Geopolitics and the Australian Financial Services Industry

KPMG Australia Geopolitics Hub

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Executive summary

Australian financial services firms are navigating an increasingly complex geopolitical environment. Four geopolitical megatrends – global power realignment, the erosion of truth and trust, the geopolitics of the tech revolution, and the geopolitics of the climate crisis – are creating risks as well as opportunities. Financial services companies are being called on to take a stand on controversial issues of social justice, pursue new cyber-enabled opportunities while managing the risks that come with them, and come to grips with the way that climate change is rapidly changing the risk outlook for their clients. Those financial services firms that act early to understand and respond to these megatrends will be best prepared for the stormy waters ahead.[1]

Global power realignment

Rising economies are calling for a greater say in world affairs, while incumbent global powers are trying to retain their influence.

In a global context of uncertainty and mistrust driven by these power shifts, many countries are pulling back from global interdependency, and prioritising domestic self-sufficiency and relationships with trusted partners.

This is contributing to the risk of the global financial system fracturing along ideological lines. International investment flows are at risk of disruption, as governments seek to limit inward and outward investment links with countries that are not geopolitically aligned.

The erosion of truth and trust

Real and perceived inequality and the proliferation of mis- and dis-information are driving a loss of faith in governments and financial institutions in many parts of the world.

Increasing societal polarisation often goes hand in hand with the emergence of populist leaders, who are associated with nationalist and protectionist tendencies and a scepticism of democratic institutions.[2]

In the face of a decline in citizens' trust in governments, companies are increasingly expected to take a stand on controversial issues of social justice.

The geopolitics of the tech revolution

Major global powers are engaged in a race towards technological supremacy as a means to maintain or enhance their relative power, which some describe as a 'tech cold war.'

As a result, technology supply chains are being decoupled in order to inhibit the tech advances, and therefore power, of others.

Governments are increasingly concerned about cybersecurity, and are making efforts to exclude potentially hostile actors from key national infrastructure projects.[3]

The geopolitics of the climate crisis

Climate change will affect countries differently, depending on their stage of development.

Some industrialised countries are calling for rapid emissions cuts, while many developing countries prioritise their economic development.

Varying capacities to adapt to a changing climate and different economic priorities will continue to drive competition and mistrust. Financial services firms face a rapidly changing risk environment, as well as evolving expectations (on themselves and their institutional clients) to disclose climate risk exposure.

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1 This paper does not pretend to examine the full scope of possible implications, but rather aims to present some insights to provoke further in-depth reflection by the financial services sector of their risk exposure and resilience, as well as readiness to identify and act on opportunities.

2 See, for example: Singh, P. "Populism, Nationalism, and Nationalist Populism." *Studies in Comparative International Development*, 56, 250–269 (2021); and Roberts, K. (2022). "Populism and Polarization in Comparative Perspective: Constitutive, Spatial and Institutional Dimensions." *Government and Opposition*, 57(4), 680-702

3 See, for example: "Foreign involvement in the Critical National Infrastructure: The implications for national security." UK Intelligence and Security Committee (https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/205680/ISC-Report-Foreign-Investment-in-the-Critical-National-Infrastructure.pdf); and "Sharper choices: How Australia can make better national security decisions," Lowy Institute (https://www.lowyinstitute.org/publications/sharper-choices-how-australia-can-make-better-national-security-decisions).

1 Global power realignment

What's happening

There is a reshaping of global power underway,[4] and the financial services sector needs to be prepared for the disruptions this will cause. The international power architecture of the second half of the 20th century, dominated by European and North American nations, is facing increasing challenges. Rising countries are pushing back against what they see as Western dominance over the international system. As nations look to protect their own interests and reduce dependence on those they don't consider politically reliable partners, many are pulling back from open global trade and investment markets and pursuing greater domestic self-sufficiency.[5] Policies such as 'Made in America', 'Made in India' and 'Made in China 2025' are clear evidence of this trend. Where self-sufficiency is not feasible, 'friend-shoring' and 'friend-sourcing' – governments and companies reconfiguring global supply chains to try to limit dependence to 'trusted' countries with shared political and social values – are becoming increasingly commonplace.

Implication: global financial system at risk of fracturing along geopolitical lines.

This geopolitical power realignment and the struggles of nation-states to maintain or gain influence have significant implications for global finance. Indeed, geostrategic competition is playing out in global financial markets themselves.

At a practical level, this can mean greater obstacles to the movement of people across borders, a major challenge for global banks and capital markets and the companies that rely on them.

To date, China has relied on the United States dollar (USD) to trade with the world, but Beijing increasingly sees this reliance as a source of vulnerability, especially since learning that the US National Security Agency monitors global USD transactions. Some analysts argue that China is attempting to end this reliance, and is taking steps to develop its own domestic capital market.

Russia has taken similar steps. In 2014, following the invasion of Crimea, the EU urged the global interbank SWIFT payment system to cut Russia off from its network. Russian Prime Minister Dmitry Medvedev responded that Russia's retaliation to such a move would be 'unlimited'. While ultimately Russia was not removed from SWIFT at that time, it subsequently developed a parallel payment system, Mir, designed to be able to evade Western sanctions. The domestic Mir payment system became essential when global credit card companies cut off services to Russian inhabitants following the outbreak of conflict in Ukraine in 2022. Russians were able to switch from Western credit cards to the Mir card for transactions in Russia, avoiding major disruptions. However, Russian capital markets were impacted, particularly those that are connected to non-Russian exchanges via derivatives.

These fault lines in financial markets and payment systems are expected to continue to widen, and financial services firms may need to choose which part of the global system they operate within.

Insurers face specific challenges, as the insurance and reinsurance industries are global and currently highly interdependent. Super funds may find that their scope for potential investments reduces, with negative implications for diversification. The speed and scope of these developments will differ across industry sectors and geographical areas, but one thing seems clear: the globalisation of markets appears to have peaked.

4 See, for example: "China and the challenge to global order." Brookings Institution (https://www.brookings.edu/research/china-and-the-challenge-to-global-order/); and "From the Local to the Global: The Politics of Globalization - Rewiring Globalization." Carnegie Endowment for International Peace (https://carnegieeurope.eu/2022/02/17/from-local-to-global-politics-of-globalization-pub-86310)

5 See, for example, "The pandemic adds momentum to the deglobalization trend." Peterson Institute for International Economics (https://www.piie.com/blogs/realtime-economics/pandemic-adds-momentum-deglobalization-trend)

Implication: restriction of FDI flows.

In addition to the fragmentation of the digital payments system, evidence suggests that these global shifts in power are also driving a growing number of countries to restrict inward and outward foreign direct investment (FDI) on national security grounds.

For example, concerns about firms backed by foreign governments acquiring important Australian assets at a discount during the pandemic resulted in Australia tightening its FDI rules in 2021, when major reforms were made to the Foreign Acquisitions and Takeovers Act. Policymakers were wary of "rapid technological change and changes in the international security environment", and revised the Act to require that the Foreign Investment Review Board (FIRB) be notified if a foreign investor moves to acquire a "national security business", which is broadly defined as anything relating to telecommunications, defence or national intelligence assets or their supply chains.

Similarly, in the US in 2022, President Biden issued an executive order expanding the national security remit of the Committee on Foreign Investment in the United States, explicitly stating that, "Some countries use foreign investment to obtain access to sensitive data and technologies for purposes that are detrimental to US national security".

Ironically, because governments are increasing scrutiny of foreign investment in sensitive industries, some of the sectors most in need of capital (infrastructure, tech, advanced manufacturing) are facing the most restrictions on where they can source funds.

It is becoming increasingly likely that these changing rules will impact the financial services that firms can offer, and the investments that their clients can pursue.

2 The erosion of truth and trust

What's happening

Around the world, trust is in decline. The 2023 Edelman Trust Barometer found that over the last 12 months there had been a "descent from distrust to acute polarisation in society". Real and perceived inequality is driving societal polarisation and instability, dramatic declines in faith in government and other public institutions, and creating fertile ground for the rise of populism in many parts of the world.

Citizens, especially those in industrialised countries, are increasingly polarised on political issues. The COVID pandemic laid bare this polarisation, but it is a process that was already underway. Polarisation breeds mistrust in public institutions. The loss of faith in the political establishment has created space for populist leaders to emerge. Evidence suggests that populist leaders – whether they come from the political left or right – are associated with protectionist and nationalist trade settings, and a marginalisation of democratic institutions like a free press and independent central banks. And in times of financial strife, banks and other financial services firms can find themselves taking the blame levelled by populist leaders.

Researchers point to multiple causes for this trend of mistrust, polarisation and populism, including the erosion of mainstream media, increased corruption, and the electoral returns that stoking polarisation can deliver. In this climate of mistrust, fewer and fewer institutions are perceived as neutral.

Implication: populist leaders may channel public anger against financial services firms.

In uncertain economic times, the financial services sector can become a lightning rod for public discontent. Populist leaders recognise that stoking this discontent can deliver political dividends – an example of the populist leader positioning themselves as on the side of 'ordinary people' against the 'elites'.

Banks and large insurers are arguably more exposed than other companies to this 'anti-institution' sentiment, because of their role as both profit-making enterprise and public good – what the Reserve Bank refers to as a "critical link in the functioning of the economy". Financial services firms may find that monitoring public attitudes to broader public institutions – and especially the rise of populist leaders – can provide early indicators of growing risks of adverse regulatory developments.

Implication: companies are increasingly expected to take a stand on social issues.

The 2023 Edelman Trust Barometer found that business has overtaken NGOs, governments, and religious organisations in rankings of trustworthiness, and is now the only institution seen by many around the world as being ethical and competent. According to the Harvard Business Review in 2020, 53 percent of consumers believe brands should take a stand on contentious social issues, and more than half of employees expect their CEOs to do likewise. As citizens expect more and more from businesses, companies must carefully consider how to respond to and manage these expectations.

In this environment, the financial services sector increasingly needs to take steps to safeguard its social licence to operate. Deciding which issues to address publicly, and what stand to take, is an area of growing strategic and moral importance for today's financial services leaders. Scrutiny over partnerships, suppliers, products, and customers threaten the industry's ability to sell services, attract investment and retain talent.

3 The geopolitics of the tech revolution

What's happening

As competition between nation-states increases, various actors are pursuing technological advances to try to get ahead of others. In this context, the race to develop cutting-edge technologies – including artificial intelligence (AI), quantum computing, and machine learning – has been described by some as a 'tech cold war'. Geopolitical rivals are trying to simultaneously protect their technological advantages and contain their main competitors by decoupling their technology supply chains and markets from each other in these strategic fields. Data is becoming an increasingly important strategic commodity, and has even been dubbed 'the new oil'.

The US-China relationship is the main arena of this competition and decoupling, but the rest of the world is also grappling with the same concerns. In 2020, the Indian government banned more than 200 million Indian users from accessing more than 200 Chinese apps, citing issues of data privacy and national security. Some analysts argue that this has resulted in a long-term split between India and Chinese technology.

Implication: new tools, but also growing exposure to cyber threats.

For financial services firms, the tech revolution carries risks and opportunities. Innovation can make new financial products possible, and can drive greater efficiencies for firms. At the same time, increasing digitalisation exposes companies to cyber risks originating from both state-sponsored and unaffiliated criminal networks. The geopolitical motivations of some technologically advanced nations, along with the financial returns from cyber crime, are contributing to a rapidly evolving threat environment for the financial services sector.

A recent annual report from the Australian Security Intelligence Organisation (ASIO) advised that Australia is subject to technologically enabled espionage and foreign interference attempts from multiple countries on a daily basis. It should be no surprise that cyber security consistently ranks amongst the top risks for the Australian financial system. A cyber attack can disrupt a financial institution's ability to conduct business, presenting operational risks. The reputational impact of an attack may include a loss of customer trust and confidence.

Implication: getting caught in the crossfire of the 'tech cold war.'

The tech cold war also entails both opportunities and threats. Australian firms may find increasing demand from customers and investors in values-aligned countries. However, technological decoupling can also narrow markets and complicate strategic decisions – especially for firms that operate in multiple countries. For example, the US government has restricted the export of advanced microchips to Chinese firms, while China is considering restrictions on rare earths and solar components, and has announced it intends to eliminate reliance on foreign countries and firms for critical technology.

The decisions of multiple countries, including Australia, to exclude certain firms from participation in critical infrastructure projects is another example. With technological decoupling not looking set to slow down, it is important for the financial services sector to understand where they are sourcing their tech from, and what regulations or restrictions may impact their procurement strategies.

4 The geopolitics of the climate crisis

What's happening

The climate crisis both drives and is driven by geopolitics. Most national governments have now committed to decarbonisation; however, disagreements around timing, costs, and compensation are exacerbating the already existent rift between the developing and developed world. Developing countries – many of which are most exposed to the impacts of climate change while having contributed very little to global emissions, and with the least resources to fund adaptation and transition – are calling for faster emissions cuts and more financial support for adaptation.

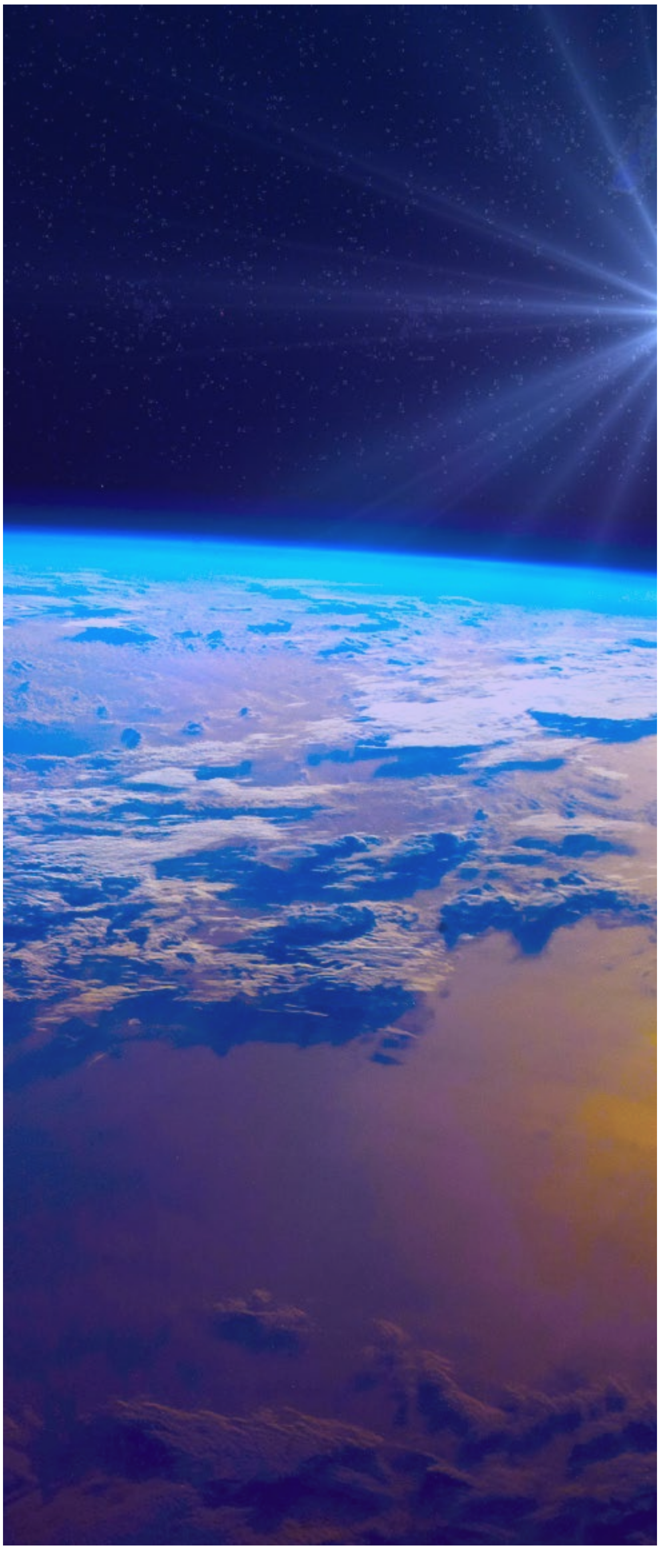
However, a 2009 commitment from industrialised countries to mobilise US$100 billion per year to help developing countries deal with the effects of climate change is well behind schedule, and according to some, is inadequate to meet developing countries' needs. As the world heats up, analysts forecast growing geopolitical risks, including increased competition for resources and water, displacement of massive numbers of climate refugees, and mounting inter- and intra-state conflict.

Implication: increased risk disclosure requirements for financial services firms and their institutional clients.

As populations around the world demand action on climate change, and governments respond, financial services firms in a growing number of countries can expect to face mandatory climate-related risk disclosure requirements over the coming years.

The sustainability programs of major corporations have often come under criticism for being insufficient, poorly targeted, or even public relations campaigns in disguise. Pressure is building on companies to take meaningful action to contribute to a sustainable future.

At the 27th Conference of the Parties to the UN Framework Convention on Climate Change (COP-27) in Egypt in 2022, a UN Expert Group published a report highlighting the dangers of greenwashing (false or misleading environmental commitments made by corporations). ASIC is targeting unsubstantiated ESG claims in an attempt to improve environmental governance and accountability.



The next step could be mandatory disclosure rules, which have already been introduced by corporate regulators in the UK, EU, Switzerland, Japan, Singapore, Hong Kong and New Zealand. Whilst not yet mandatory in Australia, pressure is mounting. ASIC has suggested that stakeholders incorporate the approach of the G20 Taskforce for Climate-related Financial Disclosure (TCFD) when designing disclosure systems, and the Investor Group on Climate Change (IGCC) has called for Australia to make climate-related financial disclosures mandatory.

ASIC outlined guiding principles for the finance sector's climate reporting, indicating that they are already monitoring the market for false claims about sustainability. Many leaders in the banking and insurance sectors are already preparing for decisive regulatory moves in the near future.

Implication: rapidly evolving risk environment creates challenges and opportunities.

The effects of climate change and the policy responses of governments are already having multiple complex impacts on the financial services sector.

For example, climate-related disruptions to whole industries, such as agriculture, tourism and transportation, affect investor and consumer confidence. Insurers and financial regulators are faced with a rapidly changing risk management environment, and the potential for losses.

These losses could be substantial – the 2021 Global Insurance Market Report (GIMAR) found that more than 35% of insurers' investment assets could be considered exposed to climate risks. At the same time as these risks are being driven by the changing climate, the focus of governments all over the world on decarbonisation and climate adaptation will provide opportunities for financial services firms and many of their customers. As countries transition to a lower emissions future, companies will have to adapt to new rules.

While this changing regulatory environment will create challenges for financial services firms, the financial services sector may also be well placed to advise clients on innovative risk management strategies and guide new investment. For example, Australian banks have welcomed the Federal Government's increased decarbonisation ambitions, recognising that the required infrastructure investment represents a large and growing opportunity for the sector.

Different implications for different industries

The four intertwined geopolitical forces outlined here create complex risks and challenges for financial services companies, and for the industries they service. Banks, insurers and other financial services firms should consider which institutional clients in which industries will be positively and negatively impacted by these trends.

For example, real estate, agriculture and tourism are vulnerable to the negative effects of climate change, and insurance companies and lenders need to understand and price this vulnerability. Other industries – including defence and critical minerals – may see new and evolving opportunities flow from these megatrends.

With increasing geopolitical competition, many nations are increasing funding to their defence industries and prioritising domestic spending on specialised manufacturing – and paying a premium for supply from friendly nations. Australian firms within these critical industries may benefit both from increased domestic demand and opportunities for sales to Australia's strategic allies.

For banks themselves, rising inflation and interest rates represent a source of significant risk, as recent bank failures demonstrate. The geopolitical forces contributing to these risks – including conflict, trade restrictions and policy responses following the pandemic – are not going away, so banks and governments alike will need to prepare to respond to them.

The bottom line is that Australia's financial services firms will need to investigate, understand, and manage the full range of geopolitical risks and opportunities that they face themselves, as well as those faced by their institutional customers in industries across the economy.

What should you do?

Leaders in the financial services sector are faced with a delicate task when managing geopolitical uncertainty, due to the multiple competing responsibilities that they hold. Those at the head of major banks and insurance companies are expected to safeguard customer interests and help ensure the stability and health of the financial system and broader economy. As a result, some of the strategies recommended below may be better approached by coalitions of financial sector leaders, rather than by companies operating in isolation.

Whether assessing their own risks and opportunities or those of their customers, financial services companies must monitor and adapt to rapidly changing geopolitical dynamics to have the greatest chance of not only building resilience, but also seizing emerging opportunities.

Market leading firms are moving away from piecemeal approaches to geopolitical risk management, in favour of holistic, integrated strategies. Key elements of a gold standard geopolitical risk management strategy should include:

1. Scanning and monitoring specific indicators and data points to provide early warning of geopolitical developments that affect company interests;
2. Identifying and modelling risk scenarios to quantify organisation-specific vulnerabilities and opportunities that could flow from these developments;
3. Designing and then role-playing/war-gaming mitigation and adaptation strategies based on these scenarios;
4. Evaluating dynamic connections between geopolitical risks and the velocity of the risks; and
5. Preparing action plans to put into effect if and when geopolitical risks eventuate,including reviewing governance structures.

To prepare for geopolitical volatility, it is important that your firm develops an end-to-end strategy; from identification to mitigation. KPMG Australia's Geopolitics Hub and our colleagues throughout the firm can assist in multiple ways, including:

- Providing a tailored geopolitical analysis outlining the macro trends and exploring implications for your sector/industry.
- Facilitating workshop sessions with company stakeholders to identify material geopolitical risks.
- Delivering a Dynamic Risk Assessment to investigate the connections between risks, their velocity and impact.
- Providing access to KPMG's Arwin Intelligent Data platform to identify potential disruptions before they occur.
- KPMG can also identify risk scenarios based on the potential geopolitical developments that would have the greatest impact for your firm, and provide scenario modelling to help develop strategies and action plans.

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With thanks to Antonia Robson (Policy Economics and Public Impact) for research and drafting.

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March 2023. 1061549504DTL