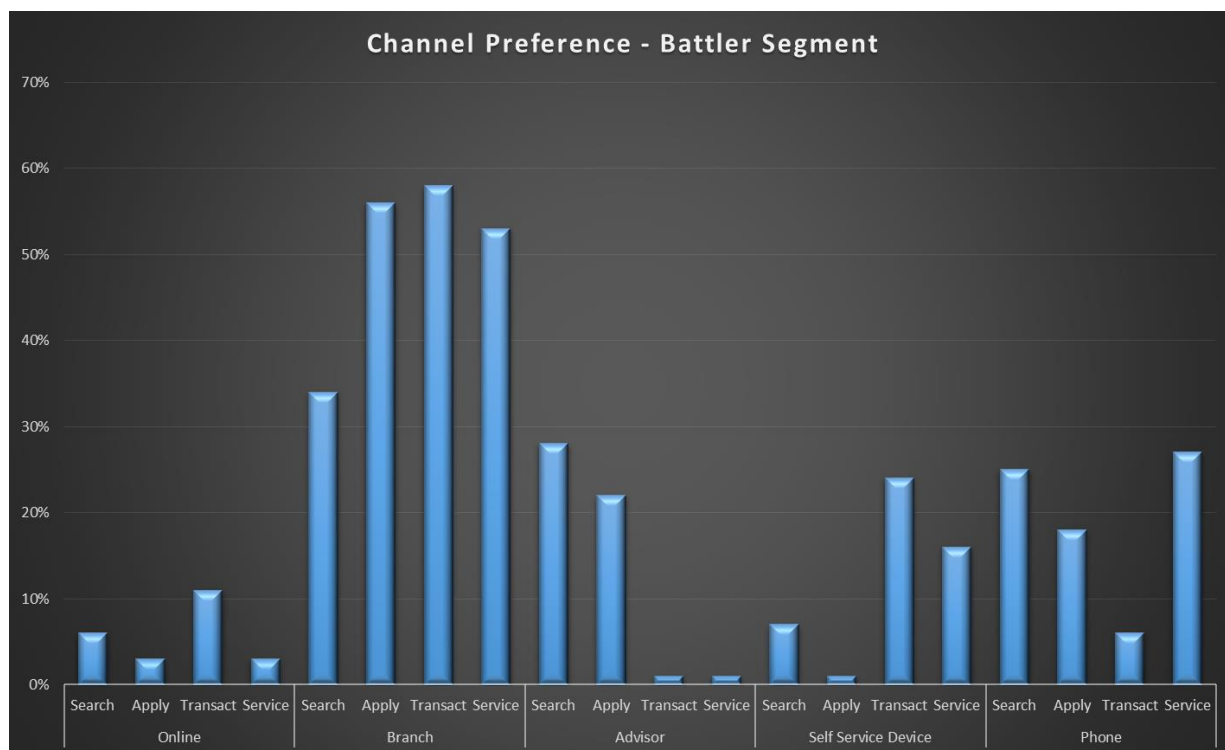


They are more likely to be using PC or laptops.

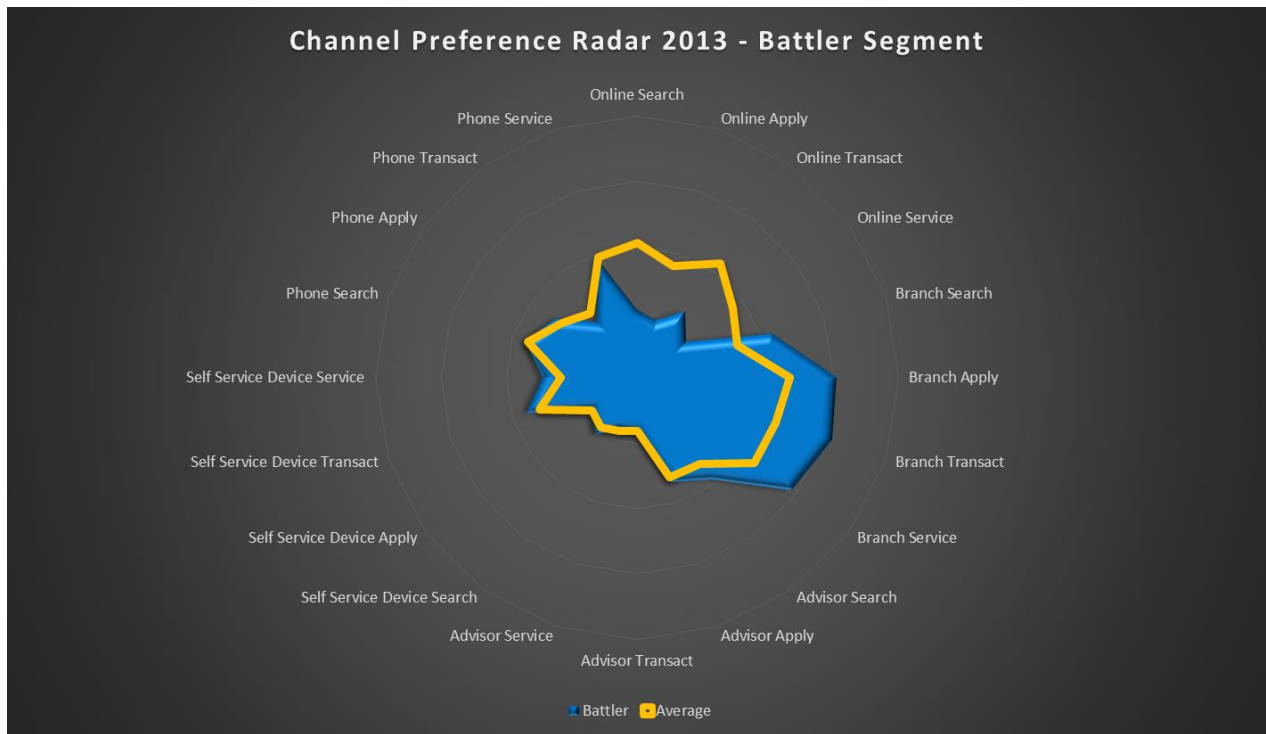


4.4 The Battlers

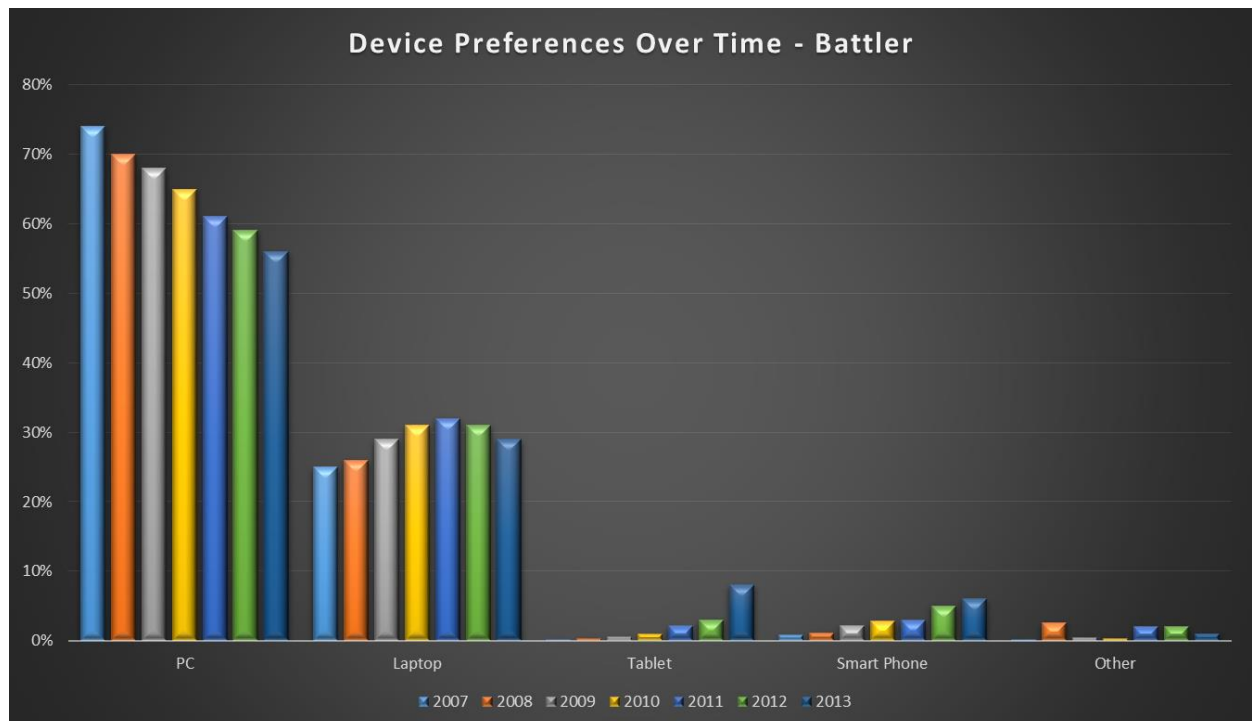
This segment is defined by low incomes, relatively poor housing, and education. Some live in urban fringe areas, others live in regional centres and are mainly blue collar workers.



They tend to be branch centric.

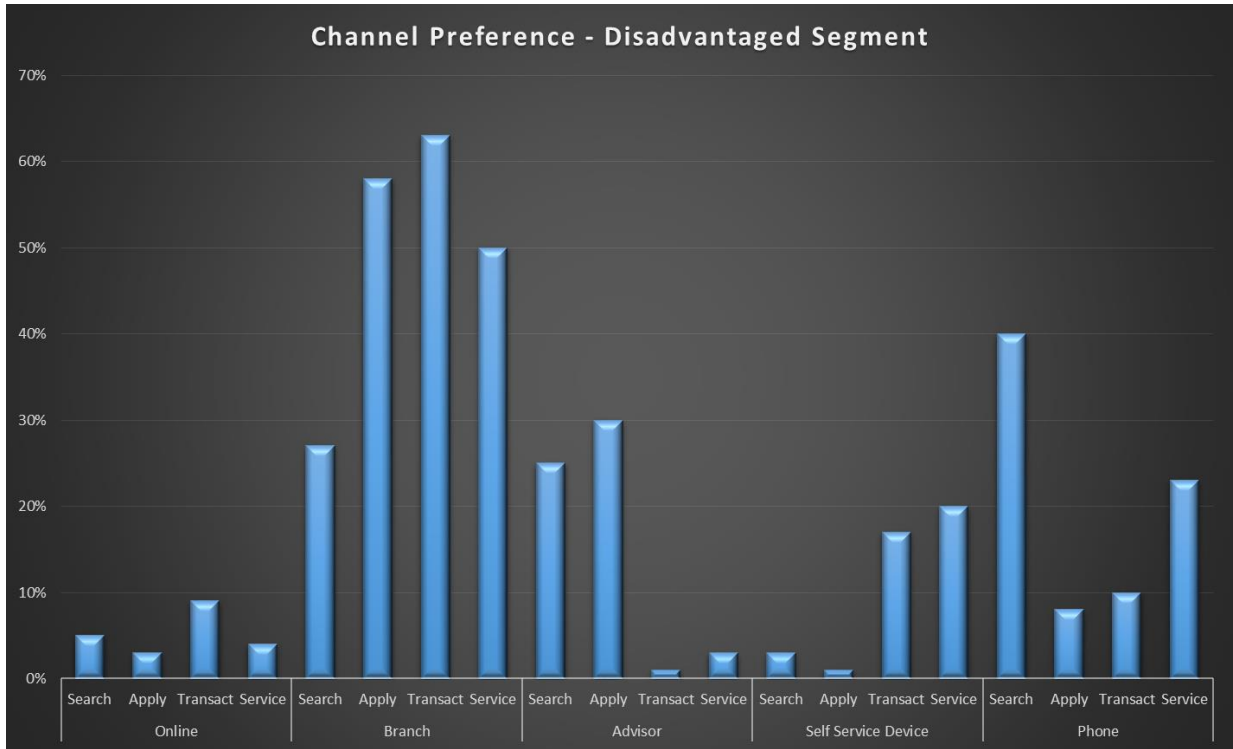


They are more associated with PC and laptop than smart devices.

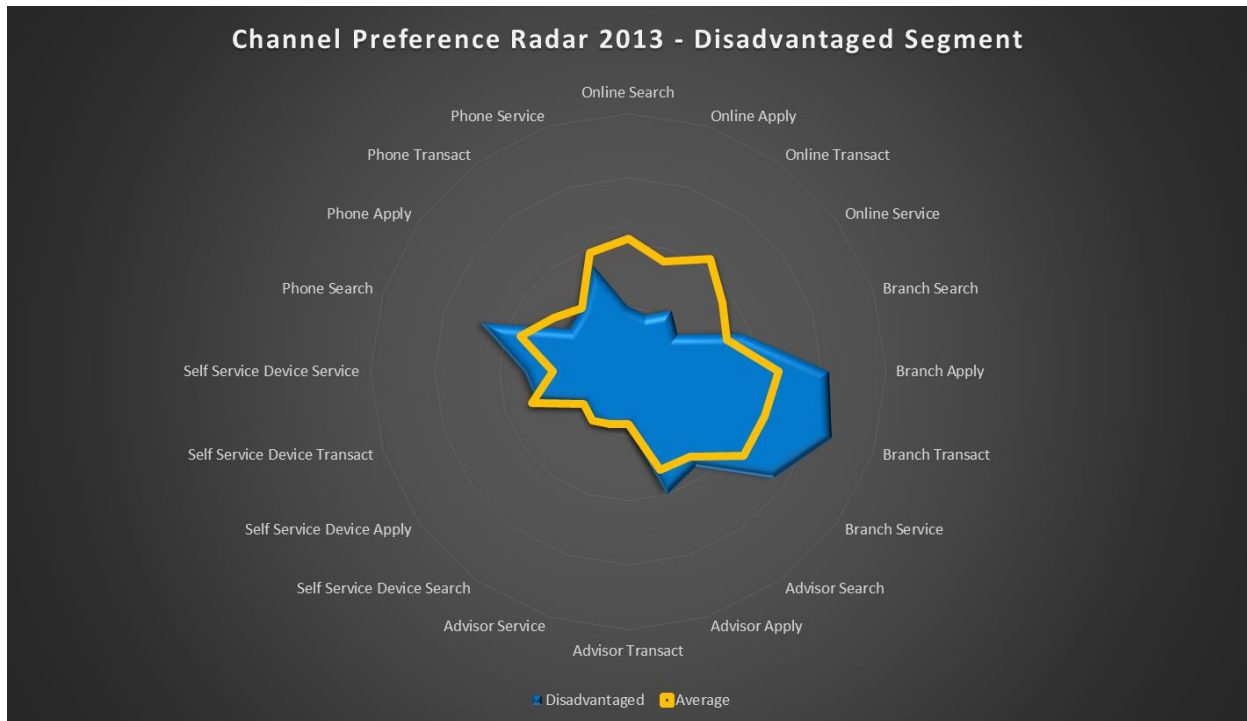


4.5 The Disadvantaged

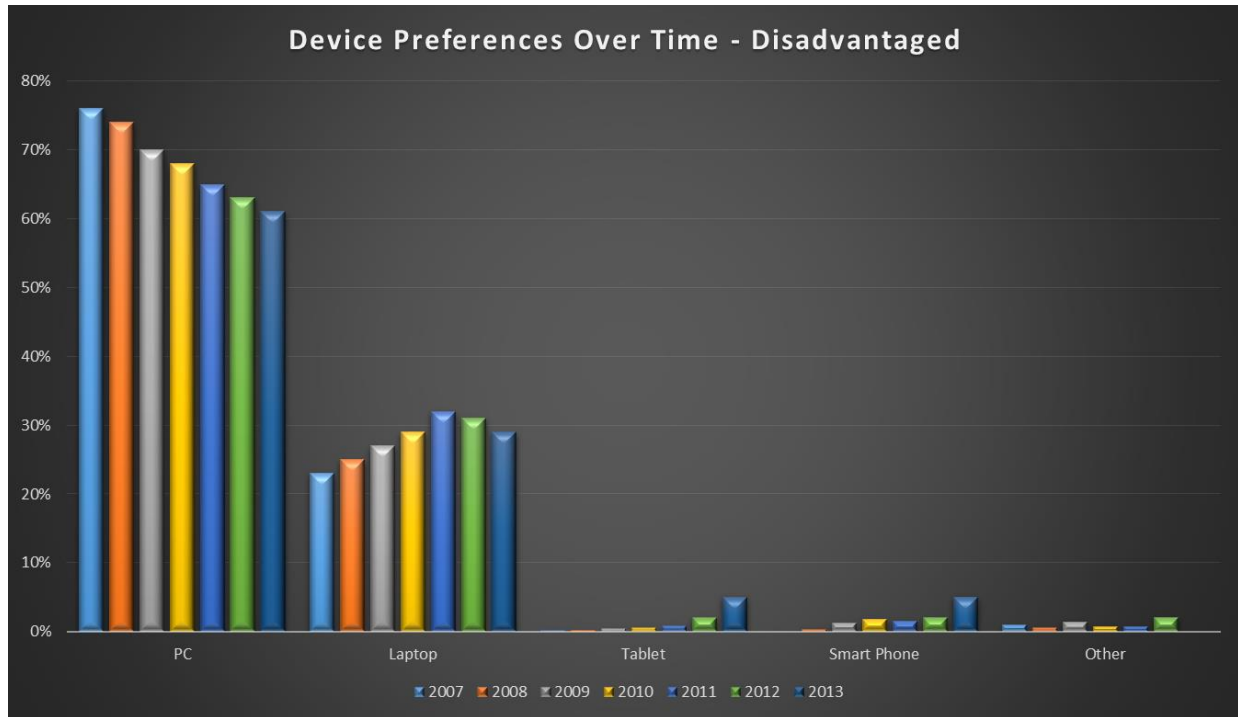
This group is close to the poverty line, often living in the outer urban rim and heavily reliant on Government support. Average weekly income is below \$500.



They are strongly branch and self-service device (ATM) aligned.

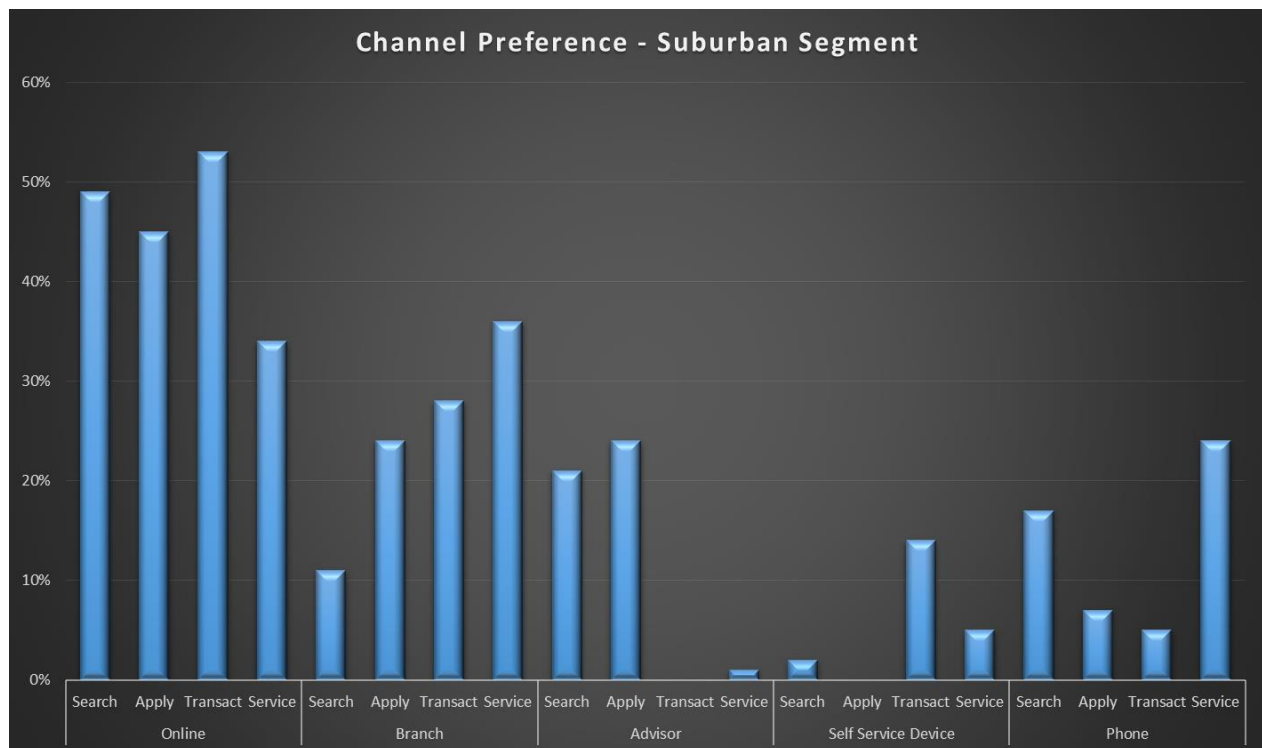


They are more aligned to PC and laptop.

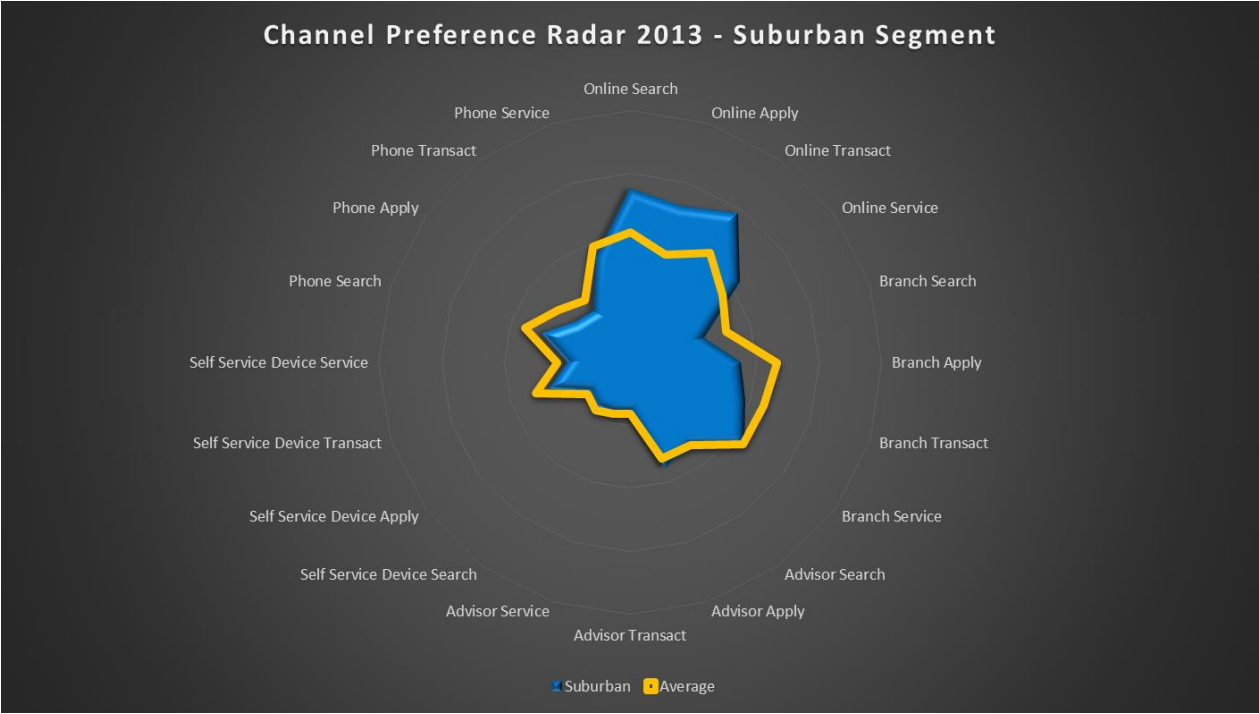


4.6 The Suburban

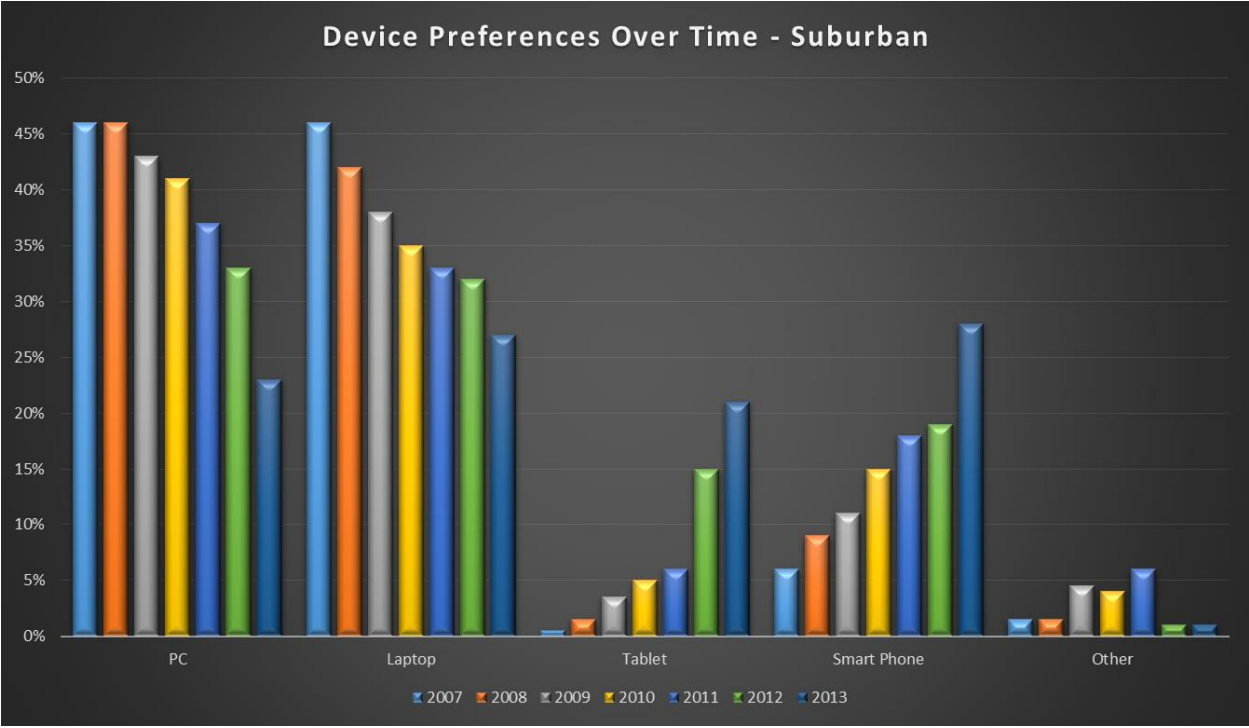
This segment, mainly in the mortgage belt will consist of families and couples, with reasonable incomes and education.



They have become quite online aligned.

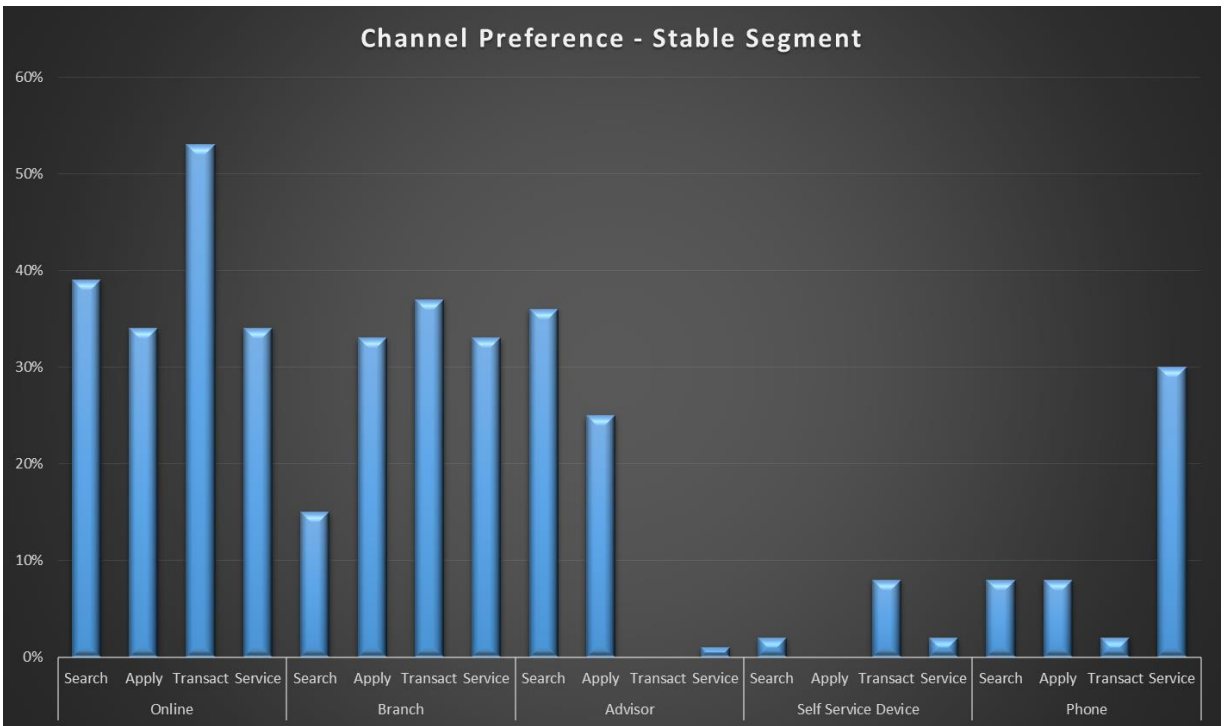


They are quickly becoming dependent on smartphone and tablets.

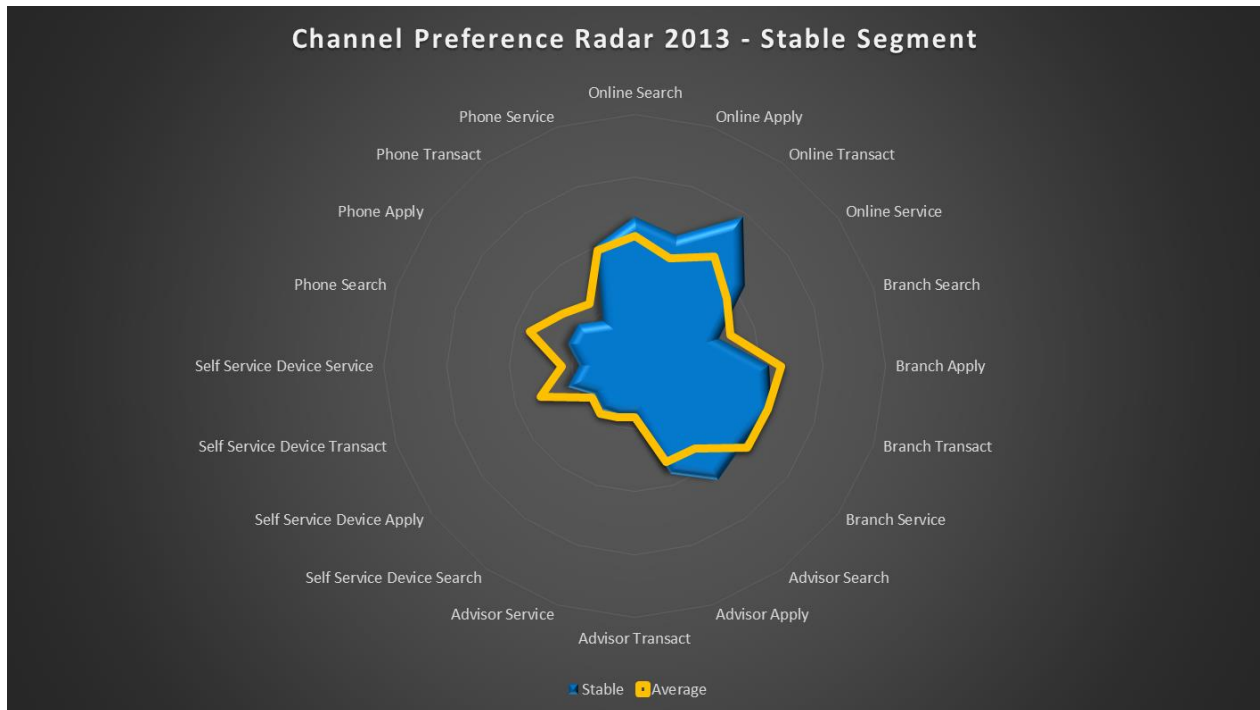


4.7 The Stable

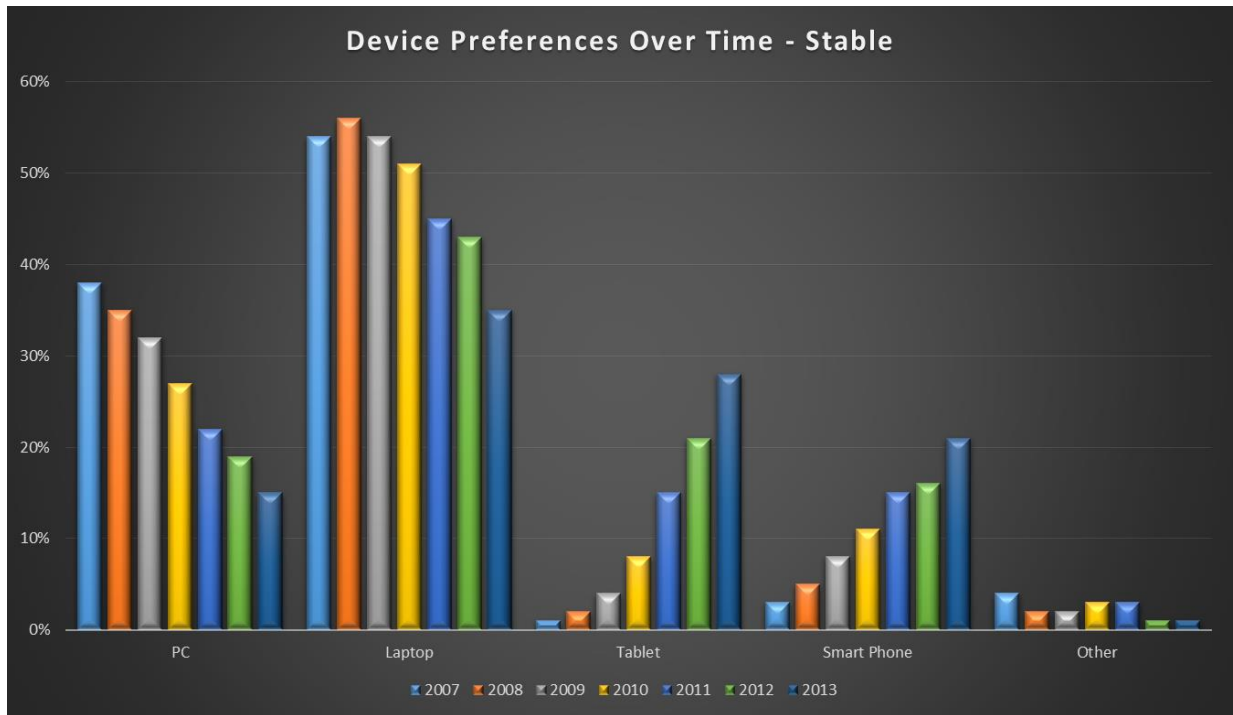
These households are more mature, often with grown-up children, and more wealth. Often both partners will be working.



They have become online aligned.

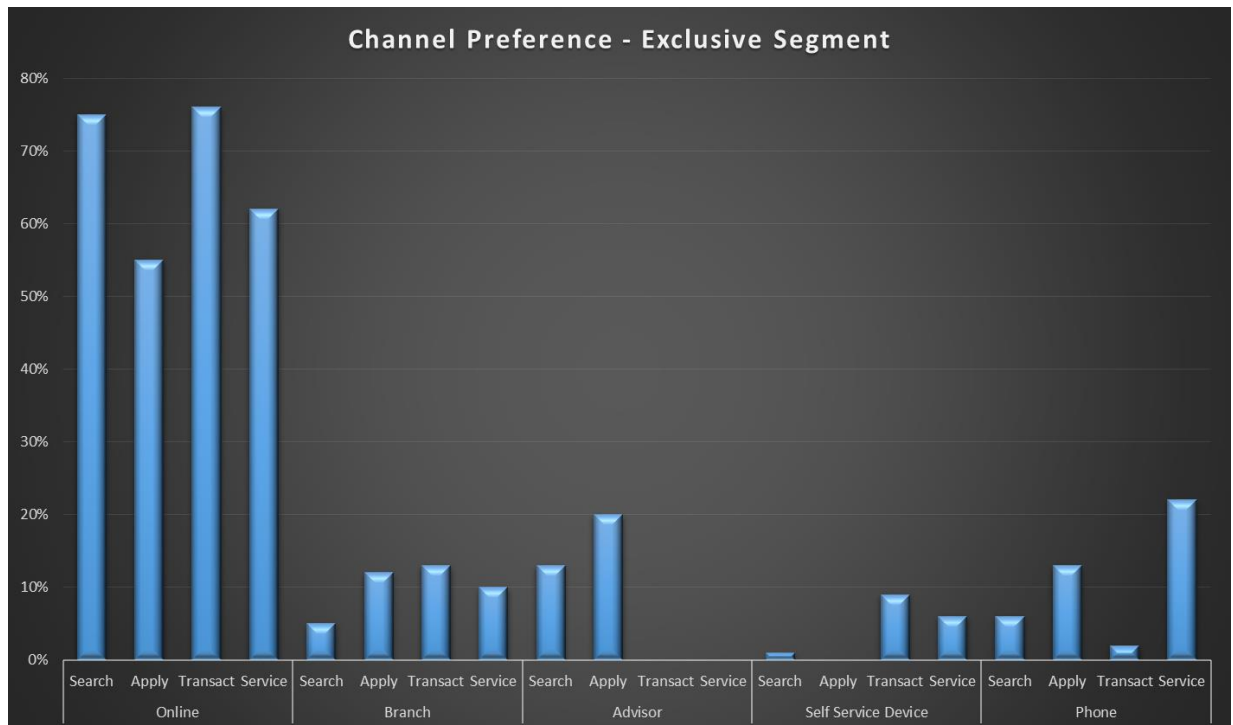


They are beginning to migrate from PCs to smart devices.

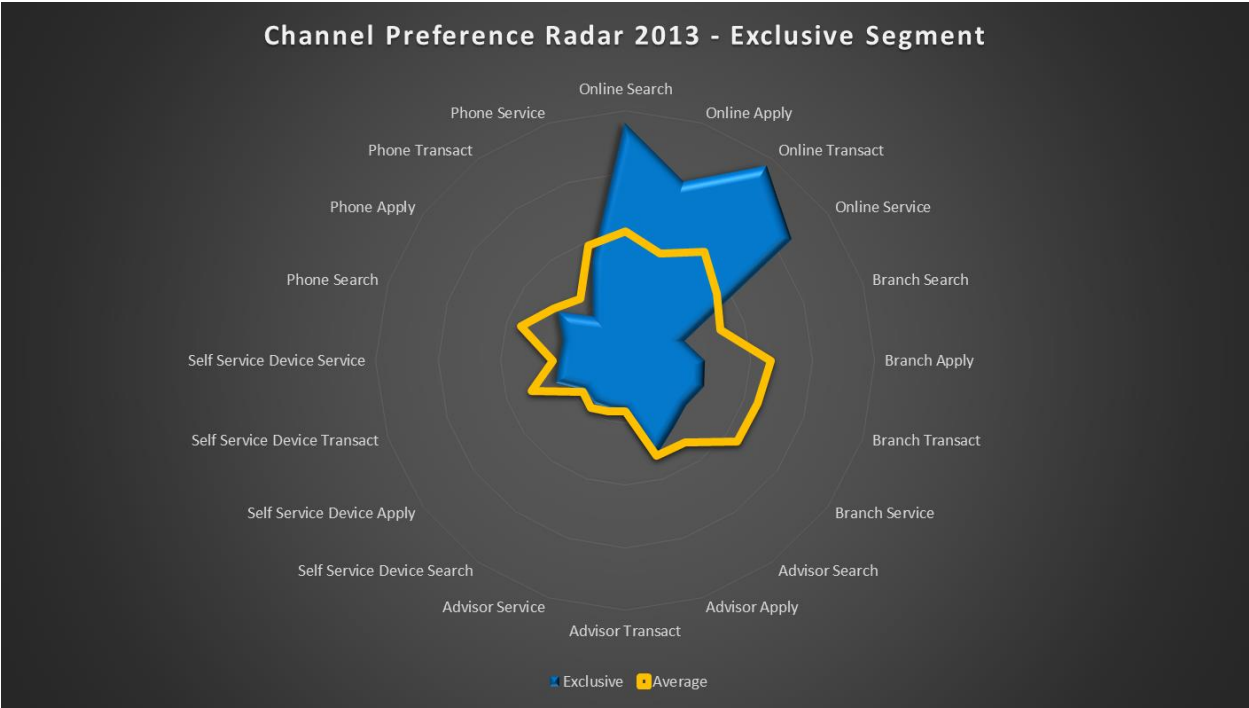


4.8 The Exclusive

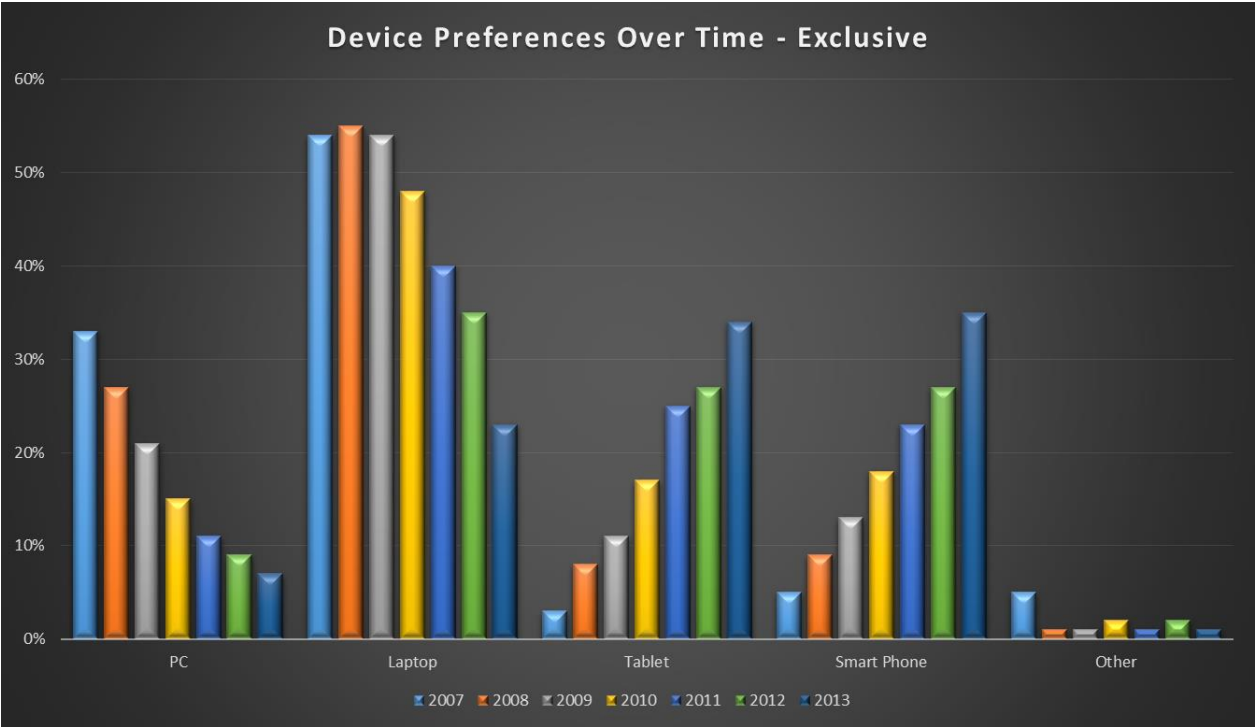
These are the wealthiest households. Average weekly income is above \$3,500. Many will be professionally qualified.



The main driver for online is convenience.



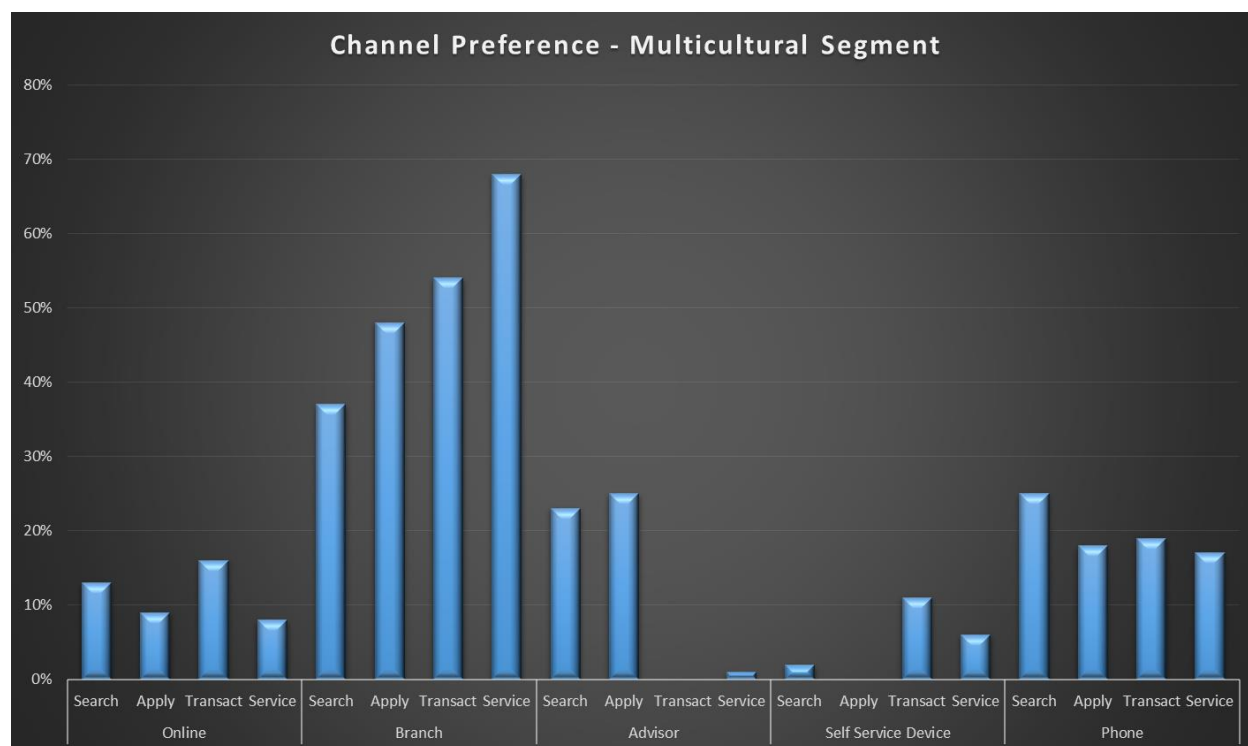
They are willing to do more online than is available today.



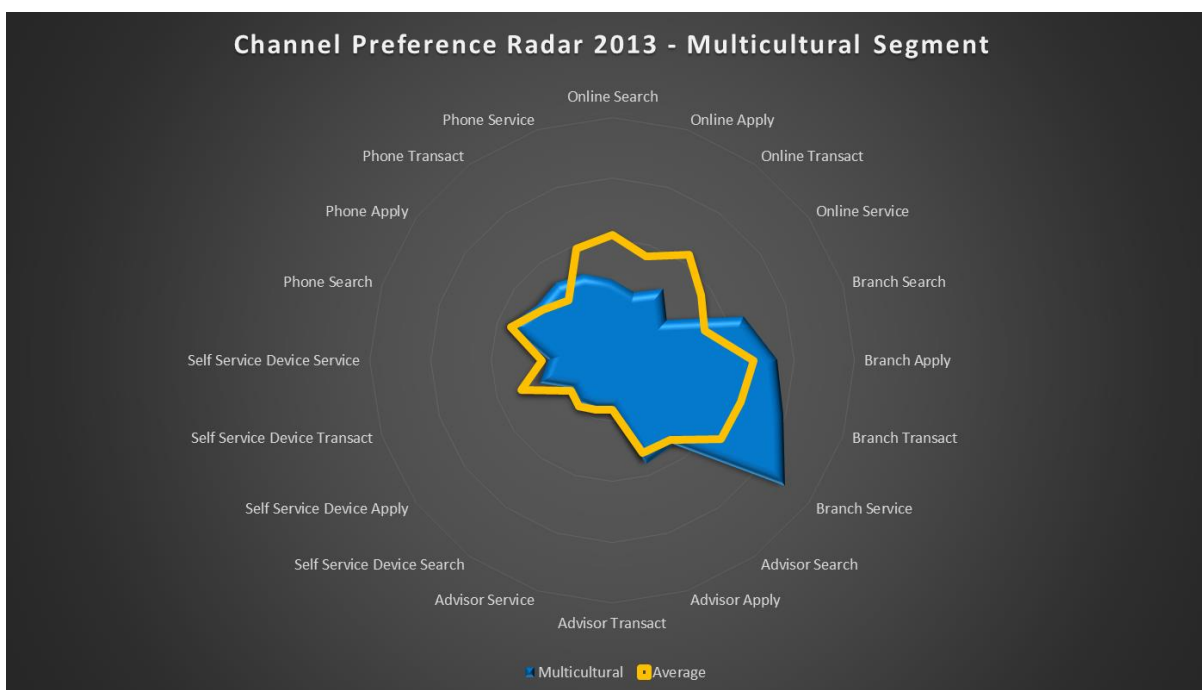
Laptops are being replaced by tablets and smart phones, though many will have multiple devices (average is 2.4 devices).

4.9 The Multicultural

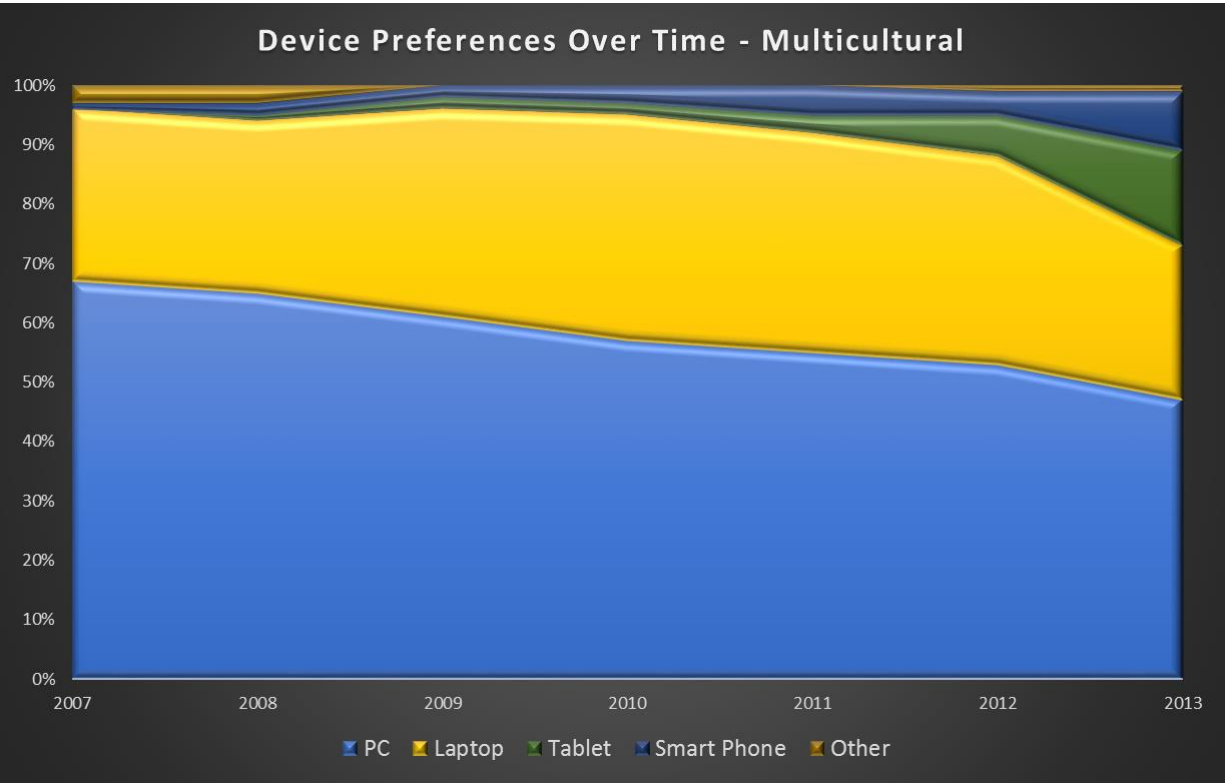
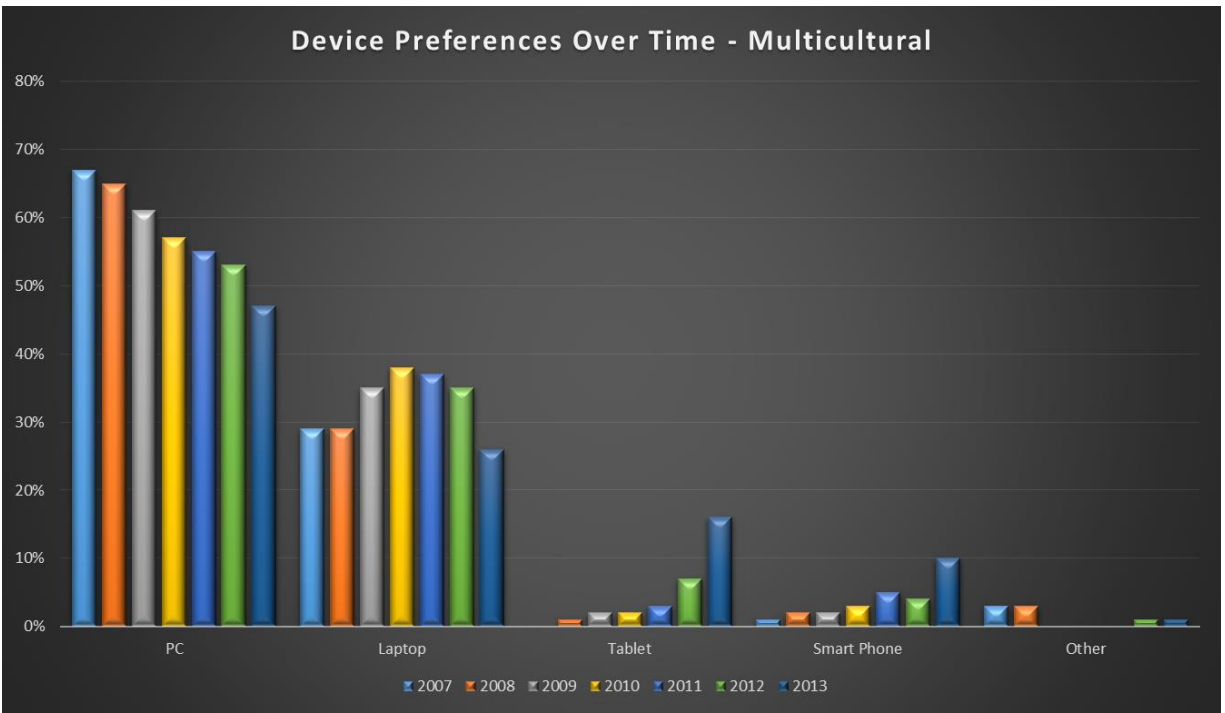
This group comprises of recent migrants and mature families with overseas origins. They will often include extended family members, and they may speak languages other than English at home.



Branches are important for this group.

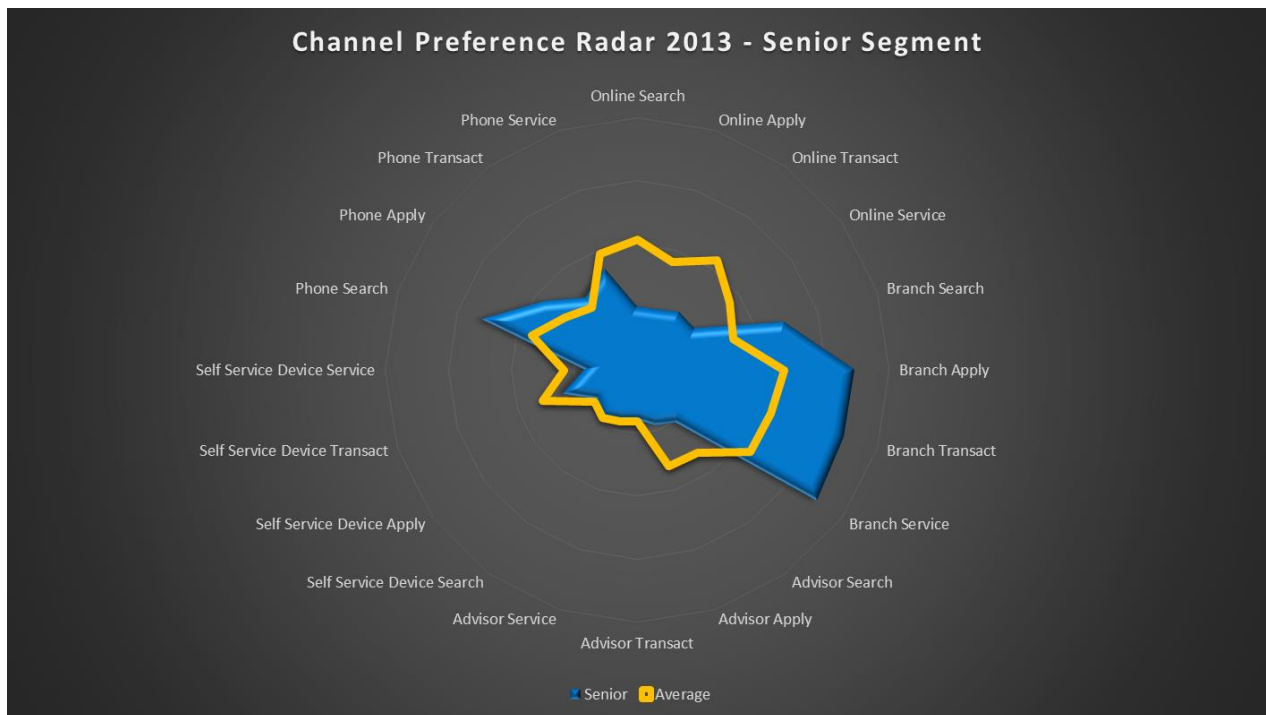
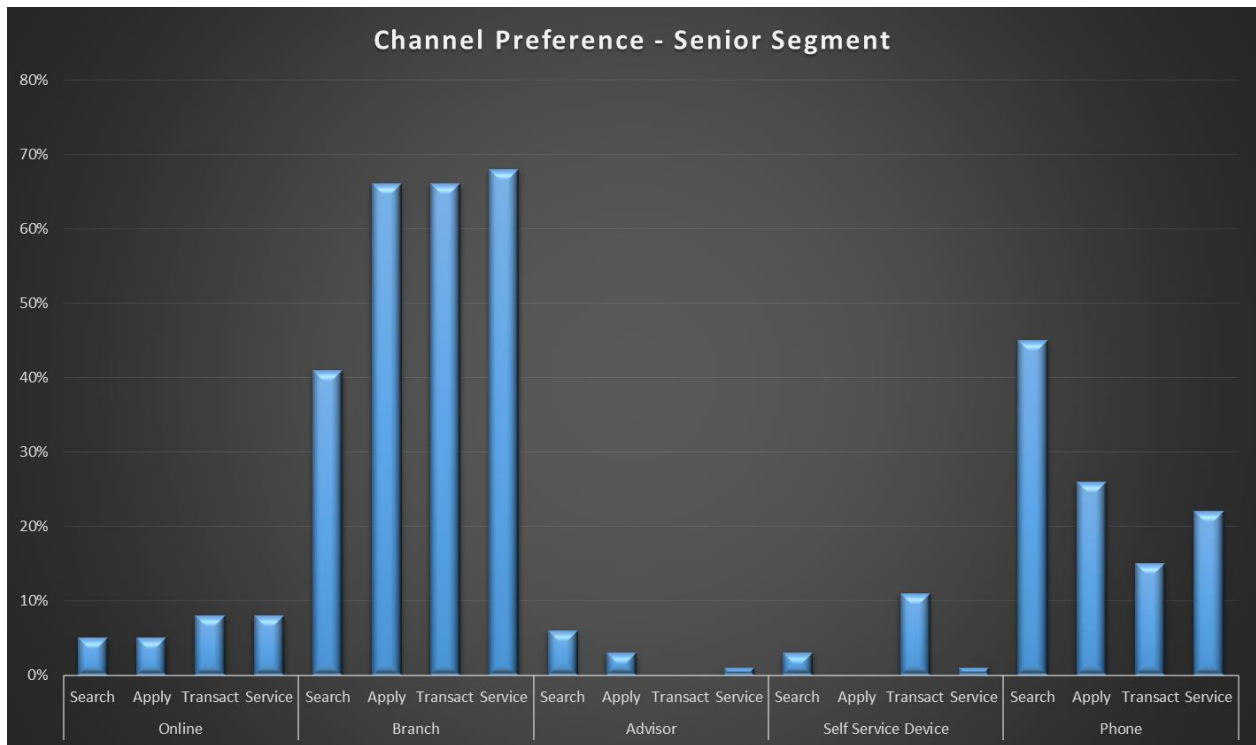


PC is the main tool for online, although we are starting to see the intrusion of smart devices.

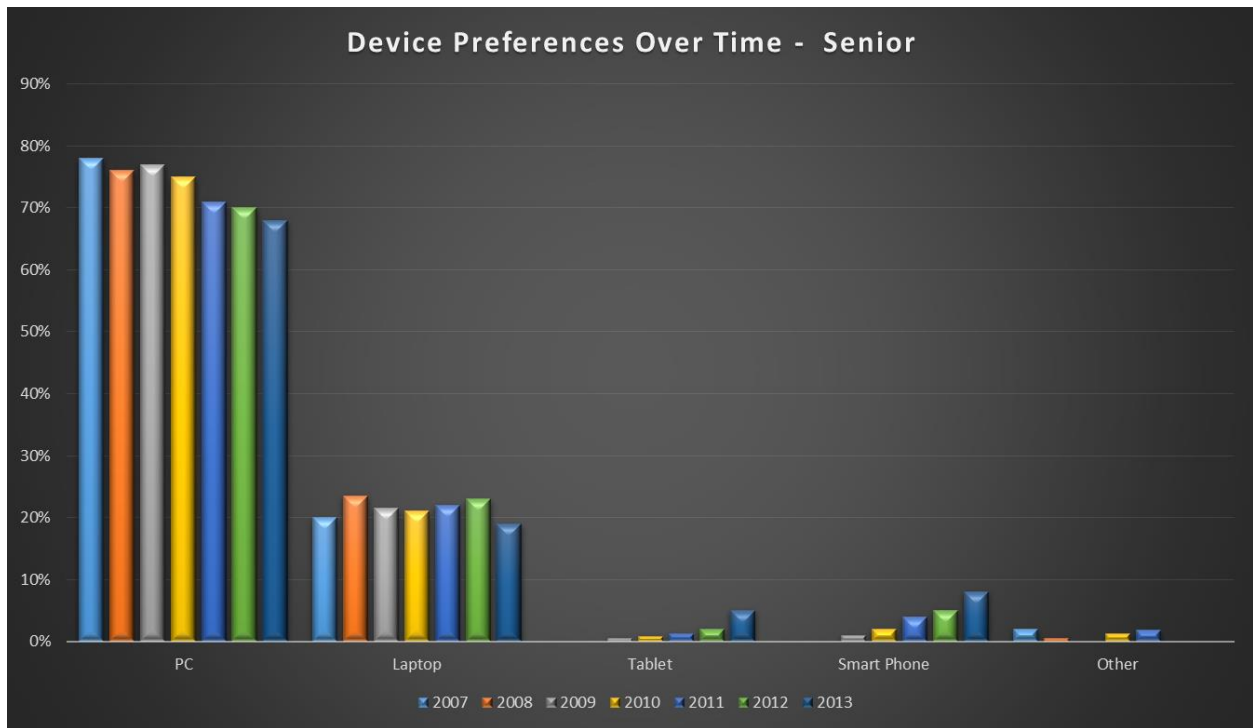


4.10 The Seniors

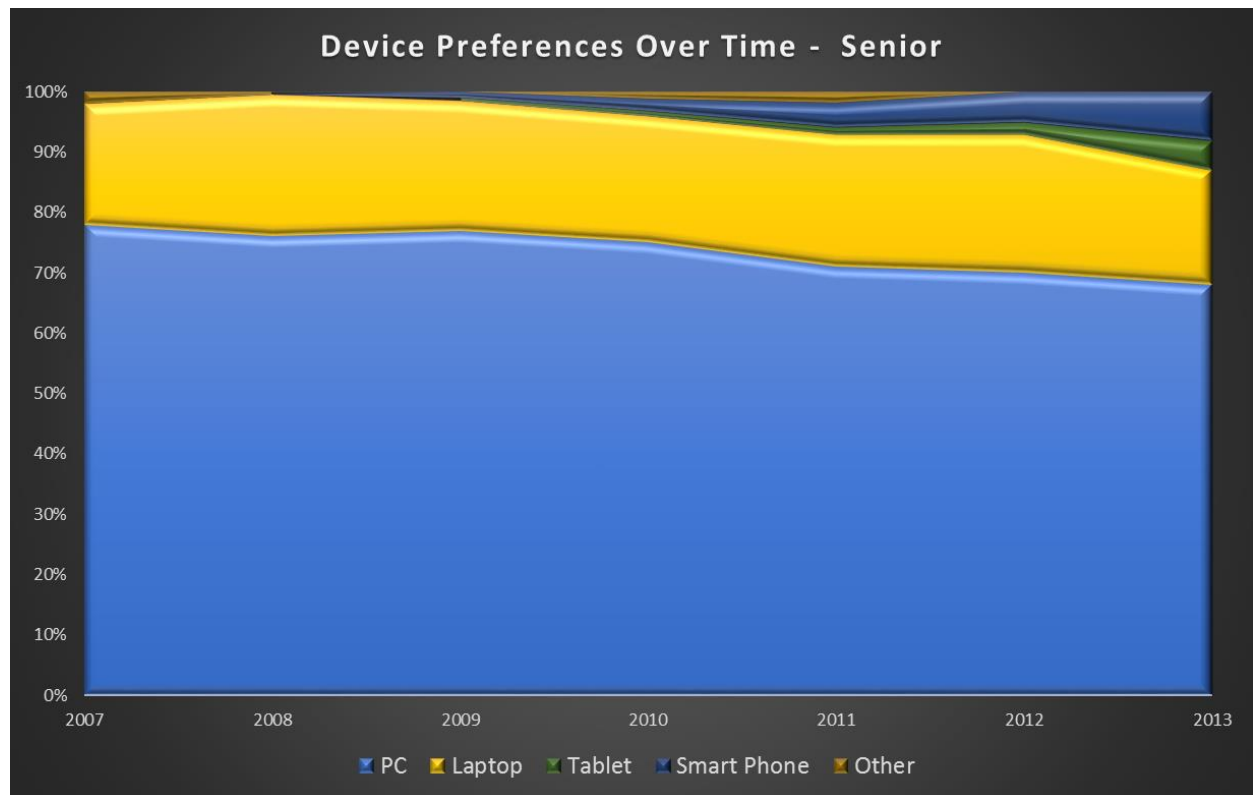
These are older people, no longer working and on Government pensions. Some will be in aged care facilities. They are strongly branch aligned.



They are not that connected, but are most likely to use a PC.

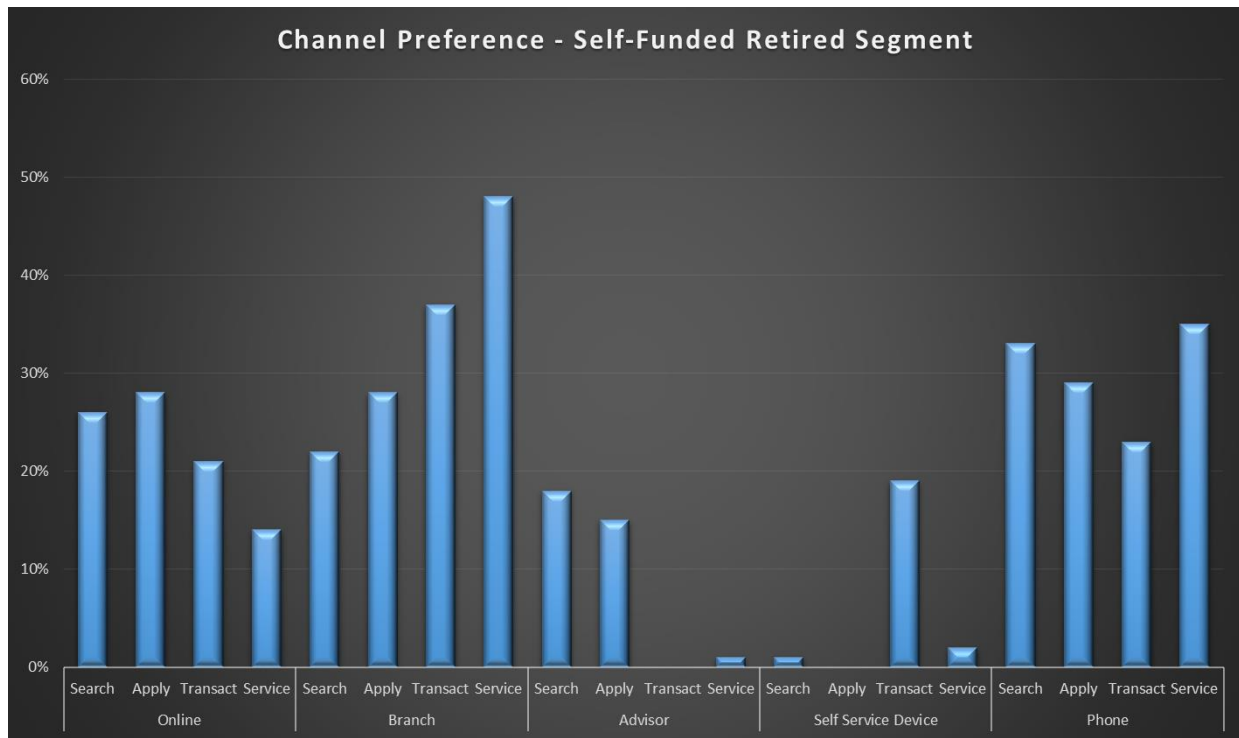


There is a slight trend towards smart devices.

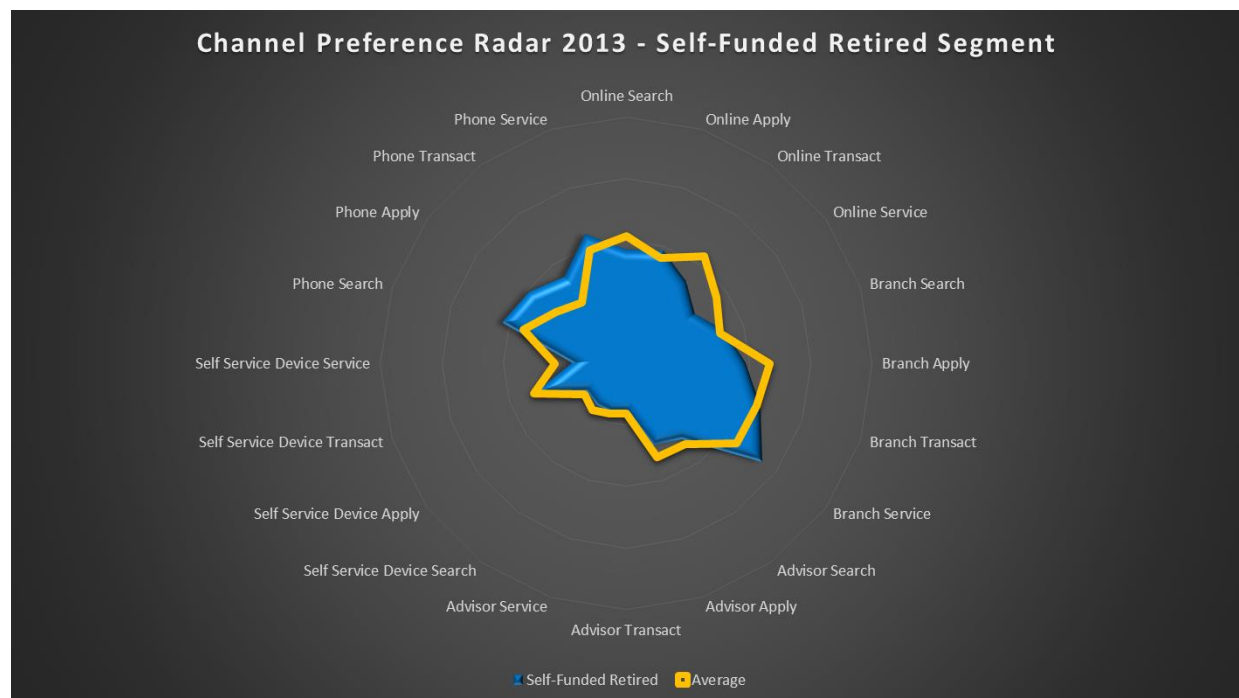


4.11 The Self-Funded Retirees

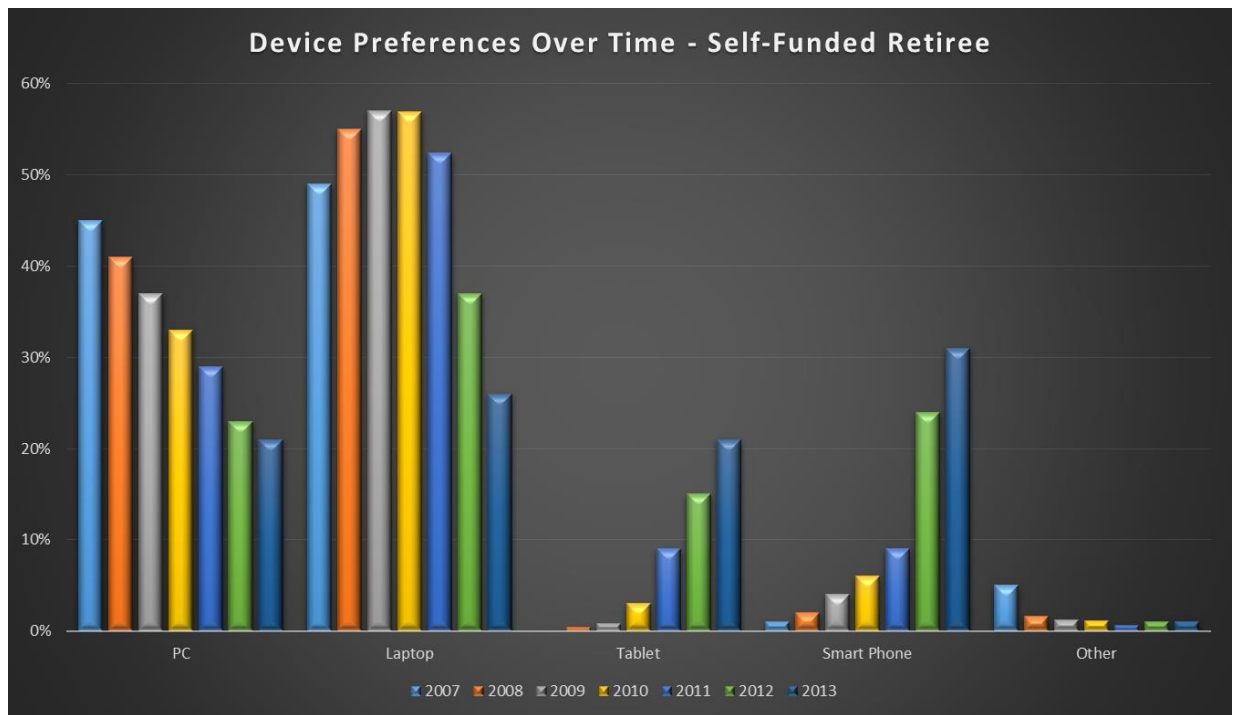
This segment, not working full time, has considerable assets from property or superannuation. They mostly live in a property with little or no mortgage. Most often the family has departed. They exhibit multi-channel preferences.



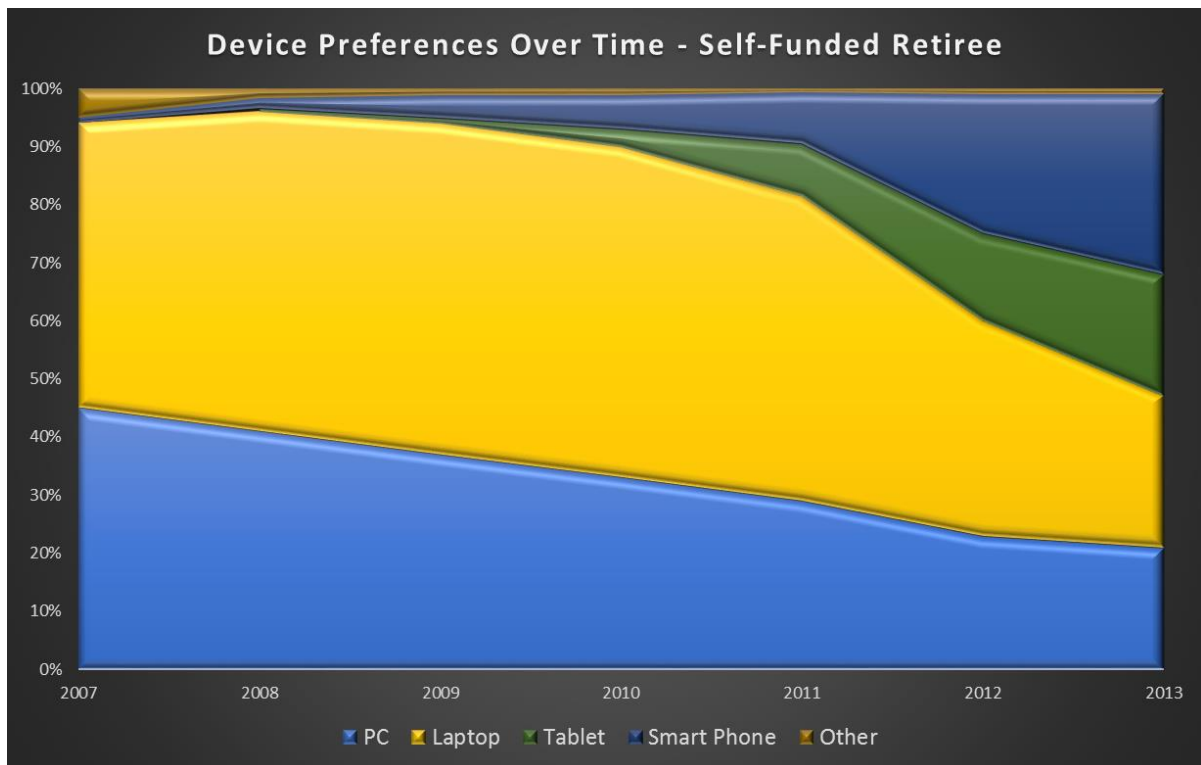
The radar illustrates this well.



They are beginning to adopt smart devices.



Although this is a recent trend over the past two years.

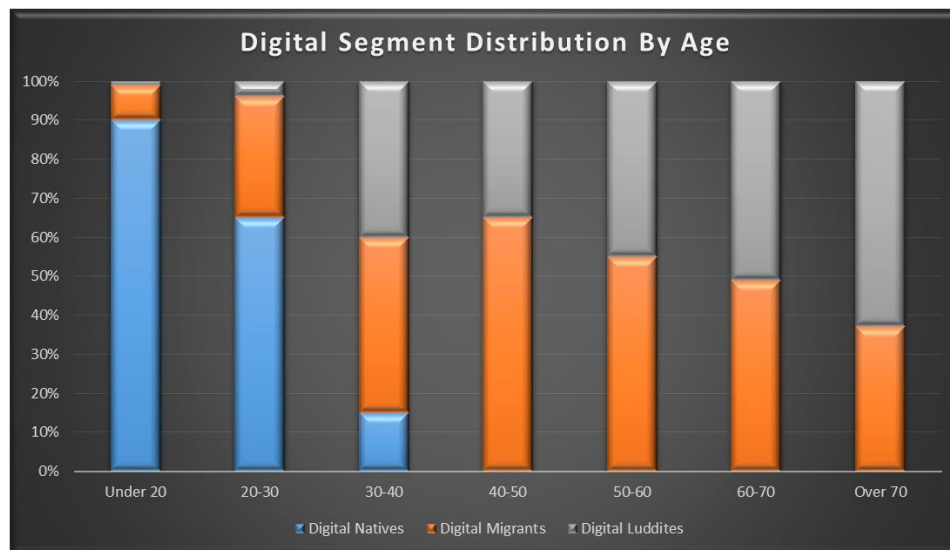


5 Digital Banking

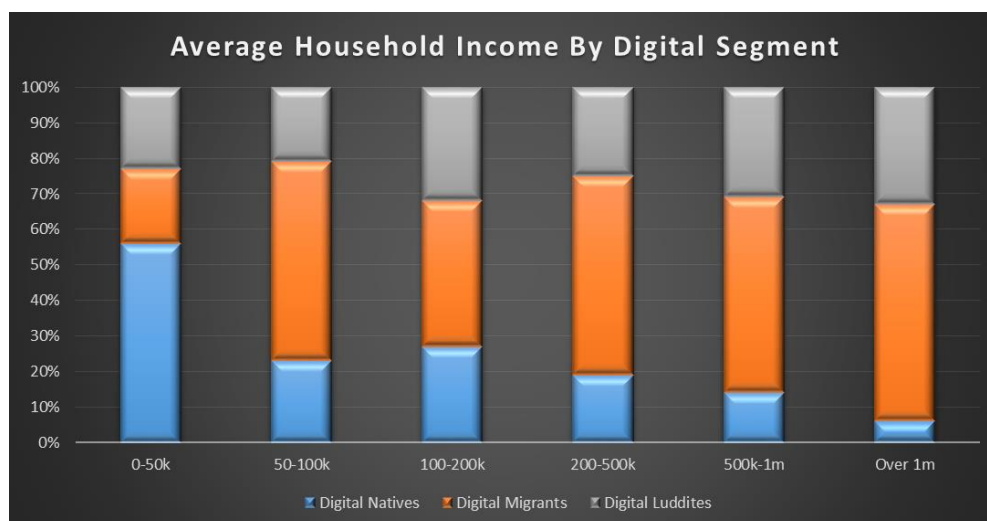
We have illustrated how segment preferences are changing. We wanted to explore the potential implications in more detail. For this we realigned our survey into three categories:

Digital Natives	Households who are naturally digital, using mobile devices, constantly online and using social media, often using multiple digital devices including tablets and smart phones
Digital Migrants	Households who are moving from terrestrial services to digital, via PC, taking up mobile devices slowly and beginning to use online and social media services
Digital Luddites	Households who use terrestrial channels, and are not interested in or capable of using digital services. May use a PC for basic internet banking, but do not use smart phones or other mobile devices

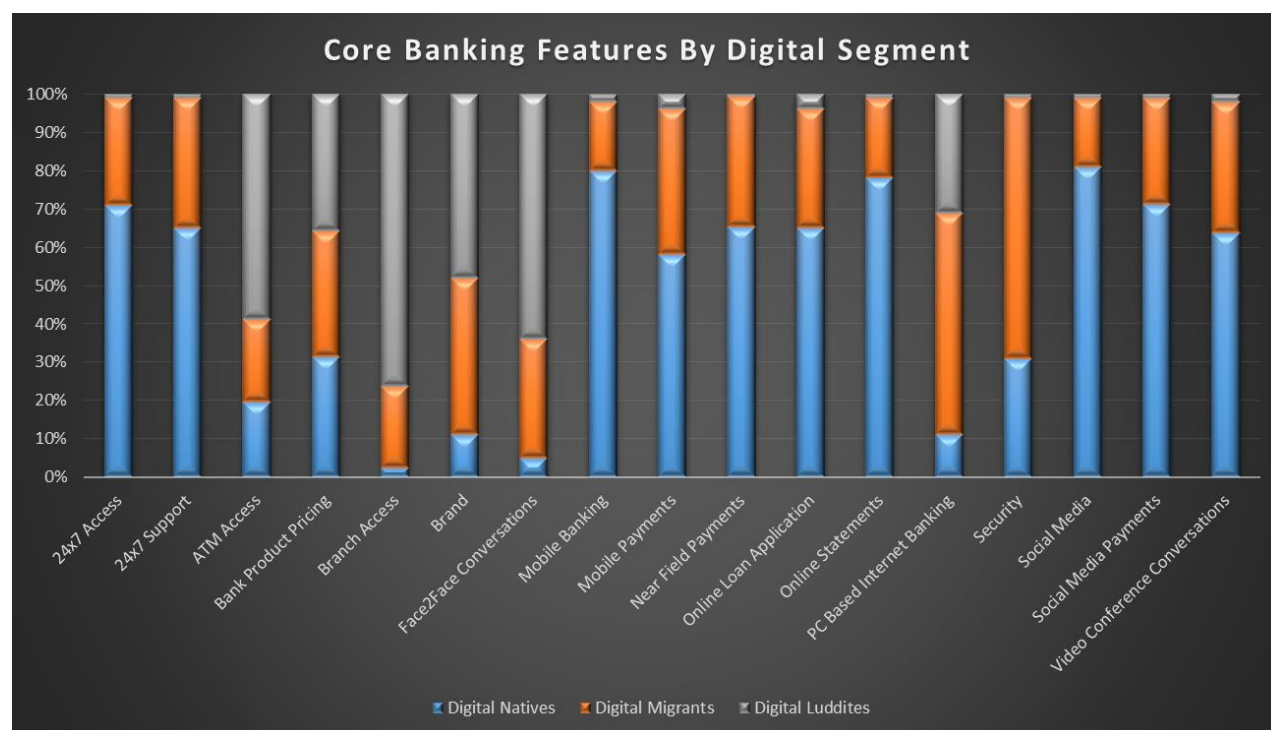
The segments are distributed across the age ranges



And average household incomes.



We extended our surveys to delve into the core features the segments would like to see from a financial services provider.



Luddites centre on branch and ATM access, value face to face conversations, and the bank brand. They tend to use PC's to access online bank services if they use them.

Migrants tend to value the PC based services, the branch and bank brand somewhat, and are very concerned about online security.

Digital Natives expect 24x7 access, mobile banking, near-field payments and online applications. They expect their bank to be in the social media environment, and would value video-conferencing with the bank advisor. Branch access, bank brand and face to face conversations are not important to this group.

5.1 The Thought Experiment

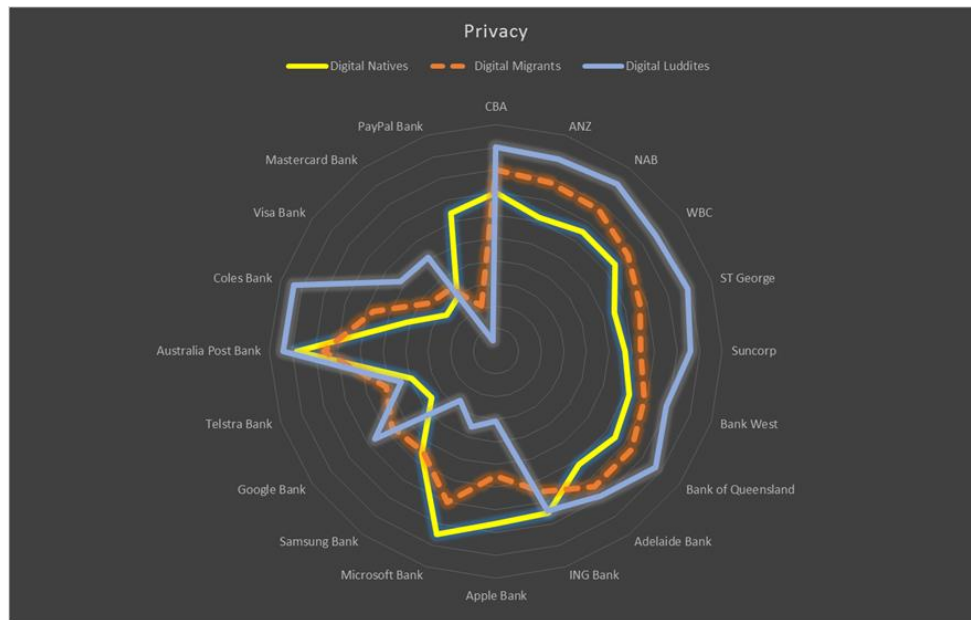
We ran the thought experiment, by listing a group of actual or potential players who might become banks. Here is the list: Adelaide Bank, ANZ, Apple Bank, Australia Post Bank, Bank of Queensland, Bank West, CBA, Coles Bank, Google Bank, ING Bank, Mastercard Bank, Microsoft Bank, NAB, PayPay Bank, Samsung Bank, St George, Suncorp, Telstra Bank, Visa Bank and Westpac.

We then asked the households to rate each player on a series of dimensions, including privacy, brand, service, baking capability, technical capability and trust. Using these dimensions, we arrived at an overall score, separating the households into the three segments, Luddites, Migrants and Natives. We will display each dimension for each segment:

5.2 Privacy

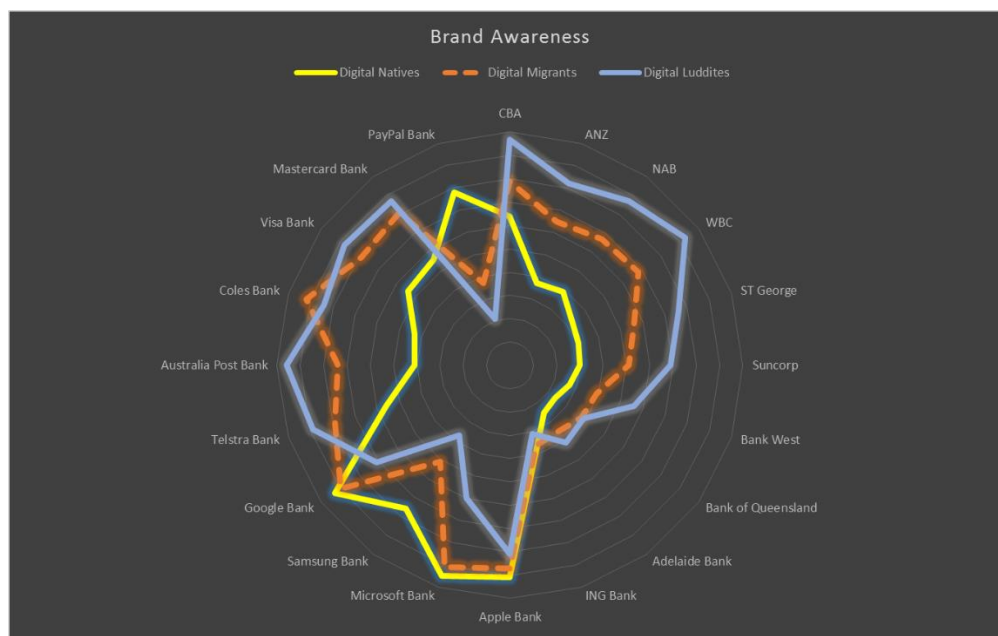
Luddites rated the traditional banks highest, with CBA leading the way. Samsung and PayPay were rated the worst. Migrants rated CBA, ANZ NAB and Australia Post highest, with Visa Bank Mastercard Bank and PayPal

lowest. Digital Natives rated Australia Post, Microsoft and Apple higher than the existing players. Google, Mastercard and Visa were lowest scored. Here is the overall summary:



5.3 Brand

Luddites rated CBA, Australia Post and Westpac the highest, and Samsung, ING and Paypal the lowest. Migrants rates Coles, Microsoft, Google and Apple highest and the regional banks lowest. Natives rated Microsoft, Google, Apple, PayPal and Samsung above CBA. The regional banks were the lowest.



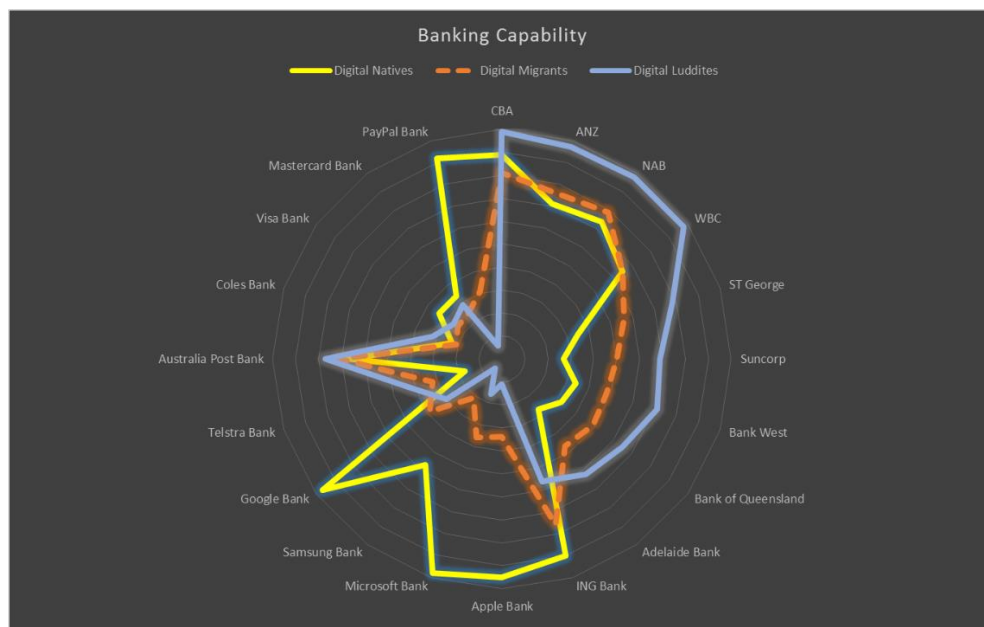
5.4 Service Expectations

Luddites rated Google above the major banks, with PayPal, Samsung and Telstra to lowest. Migrants rated Google, Australia Post and Microsoft above the majors, and Samsung, Telstra and PayPal the lowest. Natives rates Microsoft, Google and Apple the highest, the regionals the lowest.



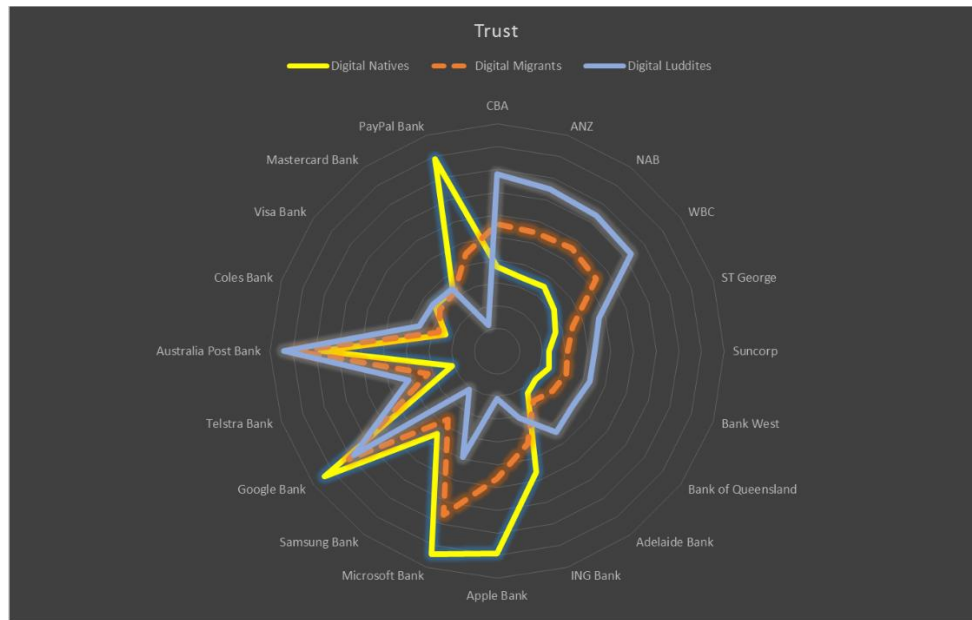
5.5 Banking Capability

Luddites rated Google, Nab, Westpac CBA and Australia Post the highest, with Paypal, Visa and Mastercard the lowest. Migrants rated the big banks highest, and Coles, Visa, Mastercard and Paypal the lowest. Natives rated Microsoft, Google, Apple and PayPal higher than the majors. The regionals, Coles and Telstra were the lowest.



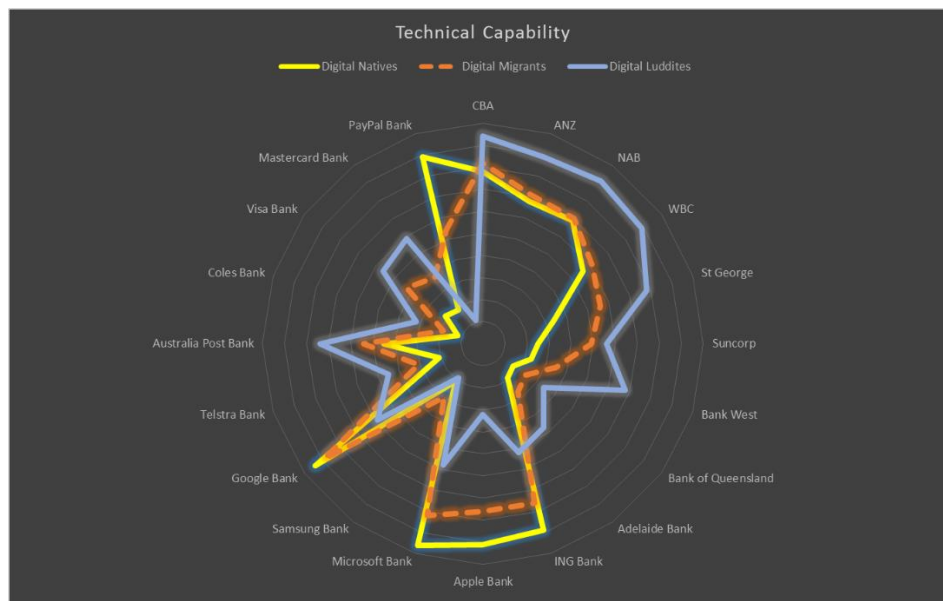
5.6 Trust

Luddites trusted Australia Post, CBA and Google the highest, Apple, Samsung and PayPal the lowest. Migrants trusted Australia Post, Google and Microsoft above the majors, with the regionals and Coles the lowest. Natives trusted Google, Microsoft, Apple, and PayPal the most, with regionals and Telstra least rated.



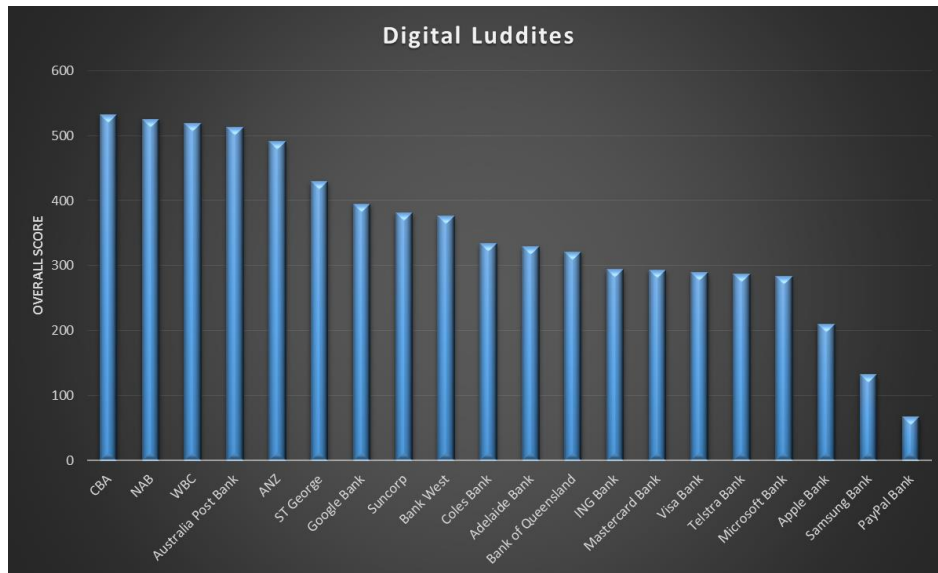
5.7 Technical Capability

Luddites rated the major banks the highest, with Samsung and PayPal the lowest. Migrants rated Google, CBA, Microsoft and ING the highest, with the regionals and Coles the lowest. Natives rated Microsoft, Google, Apple and ING the highest, with the regionals and Coles the lowest.

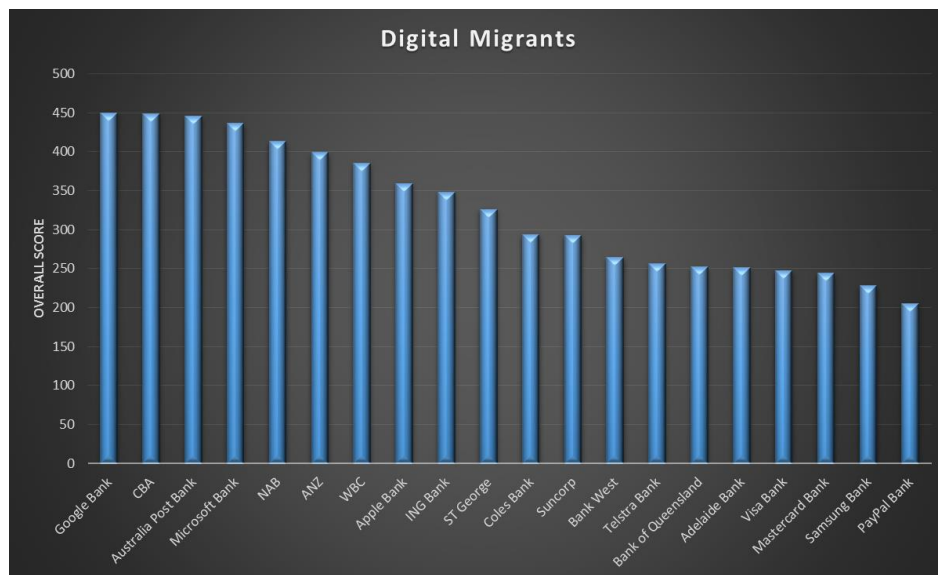


5.8 Overall Score

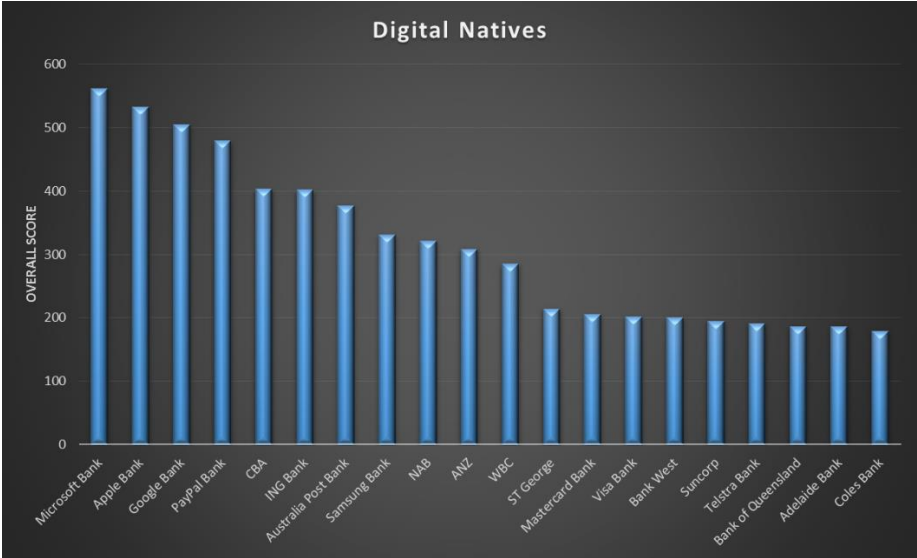
Overall Luddites rated CBA the highest and PayPal the lowest



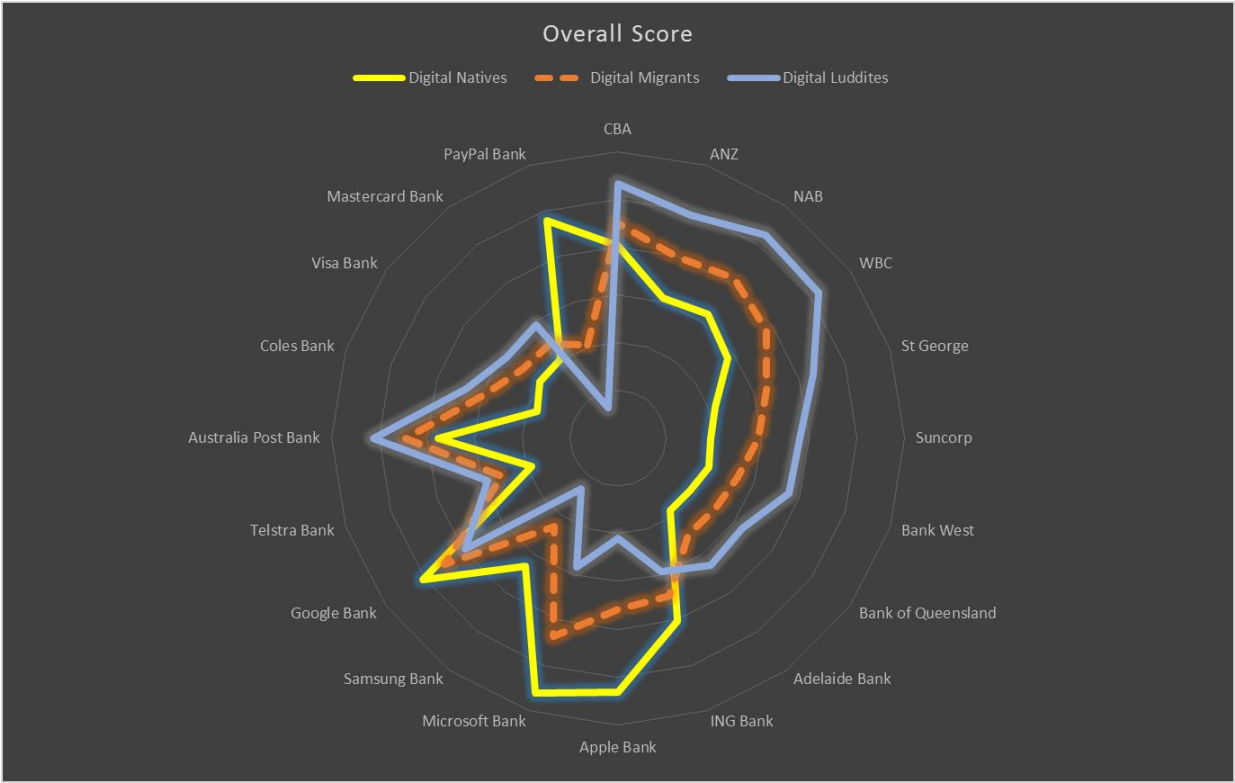
Overall Migrants rated Google highest, then CBA, with PayPal lowest.



Overall, Natives rated Microsoft, Apple and Google above the banks. The regionals and Coles rated the worse.



The overall summary radar chart shows the significant shift between the three segments.



6 Final Thoughts

Whilst it was only a thought experiment, the message is clear. Existing players need to be thinking about how they will deploy appropriate services through digital channels, as their customers are rapidly migrating there. There is an opportunity for truly digital brands to gain mind-share and disrupt the status quo.

We see this migration to digital more advanced amongst higher income households. So players which are slow to catch the wave will be left with potentially less valuable customers longer term.

Players need to adapt more quickly to the digital world. We are past an omni-channel (let them choose a channel) strategy. Digital migration needs to become central strategy because the winners will be those with the technical capability, customer sense and flexibility to reinvent banking in the digital age. Existing brands will be under the hammer in the transition. Privacy and trust will take centre stage.

7 About DFA

Digital Finance Analytics (DFA) is a boutique research, analysis and consulting firm providing advisory services to Clients in Australia and beyond.

DFA combines primary consumer research, industry modelling, economic analysis and segmentation analytics to offer insight into the dynamics of the mortgage, lending, savings, payments and superannuation sectors. Using experience derived from more than 25 years of analysis, DFA is able to pinpoint opportunities created by changing customer needs in the evolving market.

A specific focus is the changing channel preferences being exhibited by "Digital Natives" and how products, services and customer experience will need to be tailored to this new environment.

DFA provides custom research and advice to a number of clients, maintains a number of industry models, authors various industry reports and collaborates on mortgage, SME and housing sector publications.

The DFA Household survey was completed between March 2013 and February 2014, and includes 26,000 households via an omnibus survey, normalised for state and segment variations. Findings are weighted so that more recent weeks results have stronger influence on the results. Data is drawing from DFA's ongoing research, last updated 22th February 2014.

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Appendix 2 – Peer To Peer Lending

In the world of banking, little really changes, banks take deposits from savers and lend to borrowers, for a turn. The bank is the intermediary. However, peer to peer lending has the potential to disrupt this model, perhaps. So today we unpick this evolving alternative banking model and consider its potential.

Peer to Peer Lending (P2P Lending) is where people with money to invest, make loans to people who need funding for specific purposes. The transaction is outside the banking system, although lenders and borrowers will normally interact via a web based service which acts as a broker, provides various tools, and may take a fee. The P2P Broker is actually a different sort of intermediary, so I do not see this as classic disintermediation.

The P2P Broker offers a range of services, including providing a facility to match potential lenders and borrowers, process payments, spread risks by one-to-many arrangements, check the financial status of potential borrowers, manage defaults, and provide information about the status of the loans. Regulatory compliance is also becoming more significant.

The reason this is attractive to investors, is because they may be able to command a higher rate of return compared with standard bank deposits. Their capital is not protected like when depositing with a bank, so the higher returns reflect the higher risks. If the borrower defaults, they lose their cash, unless the P2P Broker has some type of insurance arrangement.

Borrowers may be able to source funds at a cheaper rate. Most loans in P2P transactions are unsecured. Loans would normally be for a few years.

The P2P Broker is generally a commercial entity who is attempting to make a profit from the services they are providing.

P2P Lending emerged in the UK in 2005, when [Zopa](#) started. Today Zopa has lent more than £467 million, with over £190 million in the last year. They have over 50,000 active savers and 80,000 borrowers and over £28m in interest earned by savers since Zopa launched. Zopa has a credit licence in the UK. One feature of Zopa's model is the protection of investors' funds in cases of default. They run a trust fund which pays out on loans in the case when borrowers can no longer repay. They call this facility the Zopa Safeguard. They are currently offering investors 4.9% return for up to 5 years, much higher than UK bank deposits. Zopa's default rate is just 0.93 per cent.

In 2010, [Funding Circle](#) was launched as a P2P Broker offering lending to small business. They have now lent £218m. Since it started more than 50,000 people have registered at Funding Circle and investors now include local councils, universities and the British Government through its Business Finance Partnership. The P2P sites only accept around 12 in every 100 loan applicants, and their default rate is only around 1%. Other players include [MarketInvoice](#), the first peer-to-business lender lending specifically against invoices and [Assetz Capital](#), which started lending in 2013 and made the the largest peer to peer loan in the UK to date, a £1.5m loan for development of some student accommodation in Nottingham.

Estimates are that more than £700 million has been lent via P2P Brokers. As of April 2014 peer to peer lending will fall within the Financial Conduct Authorities business rules, so the regulators are accepting this business model, and putting regulation in place. In a recent speech, Bank of England executive director [Andy Haldane](#) has said that peer-to-peer (P2P) lending through online sites has the potential to [eventually replace old-fashioned banking](#).

In the US, [Prosper](#) started in 2006. [Lending Club](#) followed soon after. Initially there was little regulation, and high default rates, but in 2008 the SEC regulated that they must offer securities, and fall within regulatory control. After

some initial issues, they are growing fast, with more than \$2bn lent. In addition, traditional banks are now appearing on the governance boards of these players. In November 2013, [SoFi](#) announced a deal with Barclays and Morgan Stanley to create a bond backed by peer-to-peer student loans. This leads to the first securitisation of these loans to receive a credit rating. P2P Lending is going main stream!

China, is another market, which has a rich tradition of P2P lending in the physical world. Now, online services are fast emerging. These include Creditease and SinoLending who now has links with Lending Club. Elsewhere, [Zidisha](#) is a non-profit variant who offers cross-broder P2P Lending to developed countries.

In Australia, its early days. In the past players like [Lending Hub](#), iGrin, and Fosik started out, but [SocietyOne](#) is the largest player. They say:

"SocietyOne is Australia's first fully compliant peer-to-peer online platform – connecting borrowers and investors in a secure, safe, professional online environment.

Until the Fund is registered with ASIC, all investors in the Fund must be wholesale clients as defined in the Corporations Act 2001."

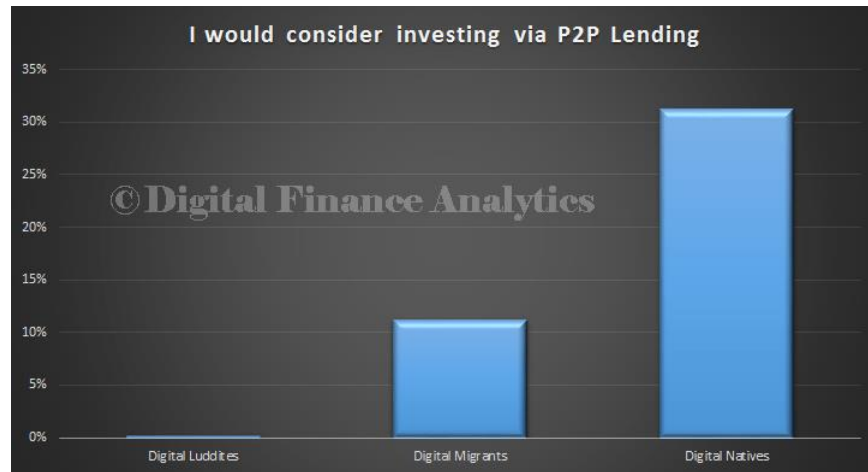
In a [recent article](#), SocietyOne is said to have made almost 150 loans, totalling \$2 million. About 11% of applications are accepted. SocietyOne's default rate at June 30 was 2.3 per cent. The market place includes auction functionality like ebay to match borrowers and investors.

We are aware of other players also considering the opportunity here. The regulatory framework is still immature, so there are a number of barriers to cross.

The key question is, does P2P Lending offer an opportunity in Australia? Well, there is significant [demand from small business for finance](#), and the big banks have upped the ante in terms of [pricing and security requirements](#). Potential investors though are taking more risk than deposits, and there is no deposit protection, although Zopa's Safeguard facility points the way ahead. The question though is, consumer demand for investment via P2P. We completed an annex to our household survey testing potential demand by using our standard segments:

Digital Natives	Households who are naturally digital, using mobile devices, constantly online and using social media, often using multiple digital devices including tablets and smart phones
Digital Migrants	Households who are moving from terrestrial services to digital, via PC, taking up mobile devices slowly and beginning to use online and social media services
Digital Luddites	Households who use terrestrial channels, and are not interested in or capable of using digital services. May use a PC for basic internet banking, but do not use smart phones or other mobile devices

The results are:



This shows that those who are digitally connected are more likely to consider it. For details of our survey, [go here](#). We also asked SME's about their appetite to borrow from a P2P source, and 35% of business owners said they would be interested to consider it. So there exists in Australia, potential investors, and potential borrowers. Whilst there is latent demand, for many the risks are unclear and the regulators do not appear to be across this issue. (a web search of RBA, APRA and ASIC).

We believe that P2P Lending has the potential to become a significant and disruptive force in banking, for unsecured credit and as an alternative to credit card debt. However, as this is a relative small share of total borrowing (~\$150bn), the overall impact on the banking system is likely to be quite small. The bulk of business is secured, and so far P2P Lending does not cover this type of business. If that were to change, all bets are off.

Appendix 3 – Shadow Banking In Australia

We look at Shadow Banking in Australia, having set the scene [by looking at the size of the global market](#) and the [core financial flows](#) in previous posts. We are talking about players who are interpose themselves in credit flows outside the regulated banking system. Not all such players carry the same risks, and some behave more like banks than others, which is why the [Financial Stability Board](#) approach is to decompose players into different risk categories.

This definitional problem is relevant to Australia as the regulators here have distinguished between “prudentially regulated” and other players. The [Australian Prudential Regulation Authority](#) (APRA)

“is the regulator of the Australian financial services industry. It oversees banks, credit unions, building societies, general insurance and reinsurance companies, life insurance, friendly societies, and most of the superannuation industry. APRA is funded largely by the industries that it supervises. It was established on 1 July 1998. APRA currently supervises institutions holding \$4.5 trillion in assets for Australian depositors, policyholders and superannuation fund members.”

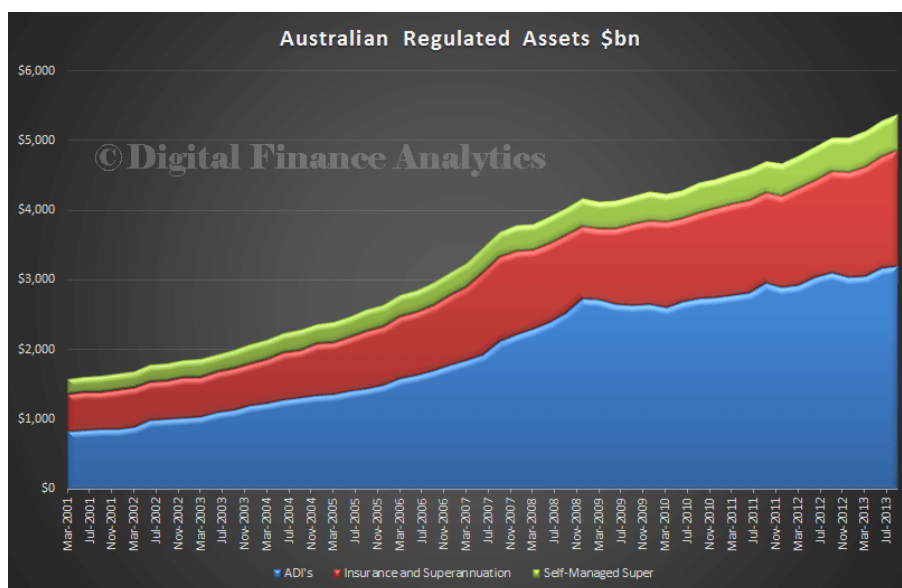
APRA maintains a list of companies it regulates under [ADI's](#), [General Insurers](#), [Superannuation](#), and [Life Insurers](#). Each sector has its own web area within APRA, but there is no one clear single list across all sectors, which makes tracking down the status of an individual company quite difficult. Each sector has its own regulation framework.

Non-regulated entities (they are regulated by [ASIC](#) as normal companies) include:

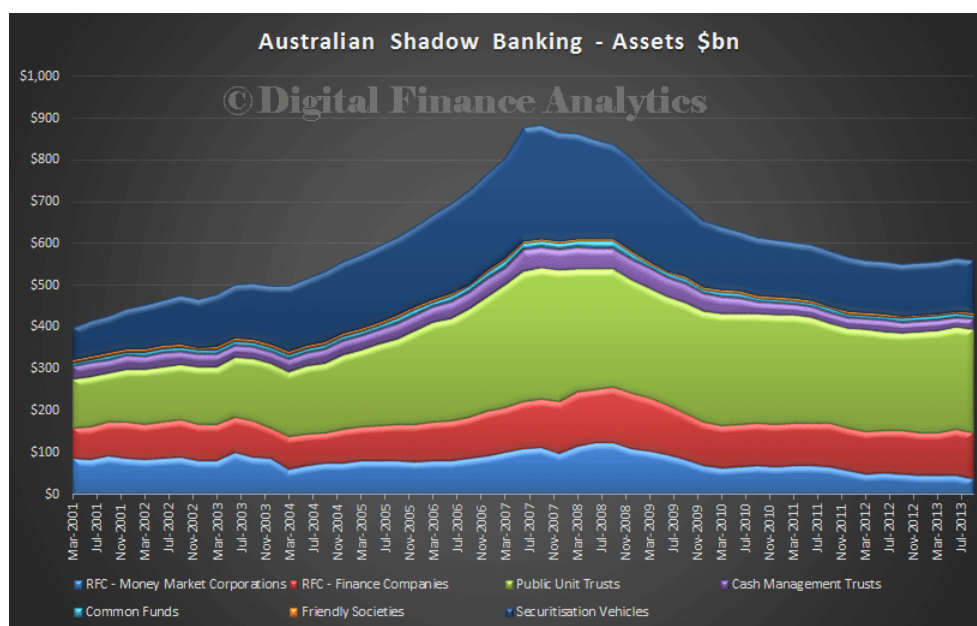
- Wholesale funders, mostly securitisers, who provide data on a voluntary basis to the RBA.
- Discretionary Mutual Funds (DMFs), who report their financial status to APRA.
- General insurance intermediaries are required to provide data to APRA.
- Registered Finance Corporation (RFC), who are required to make financial reports to APRA, [a list of entities is here](#). RFC's include activities as diverse as motor vehicle finance, consumer finance, equipment leasing, and a range of investment banking activities.

One other sector to consider is the growing number of [self-managed superannuation funds](#), which is regulated by the ATO, worth about \$506bn.

The [RBA argues that all prudentially regulated assets, and self-managed super should not be included in the shadow banking bucket](#). As a result, the data for the two categories can be shown as follows:



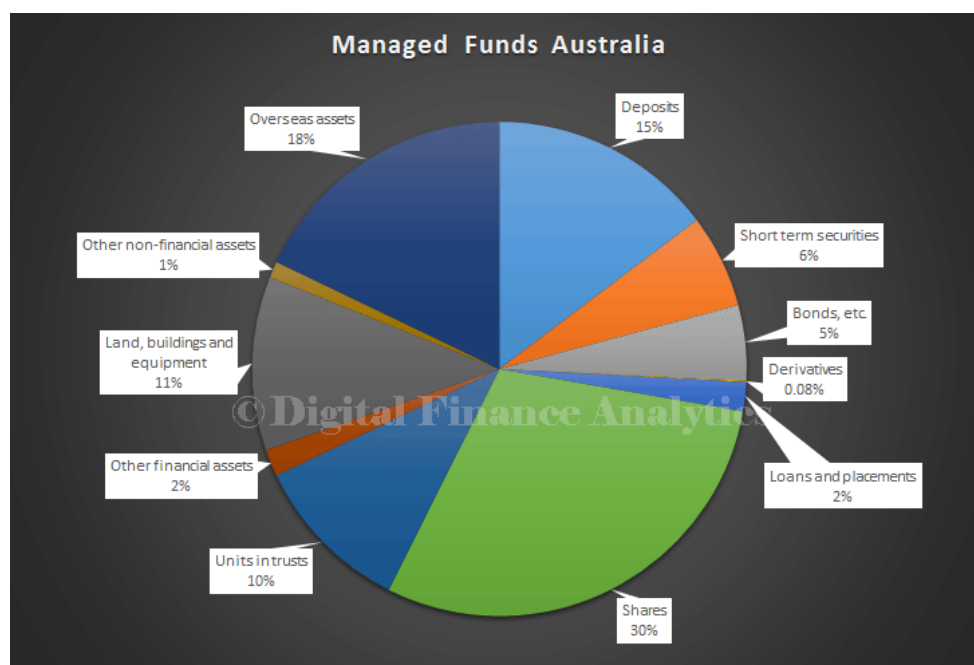
The smaller shadow banking sector in Australia therefore looks like this:



So today, shadow banking, on these definitions has ~\$500bn of assets, whereas the regulated sector (including self-managed super) is ten times larger.

Looking at the trends, prior to the GFC, we saw significant growth, especially in securitisation, this fell away after the financial crisis, [as we highlighted in an earlier post](#). The demand for wholesale funding by non-banks was strong, until the world changed, and pricing took a hike, to the point where their business models broke. Now, deposit funding is more attractive, although we are seeing some potential recovery in non-banking securitisation more recently. Likewise, many overseas money market corporations withdrew. We have split out a number of investment funds, including public unit trusts who might invest in equities or property, cash management trusts, and hedge funds.

Another way to look at the split by investment type is illustrated by this [data from the ABS](#), which shows how diverse the managed funds investments are. Data on cash management and unit trusts show the same trends.



The core question is to what extent do assets in these non-prudentially regulated sectors have the characteristics and risks of shadow banking? Actually it is hard to know, for example, are cash management trusts, or unlisted property or mortgage trusts linked to credit flows and risks? Probably. What about unit trusts which are invested in equities, perhaps not?

The wider question, however is the extent to which the prudentially regulated entities and the non-prudentially regulated entities are connected (either locally or globally). The data is hard to pin down. Perhaps 5% of Australian bank assets are exposed to shadow bank intermediaries, and 18% of shadow banking assets in Australia are exposed to the banks. The challenge is to better understand these connection, and begin to tease apart the links and risks.

This is the challenge, not just in Australia, but elsewhere, because the “unknown unknowns” lay here. This is why markets are nervous of the situation in China, where the shadow-banking sector is large, and its links unclear.

Locally, if we accept the regulatory definitions as presented here, the shadow banking sector appears small, mostly centered around securitisation, and is shrinking rather than growing. However, perhaps these underlying assumptions need to be tested harder, because it is likely that shadow banking will continue to evolve and the superficial clarity implied by the regulators in Australia may belie the complexity which exists below the surface. The truth is the financial complexity is the friend of the investment banker, and the more complex the structures, the less likely it is the full risks of transactions will be understood by the regulators.

The case for splitting retail banking and investment banking is based on the argument that it is impossible to mix the two and not lose sight of the risks involved. Some are calling for a new version of Glass-Steagall, the 1930s US Act which separated retail banking activities from investment banking activities, and which was cast aside as part of financial deregulation. Recent attempts to ring-fence retail activity from investment activity through the Volcker Rule in the US, or in the UK, (retail and capital market activities are being separately capitalised) are watered down responses. Bankers will argue that they need to access capital markets to manage their retail business. However, perhaps Glass-Steagall II would be the right objective response to tackling and managing shadow-banking.

Meantime, regulators around the world are spending time trying to get better data to map the status quo. Perhaps we need a more radical response?