The Wallis Inquiry, an Information Brief From the Perspective of a Political Economic Historian

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This paper presents an overview of the findings, recommendations and the rationale of the Wallis Inquiry compared to those of a major competitor, a conference on the future of the Australian Financial System run by the Economic Group of the Reserve Bank of Australia. The conclusion of this overview is that although the Wallis Inquiry presents the potential for radical change in the financial system vis a vis changing the delineation between the banking and non banking sectors, in relation to loosening protective measures aimed at confining bank shareholdings, in relation to removing restrictive measures confining equity links between banks and customers and industrial investors, and removing measures preventing the opening up the financial sector to more competition and more concentration, the final outcome will probably be minimalistic. One, because the position and lobbying power of the banking sector, combined with the countervailing power of providers of insurance and superannuation, will ensure their particular interests are protected. Two, because the power of the Australian Competition and Consumer Commission (ACCC) has been changed in terms of vetoeing mergers and acquisitions in the financial sector, possibly deflecting flack from the government for unpopular decisions. Three, because the Reserve Bank of Australia remains vehemently opposed to the hiving off of prudential supervision to a new Commonwealth agency, The Australian Prudential Regulation Commission (APRC) as well as the combining of prudential supervision of all financial institutions in the one body. Finally, whether the approach of the Wallis Inquiry is adopted or not depends on the passage of legislation through both houses of parliament, a political factor which could mean that the Wallis Inquiry is merely an academic exercise in scenario analysis.

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The importance of the banking sector to the national financial markets, national economy and the larger international system, is evidenced by the fact that the banking sector is subject to more controls than the non bank sector:

"Banking is and has been one of the most regulated of industries. In almost all countries and at all times since the establishment of banking, governments have imposed controls on the institutions, even when most other businesses were free to operate subject only to statutes and other general rules of law" (Benston, 1986).

It has also been subject to more inquiries than any other industry and possesses a number of supranational regulators - the Bank of International Settlements, the IMF and the World Bank. The inquiries in Australia of a major nature number three - the Campbell inquiry conducted from 1979 to 1981, the Martin Committee in 1992 which produced a report known as “A Pocketful of Pennies” \(^1\) and the most recent Wallis Inquiry in 1997. Were there any characteristics which distinguish one from the other in their terms of reference or conclusions and recommendations? Or is the Wallis Inquiry just an extension of the previous two?

This section will examine the terms of reference of each committee considering as background the historical factors giving rise to them, while the second section will give one Wallis member’s view of its conclusions. The third section of this paper disserts its recommendations, while. In conclusion the final section queries whether we have a radical blueprint for reform of the Australian Financial System or one which will in practice institute changes by incremental creep, that is approach change from the perspective of a minimalist.\(^2\)

Post deregulation the Reserve Bank of Australia was concerned that the total collapse of one or several bank owned non bank financial institutions, or even hint of it, would cause a contagious run on their parent institutions, or cause the parent to guarantee the subsidiary’s debts which could later threaten the public’s confidence in the parent bank itself (RBA, 1989, 1990, 1991). The subsidiaries which experienced financial distress included those of the four major banks in Australia.

Also of concern was the collapse of, or financial distress of, several State government owned banks and a foreign owned bank. The State Bank of Victoria was by government directive taken over by the Commonwealth Bank of Australia, a takeover which appears to have imposed strain on the acquirer, resulting in a 30% loss of market share in the State of Victoria (SMH, 15.10.94).

The collapse of both the State Bank of Victoria and the State Bank of South Australia have resulted in several Royal Commissions, and a multiple of legal actions, most notably by the government of the State of Victoria against the Reserve Bank of Australia (RBA, 1993). The

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\(^1\) There was a review of the Campbell committee in 1983 headed by another Martin, which was instituted by the newly elected Labor government.

\(^2\) A legal term taken from the writings of those expounding on constitutional law reform.
financial difficulties experienced by the State Bank of N.S.W. led to its eventual sale to the private sector. In 1997 the sale resulted in the N.S.W. State government writing off a further $200 million having guaranteed the loan book, while the acquirer has floated the banking and insurance arms. The difficulties of the Bank of New Zealand, which resulted in its total on book debt exceeding its shareholders funds by 35:1, led to its sale by the New Zealand government to Australia's largest and most profitable bank - the National Australia Bank Ltd.

Of the non bank financial institutions which collapsed, two had implications for systemic stability. In the case of the first, Pyramid Building Society, a State government stepped in to guarantee deposits and was forced to fund that guarantee through higher taxes. In the case of the second, Rothwells Ltd, major corporations attempted to prop it up. These cases have implications for the distinctions between banks and non banks in Australia. The former up until the Wallis inquiry had the benefit of implicit government guarantees, and therefore could raise funds at a lower cost. The latter did not. They are meant to offer higher returns to compensate for their increased risk premia (Hogan, 1992).

The accumulation of bad and doubtful debts and institutional collapse, has been debated from the two viewpoints - the economic and the social effects on the financial system. The rhetoric of the former refers to resource misallocation, failure of the pricing mechanism to match credit risk, and excessive contraction of credit similar to the 1880s and the 1930s, with resultant increases in the risk level of the banking sector and the financial system, with effects on the share prices of listed banks and effects on other financial prices and flows (Martin Report, 1991, p. 35). The rhetoric of the latter was couched in terms of whether greater competition, which was a principal goal of deregulation, has improved Australian banking and whether the benefits of competition being passed on to all customers (Martin Report, 1991, p.3). Confidence in the banking system was viewed as both an economic and social effect which could severely affect systemic stability. Recently similar rhetoric has been applied to the effect of reregulation in the late eighties.

So what then was the precise aim of the Wallis inquiry compared to others and how do its recommendations differ?

1.11 Terms of reference - points of difference or similarities.

The terms of reference of the Wallis inquiry were announced by the Treasurer, the Hon Peter Costello MP, three months after taking over the reins of power post a thirteen year rule of the Labor Party, on 30 May, 1996 (FSI, 1997, p. 709). A comparison of a policy document issued by Peter Costello, the then Shadow Treasurer on 2 February, 1996, one month before the election, shows a remarkable similarity to the eventual terms of reference and the desired outcomes as listed in the from of the final report (FSI, 1997, p.2).

This previous policy document stipulated terms of reference to govern a future "financial regulation review" -

"the aim of the review is not to increase regulation. Rather it will:

- stocktake financial deregulation including an audit of the successes and failures of the last
thirteen years;
- investigate methods of modernising existing structures;
- seek to establish a common regulatory framework for overlapping financial products by rationalising and harmonising existing regulation; and
- establish procedures for addressing further financial innovation in a timely fashion” (Costello, 1996, p. 9).

Such a review was justified in terms of product similarity between the banking and non-banking sectors, yet each had separate regulators - one for banks, one for insurance companies, one for all other non-banking financial institutions with the corporate and competition regulators and other self-regulatory bodies overlapping all. The net result according to Costello (1996, p. 2) should be to streamline regulation of the Australian Financial System, ensure that it is by function, so that prudential supervision and consumer protection systems offer maximum protection for Australian investors. However Costello (1997, p. 10) emphasised that,

"The Reserve Bank and the Australian Competition and Consumer Commission will retain responsibility for monetary and competition policy respectively".

It is interesting that in this policy document the review was given objectives on advising on the mechanics to develop a corporate bond market as a new avenue for raising funds domestically – an objective not pursued in the Wallis Inquiry.

The final terms of reference omitted emphasis on further innovation and modernising structures but otherwise were very similar to the policy foreshadowed one month before the election:

“The Inquiry is charged with providing a stocktake of the results arising from the financial deregulation of the Australian financial system since the early 1980s. The forces driving further change will be analysed, in particular, technological development. Recommendations will be made on the nature of the regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness” (FSI, 1997, p.vii).

This was broken down into further specifics, covering the provision of financial goods and services, factors driving change, the optimum regulatory arrangements, and factors to consider in designing financial system regulation. In relation to the provision of financial goods and services the Wallis inquiry was instructed to examine the results arising from the financial deregulation flowing from the Campbell Report (1981), particularly focusing on the choice, quality and cost of financial services available to consumers and other users; the international and domestic competitiveness and efficiency of the Australian Financial System; the macro effects of deregulation, and the evolution of financial institutions and products and their impact on the regulatory structure of financial system. Of most interest is the objective of designing the optimum regulatory model that will best promote operational efficiency consistent with financial market stability, prudence, integrity and fairness; promote dynamic efficiency; provide the best means for funding the direct costs of regulation and in contrast to the terms of reference to previous inquiries,

“establish a consistent regulatory framework for similar financial functions, products or services which are offered by differing types of institutions” (FSI, 1997, P. 708).

In so doing the inquiry was instructed to take account of the objectives of the central bank in
conducting monetary policy, retirement incomes policy, corporate regulation and policies for the taxation of financial arrangements, products or institutions.

Unlike the Campbell Committee which was given two years, and the Martin Committee which was a standing committee and could therefore report periodically (after the Martin Committee took as long initially as it felt necessary), the Wallis Inquiry was given only ten months to report. Submission closing dates were strictly policed. With that type of time limit the research methodology of the inquiry was hardly to conduct original research – it was more to garner views and seek information from any persons or bodies. These were largely based on a total of 268 initial submissions and 155 supplementary submissions. A further 29 confidential submissions from unnamed sources were also received. The Campbell Committee by contrast sought written responses to specific questions, and commissioned consultants to undertake reports. Both the Martin (1992) and the Campbell committee undertook direct discussions with many individuals, corporations, industry groups and government officials both in Australia and overseas.

The Campbell Committee’s terms of reference were principally aimed at examining “the importance of the efficiency of the financial system for the government’s free enterprise objectives and broad goals for national economic prosperity” from the perspective of the structure of the financial system, and the regulation and control of the system (AFSI, 1981, p. xxiii). The Committee was instructed to make recommendations to improve the regulatory model governing the Australian Financial System specially in relation to the structure, the operations, and reform of existing legislation including more importantly the Reserve Bank Act, the Banking Act and regulations, the Financial Corporations Act.

Rather than tinker around the edges, the Campbell Committee of Inquiry into the Australian Financial System recommended deregulation on the grounds of enhanced efficiency of the financial system. They divided this concept into three types - allocational or the efficiency in resource allocation, operational in terms of the efficiency in providing financial goods and services at the lowest cost, and dynamic in terms of providing an enhanced range of products and services to satisfy demand. The committee did not spell out exactly how to achieve this and the time frame by which to achieve changes such as loosening of controls over financial prices and making the market more contestable by permitting foreign banks and domestic non bank financial institutions to enter. Professor Valentine, a former consultant to the Campbell Committee, explained it thus: the original blueprint for change in Australia did not attempt to forecast outcomes from the assumption behind the change (Valentine, 1991, p 37). The assumption was that a free market is desirable, as the financial system was to be allowed to develop in ways in line with users needs:

“...most of these developments are basically unpredictable. That is the committee created a blueprint for the deregulation which was to create a competitive financial system not a detailed plan for the future development of a financial system”.

Another flaw was that the Campbell Committee did not operationalise its efficiency performance measures. Currie (1996) has attempted this in order to isolate reasons why deregulation may not have achieved its ordinal goals and necessitated a further inquiry in 1992. For instance these measures can be operationalised solely on a micro or firm based level for both theoretical reasons
in isolating causal relationships and measurement reasons.\textsuperscript{3}

As a result of a Commonwealth Standing Committee inquiry into the law relating to corporations and securities industry in 1990, commissioned because of the havoc wreaked by what has aptly been called bold riders (Sykes, 1996) or “corporate cowboys”, \textsuperscript{4} a member of that committee, the Hon. Stephen Martin, made representations to the then Prime Minister. This resulted in the Treasurer asking the Standing Committee on Finance and Public Administration to inquire into and report on the importance of the banking system to the Australian economy, its profitability over time and compared with other industries, the effectiveness of competition including barriers, and the benefits of competition to different sections of the community including access to financial services, product innovation, choice and quality of financial services, information to users (Martin, 1992, p.xiv).

The committee which became known as the Martin committee in view of the M.P.’s propensity to take a high media profile ranging from the release of confidential submissions to the parliament by tabling\textsuperscript{2} to open hearings from witnesses to which the press were invited, relied largely on anecdotal evidence rather than objectively verified empirical evidence. The committee did however uncover many flaws in the financial system such as lender liability in making foreign currency loans, and inducing rural customers to borrow beyond the capacity to repay (in Nyngan, N.S.W. in particular, where the committee held an open hearing), the lack of prudential supervision particularly of credit risk equal to world best practice, poor education levels of bankers, and a situation of severe asymmetry in the supply of information.

Although not specifically instructed to make recommendations the committee made 103 suggestions as to how to reform the Australian Financial System. Although space precludes any discussion, there is merit mention as they started the process of change in thinking that has been continued by the Wallace inquiry - the establishment of a Megan regulator (which although vehemently opposed by the RBA and the ISC, did result in the regrouping of dispersed control of the non banks under AFIC, the Australian Financial Institutions Commission); the introduction of on site bank examinations, not full ones as practiced in all the major OECD countries, but partial only; and the transfer of control of State Banks to the Commonwealth regulator.

\textsuperscript{3} Allocational efficiency can be measured by investing patterns of banks - or bank’s balance sheet changes. Operational efficiency can be measured by changes in return, risk and cost measures. Dynamic efficiency can be measured both by changes in investing and finance patterns, as well as the interest margin charged. In fact the latter reflect both former types of efficiency, as price rationing can cause allocational inefficiencies while loan stickiness can reflect operational inefficiencies. These effects can then be tested for statistical significance in order to relate any such effects to major changes in the financial system such as deregulation.

\textsuperscript{4} To which the author made presentations on the role of the financial system in contributing to a net $30 billion fiasco (the extent of bad and doubtful debts across the banking system resulting from faulty credit risk assessment) and on the role of poor accounting disclosure rules, cash as failure to provide for mandatory cash flow statements (Currie, 1986). Cash flow statements were only mandatorily required from 1992 onwards.

\textsuperscript{5} This resulted in litigation and purported harassment of witnesses, in particular John McLennan, who became known as martyr to the cause of cost recovery by swiss franc borrowers (refer to “The Swiss Gnome Loan Scandal”, Four corners Report, ABC, 1991, and various articles by Anne Lampe of the Sydney Morning Herald on the infamous PPL letters throughout 1991-2.

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Martin and Hawkins (1992, p.12) summarised the findings of the committee thus,

"The net effect of deregulation has been positive. The banking system has become more efficient and fairer with finance more widely available. Product range has increased and banks have increases their responsiveness to customers."

In view of bank results post deregulation up until the date of the Martin Report (1992), the committee appeared to have formed a sanguine view of bank performance from 1983 until 1992. It will be suggested in the concluding sections of this paper that the true impact in Australia is that deregulation of the financial sector during the period 1983 to 1992 was carried out without leaving the necessary controls, albeit indirect, in place. This resulted in less than satisfactory banking performance, which in turn resulted in credit down gradings, some system instability and some damage to Australia's international reputation.

The commissioning of the Wallis inquiry is based on a recognition of this perception of reality, so we now turn to an examination of its views of the Australian Financial System, and how best to achieve the original goals of the Campbell Committee.

1.2 An Overview, According To Carmichael.6

The objective of the Wallis inquiry, according to Professor Carmichael, a member of the committee, is to achieve more competitive outcomes while maintaining safety and stability. The inquiry was not aimed primarily to deregulate but to recycle and streamline regulation. According to Carmichael (1997)

"users of the financial system pay over $40 billion in costs per annum of which up to $4 billion per annum could be saved. That is the financial system costs the overall economy 4.5%, whereas a more efficient system could cost 3%.”

The financial system is the largest sub system in the economy, and is dominated by the banking sector, which represents over half (by which measure - not specified). The cost to the rest of the economy is in the middle and upper range compared to international economies. Therefore the cost savings could be at least 5 - 10% or more. With the advent of the electronic age we need these savings to remain competitive.

The committee views the changes in the financial system resulting from regulation and the ensuing innovation to be threefold - the population aging, the cost of handling data and globalisation of markets. The committee sees the financial system as heading for gradual changes of a minimalist or incrementalist type, and has a five to ten year horizon. The final outcome will be determined by markets not regulators.

The changes are already here in terms of electronic changes, regulatory flexibility with emphasis on the philosophy of regulation, with regulatory reform where intervention is justified. The

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6 This section is a summary of a speech given by Professor Carmichael to a joint meeting of the Economic Society of N.S.W. and Australian Business Economists 15.4.97, except where otherwise indicated. The author is merely reporting Professor Carmichael's view either verbatim, or in paraphrased or summary manner.
Wallis inquiry is shifting the focus from general deregulation to fundamental changes in regulation. There is a need for better focussed cost effective regulation.

Regulation should be accountable in terms of cost and effects. The main items are the contestability of markets, safety and stability, decreasing the costs of the provision of financial services and protecting consumers.

Regulation should be organised along broad functions of consumer and market protection, oversight of the superannuation and banking industry in terms of prudential supervision, and protection of the safety and stability of the financial system with particular attention to the payments system, with one regulatory body for each of the functions: the ACCC, the APRC and the RBA. Each body should be aligned with the three sources of market functions, which are the provision of competition and contestability, safety and stability, and consumer protection.

**Re Competition and Contestability:** This will be promoted by revised prudential regulation towards conglomerates and holding companies. The payments system will be opened up, with a member choice in superannuation. The ASX will provide competition to the SFE and restrictions will be eased on the OTC markets.

**Re Safety and Stability:** The committee recommends regulatory neutrality and regulation on a functional basis. This will be achieved by the Australian Prudential Regulatory Commission regulating deposit taking, insurance and common licensing arrangements in terms of common products and risks. The Reserve Bank of Australia will concentrate on systems safety and stability and the payments system, substituting a system of depositor preference for depositor protection. This meant that small depositors would be paid out first, but with no guarantee of a fixed return. The fact that there is no guarantee will be made clear to the public. It will be the same as an airline. Depositor insurance is rejected as the case for it is not strong. The new system will have depositor priority.

**Re Consumer Protection:** Branch banking will change because of electronics such as EFTPOS. Therefore there will need to be a legal reorganisation in terms of competition, with simpler regulation, promoting a faster shift to electronic markets, efficiency gains in managed funds, with a new regulator for market integrity and consumer protection.

The changes promoted by the Wallis inquiry are evolutionary not revolutionary:

- the removal of the six pillars policy is proposed - which support the retention of four major banks and two large insurance policies;
- the relaxation of foreign ownership rules;
- changes in market boundaries. Competition policy should be the same as other sectors, with the ACCC arbiter of merger proposals, with the Treasurer to assess with no preconceptions on merits and demerits.

The new regime of prudential supervision will separate the RBA from this function, with focus.

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7 Refer to Baumol (1986) for a clear theoretical exposition of this term.
on functional regulation, with superannuation and insurance included. The rationale is that half
the world central banks are organised like this. The rationale for combining market integrity and
consumer protection is the common ground among types of regulation, clear cut enforcement
powers, with no regulatory gaps. The CFSE will be the primary body here, taking over the
functions from ACCC and the ASC. The Wallis committee would like to see fees and charges
based on costs with cross subsides eliminated, with the cost of transaction accounts appropriately
priced (not underpriced), with no distortion in consumer behaviour.

The Wallis committee saw the necessity for financial markets to demonstrate "drive and vision",
to introduce electronic commerce. The industry was performing well, but must do better. The
regulatory system was coping well, but was out of line with evolving trends. Maintaining the
status quo was not an option. This financial system inquiry above all has put forward
recommendations to position Australia for the future, to increase efficiency and competitiveness,
thus lowering costs while preserving safety and stability.

The above is an attempt at a fair and accurate report of Professor Carmichael’s summary of the
conclusions of the Wallis inquiry. The next section details a brief textual analysis of the actual
report comparing at times with the contributors to a Symposium on “The Future of the Financial
System” organised by the Economic Group of the RBA on 8 and 9 July, 1996, in what looks like
an attempt to head off the Wallis committee. The contributors of that inquiry included two
prominent overseas academics who had worked in overseas central banks, employees of the RBA
and major industry persona, such as the MAD. of Westpac, Robert Joss.

1.3 The Wallis View Of Change In The Australian Financial System, Of Regulatory
Reform And The Effects Of Financial Deregulation.

The Wallis inquiry topped the number of recommendations made by the Martin committee (103)
at a total of 115. These are divided into 8 topic areas -

• **conduct and disclosure**, incorporating 29 proposals largely relating to the proposed new
Corporations and Financial Services Commission (CFSC);

• **financial safety**, with a subset of 25 recommendations covering prudential supervision of all
institutions in the financial system through the Australian Prudential Regulation
Commission (APRC);

• **stability and payments**, comprising 23 suggestions re the division of regulatory controls
between the RBA, the CFSC, the disbandment of the Australian Payments System Council
(APSC) substituting a Payments System Board within the RBA, with liberalisation of the
entire system in particular access to exchange settlement accounts (ESAs);

• **mergers and acquisitions**, consisting of 7 quite revolutionary recommendations clearly
dividing the responsibility of assessment of a merger between the “prudential regulator” and
the ACCC, which is confined only to compassion considerations formalised by amendments
to banking and insurance laws with the removal of 'six pillars' policy,\(^8\) subjecting merger assessments to sectoral change considerations and applying general foreign investment policy which is far more 'liberal' than existing prohibitions under long term bipartisan policy positions.

- **increased efficiency**, relating to the funds management industry such as reviewing foreign investment, takeover and merger provisions, consumer choice regulation of trustee companies, electronic commerce, interlunation legal and technological harmonisation, exemption of superannuation funds from direction of their investments, exemptions of banks and other financial institutions from freedom to set fees and charges for retail financial and transaction services, sharing of credit information and privatisation of the housing loans insurance.

- **coordination and accountability**, consisting of 10 recommendations pursuing operational autonomy of regulatory agencies through legislation which have the right to charge for regulatory services provided (in particular interest paid on NCDs) so that regulatory agencies are off-budget, with their own boards, with a majority of independent directors (each regulatory agency is set a specific number and composition)\(^9\). Regulatory agencies are to be subject to stricter disclosure rules and a new body, a Financial Sector Advisory Council (FSAC), to overview the implementation of the Wallis recommendations. In addition the Council of Financial Supervisors should be renamed as the Council of Financial Regulators (CFR) and reconfigured with the aims of facilitating cooperation of its three members - the RBA, the APRC, and the CFSC in order to coordinate a broad range of activities of financial institutions to achieve systemic stability.

- **managing change**, consisting of three recommendations relating to a staged approach the development of uniform commercial legislation by all government levels under a Panel for Uniform Commercial Laws in Australia (PUCL), with a specific blueprint for change (recommendation 115).\(^{10}\)

By comparison the Symposium on the Future of the Financial System was more a general commentary on the regulation model governing financial systems, containing no specific recommendations for instance Robert Joss, (MAD. of Westpac), William Ferguson, Bob Ferguson (MAD. of Bankers Trust) and Tony Cole representing non banks, commented on the forces for changes, principally globalisation, predicting the creation of pressures for increased concentration of the domestic industry, with fewer large banks and smaller banks engaged in niche markets or as specialist providers (RBA, 1996).

Overall the symposium concluded that,

"any blurring of distinctions among the main groups of financial institutions is bound to raise difficult questions as to where the boundaries for prudential regulation are to be drawn .... a

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8 An interesting point, deserving of research into its origins and embalment in law, as it does not appear to have formal legislative backing.

9 Refer to FSI, 1997, p.69.

10 Unlike the Campbell Committee the Wallis inquiry has announced a PERT with specific stages (FSI, 1997, p. 72-73).
second major implication for regulatory policy concerns the changing nature of systemic risk ... related to payments- system risk, depositor runs, or more general problems of balance-sheet insolvency ... Increasingly, however, systemic risk is seen as coming not only from traditional balance-sheet items but also from banks’ involvement in securities and derivatives markets ...(this) points to an important shift in the nature of prudential policies - towards much greater reliance on the analysis of markets and evaluation of risk-management systems, rather than the older more mechanical approaches” (RBA, 1996, pp. 4 - 5).

This Advice is long on generalities and short on detail, neither operationalised in specifics or supported by empirical evidence. What then was evidence provided by the Wallis inquiry to support their conclusions, and how is that evidence substantiated by other studies?

1.4  Conclusion: From Here to Eternity, A Minimalist Approach vs Radical Change.

In a recent discussion in the U.S.A. regarding the future of banking, there were calls for returns to old fashioned standards of safe and sound banking (Seidman, 1991), for proper systems checks so that banks would be reorganised at the first sign of trouble, and for inspection and regulation of all systems components (Baptista, 1991). Some would negate this call for a stronger enforcement mode governing prudential supervision on the grounds that the U.S.A. regulatory model has one, but still experiences instability. However the U.S. regulatory model governing its financial system, is one marked by regulatory confusion, with a multitude of legislation consisting of twenty-six separate Acts and seven regulators. Objectives are diverse. Under the taxonomy developed in Currie (1996) it is classified as a “strong-strong strong enforcer”.

Australia on the other hand, classified as a “weak-weak modest enforcer” has only three Acts, one regulator, and is moving to a less restricted regulatory model but with an enforcement mode that is still classified as weak. Its objectives when taken in total resemble more that specified by the BIS (1992) - of containing systemic risks and of preventing and controlling systemic crises. However the Australian regulatory model does not have the prudential supervisory measures to do this, and may still retain some protective measures which are dysfunctional in terms of regulatory goal achievement.

Australia’s track record post deregulation indicated a failure to concentrate on prudential supervision. One way to assess this statement is to use the criteria of one of Australia’s central bankers who maintains that the effectiveness of prudential regulation can be measured against measures of stability such as:

- exits and failures of banks, when the reference is to winding up, or sale due to insolvency;
- a lack of community confidence in banks;
- a weakened banking system beset by poor profitability and low capitalisation, and
- depositor losses, which have never occurred to date (Thompson, 1991, p122).

Although no formal insolvency has occurred in Australia, several banks have exited by handing in their licence or selling out (for instance, NMRB, Bank of America, State Bank of South Australia, and the Tasmania Bank), while others (the Bank of New Zealand and the State Bank of
Victoria SBV) have been sold or propped up. This ignores the merchant banks (Security Pacific, Rothwells, Tricontinental, Partnership Pacific, NZI) which have been sold, liquidated or absorbed back into their parent. A similar comment applies to finance companies, Custom Credit Corporation, the finance arm of NAB and Australian Guarantee Corporation, a wholly owned subsidiary of Westpac, being the most notable.

Thompson’s second criteria of the effectiveness of prudential supervision is community confidence. However the criteria of community confidence is difficult to measure. The foreign currency loan fiasco, the banks’ reporting standards particularly in regards to transfer to and from superannuation funds, runs on a couple of smaller banks and loss of some deposit base by one of the majors, have not been evident in the movement of savings, which has been to banks from other financial groups in recent years. The biggest complaint isolated by several studies (Martin, 1992; ACOSS, 1994; ACA, 1992; RBA, 1993) has been interest rate margins.

Public interest groups expected deregulation of the financial institutions would deliver better service, more available funds for lending and interest at competitive rates. Why then has there been criticism that financial deregulation has failed to deliver smaller net interest margins in the retail side of banking?

First this has not ever been established using appropriate measurement techniques of interest margin, and applying statistical techniques to test for significant differences using lay time periods which has been attempted in this thesis. Second, Milbourne offers two answers as to why interest rate margins have been 'sticky' during the 1987-1989 period, that is lower interest rates have not been passed on so that the perceived interest margin between the basic deposit rate and lending rate widens.

The first answer is that the effective competition supplied by new banks have been confined for the most part to wholesale businesses. New domestic banks (formerly building societies) were operating in the same market prior to conversion and the impact of changing to bank status was marginal. Foreign banks which could have been a real competitive force to contend with, generally avoided retail banking markets because of the high cost of establishing a retail network similar to that of establishing a retail network similar to that of the local banks. Exceptions to this include Citibank, National Mutual Royal (which already had some form of network) and Chase AMP (until sold to Westpac in 1991).

Deregulation and competition has pushed banks to accept into their portfolios assets of higher risk than they would have in the regulated era. Bad debt and write-offs of banks loan assets as a percentage of their total lending provides evidence of the deterioration of asset portfolios owned by the banks.

In the regulated environment where funds for lending were severely limited and interest rates low, the banks' portfolios contained fewer credit risks and carried very low interest rate risks. Therefore the overall default risk was contained at an artificial low level. With the sudden availability of funds, banks had to seek out borrowers. Bank management generally considered that it was better to lend (accepting profit/risk trade off) than have their assets portfolio severely
reduced and to be seen as unproductive in light of the new environment.

This higher risk required banks to make more provisions for doubtful debts. These provisions (and loan losses) can only be recovered through higher net interest margins, service fees, reduction in operating costs, lower dividends to shareholders or by raising more capital. The less intense competitive environment of the retail market has given the 'big four' Australian banks ability to recover some provisions through the wider retail market. However, to prove this from external bank reports is impossible.

What then can we conclude regarding the implications for regulatory goal achievement of the Currie (1996) study. That although the stability of the financial system has been maintained, but at some cost in terms of bad and doubtful debts, that public satisfaction with the achievement of better operational, allocational and dynamic efficiency has not been apparent. The area of risk management, in particular credit risk management appears to be the worst performing area post deregulation, a view echoed by the Head of Supervision at the RBA. He sees the two big challenges as the need for improvement in banks' risk control systems and the establishment of early warning systems (Thompson, 1992, p129). Adoption of the goal of confining prudential supervision to preventing runs on healthy entities gives no guidance as to the legitimacy of the RBA's areas of interest. The BIS and OECD concentration on systemic risk and crises containment using a coordinated consolidated approach does.

Restructuring the goals of prudential regulation along BIS lines appears far preferable than merely trying to prevent speculative runs, as this is often a third final stage in a systemic crisis (OECD, 1991) and also appears to ignore unhealthy institutions. Similarly smoothing daily operations should be part of systemic risk containment -

"Not to inspect and regulate the critical components of the payments system is like running a large electric-power grid without inspecting the bid relay stations - it risks a power failure that would compromise the entire system" (Baldwin, 1991, p147).

Such a conclusion is supportive of the worldview of the Wallis inquiry, but where we go from here? Will it ever be instituted?

The response of those who are going to facilitate the introduction of Wallis recommendations, such as Professor Alan Fels, head of the ACCC, has been that the most important issues will be that relating to competition and mergers. Fels saw merit in unifying prudential supervision, ensuring competitive neutrality, and in loosening foreign ownership and bank shareholding restrictions, while ensuring more liberal access to the payments systems. Fels pointed out that the government did not want big banks merging and would only lift the six pillars policy if there was more competition regarding new business lending. Mergers, unlike joint ventures, would be scrutinised carefully. State or regional markets were regarded as different to national markets, and any takeover would be assessed against the criteria, "Would it lessen competition?". An example was the proposed acquisition of the Bank of Melbourne by Westpac Banking

\[1\] Speech in response to Professor Carmichael., 15.4.97(ibid)
Corporation. This would be judged by the criteria of public benefit on a case by case basis, so as not to reduce the main role of banks in the provision of retail transaction accounts and small business lending.

Regarding consumer protection, the Wallis inquiry’s recommendations were endorsed by Alan Fels. However he felt the role of conduct disclosure necessitated a gateway for dispute resolution, and that there was a need to define a due diligence defence.

Other reactions have ranged from endorsement with qualifications from industry bodies such as representatives of the managed funds industry. For instance the Investment Funds Association of Australia commented in their April/May 1997 issue that they welcome recommendations which if adopted will ensure the funds management industry and consumers will benefit from significant efficiency gains in the areas of simplified disclosure, harmonised supervision of public offers, with one regulator for all financial products, and one prudential regulator for the entire financial system. Access to the payments system, freedom of choice of superannuation funds, Rasps, a single pathway to dispute resolution, eliminations of the overlap between section 52 of the Trade Practices Act and the Corporations Law, and review of the taxation system affecting managed investments were also praised (FI, April/May, 1997). However reservations were expressed regarding the division of regulation of superannuation products:

“the CFSC’s sole responsibility for administering consumer protection over the finance sector needs clarification if the powers of the ACCC will span the economy”.

On the banking side, one of the Wallis committee members, Bill Beerworth, was reported as being highly critical of the government’s ability to introduce the wide-ranging reforms recommended in the inquiry’s report, given Australia’s tax structure, Australia’s three-year electoral cycle, the Government’s lack of a Senate majority, and other controversial decisions such as Wik that may reduce its appetite for radical change, and the necessity to negotiate with the States:

“...the States (are) likely to demand ‘brigandage’ to co-operate with Wallis reforms. It will take a great deal of political courage to get it (Wallis) there” (FAR, 19.5.97).

However the pressures of evolving best practice in other OECD countries may force change here to harmonise regulatory models. The very recent reform in the country on which Australia’s regulatory model was based, the U.K., eliminates totally the validity of the Reserve Bank’s argument against loss of its prudential supervisory role - that no central bank had ever lost its prudential role.

The newly elected British Government has decided to remove prudential supervision of banks from the Bank of England’s responsibilities. This mirrors the Wallis inquiry’s recommendations. Another committee member explains the significance of and rationale for this move:

“The model now adopted in Britain is exactly our model - the logic is exactly the logic of the Wallis report .. Convergence is a strong enough argument to warrant going this way...Taking (prudential supervision) out of the central bank makes it quite clear that the Reserve Bank does not guarantee the deposits of the banks or any deposit-takers institutions ... or insurance policies or funds” (Professor Harper, FAR, 22.5.97, p.38).
However for this to occur the hurdles mentioned above need to be overcome, although as commented frequently, an inquiry in itself forms a useful purpose in forcing debate and reexamination of existing systems.

Bibliography


