The Wallis Inquiry: An Assessment

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Abstract
The Wallis Report is a substantial document with many useful insights into the workings of the financial system and its interactions with the regulatory and deregulatory process. This article provides a brief review of the Wallis Report. It argues that the Report could have been improved by first, including a more sophisticated evaluation of prior deregulatory experience, second, providing a more thorough explanation of how its recommendations will work in the areas of systemic stability and depositor protection, and third, including recommendations for a formal and rigorous monitoring of the outcomes of the recommended legislative changes.

1. Introduction

The existence of an efficient and well-functioning financial sector is very important for the effective operation of the overall economy. In Australia, the financial system employs 300,000 people and provides over $40 billion worth of services to other sectors and to consumers. The borrowing and lending activities of this sector ensure that corporations in the real sector of the economy have access to the funds they need in order to conduct their investments and generate output, exports and jobs. In addition, the many sophisticated derivative financial instruments can be used effectively by real producers in order to reduce and eliminate the risk that is generated by volatile prices, interest rates and exchange rates. The process of financial deregulation and supervision has the prime objective of making the financial sector work more effectively in meeting the needs of the real sectors of the economy.

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Prior to the period of sustained financial deregulation which commenced in earnest in Australia in the 1980s, the financial system was heavily regulated and controlled by the Reserve Bank of Australia (RBA). For example, the RBA set the interest rate and the exchange rate, it imposed controls on the foreign borrowing and lending of Australian citizens and corporations, it set limits on how much the banks could borrow and lend, and it prohibited foreign banks from operating in Australia. Overall, the system was protected from foreign competition and was excessively burdened by regulations and red tape. This meant that it could not adequately service the other sectors of the economy in an efficient and unbiased manner.

In May 1996, the Federal Treasurer announced the setting up of the Wallis Inquiry into the Australian financial system. The Wallis Report (1997) was published in March 1997, and the Government's response, which accepted almost all of the recommendations, was made public in September 1997. The purpose of this article is to offer an assessment of the Wallis Report. Given the extensive nature of the Report which runs to almost 800 pages and contains 115 recommendations, this assessment will first provide a short overview of its key features before focusing on some of its more controversial recommendations.

The article is structured as follows. Section 2 summarizes the main findings of the Report and puts it in the context of the ongoing process of financial deregulation which has occurred in Australia and overseas. Section 3 takes up some of the key issues which have received attention, including the recommendations concerning supervision and regulation and their relationship to the recognized necessity to maintain systemic financial stability. The final section provides a brief conclusion. Amongst the main findings are *first*, although the Wallis Inquiry was explicitly asked to evaluate Australia's historical experience with financial deregulation, the relevant analysis in the Report is overly simplistic, and *second*, the Report could have been improved by including recommendations for a formal and rigorous monitoring of the outcomes of the recommended legislative changes.

2. The Wallis Report in Perspective

Although it was specifically excluded from making recommendations on the RBA's conduct of monetary policy, the Wallis Inquiry was charged with;

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- assessing the experience with financial deregulation since the Campbell Report (1981),
- identifying the main factors likely to determine further changes to the financial sector; and
- recommending changes to current regulatory arrangements in view of the ongoing development of the financial system.

The initial impetus for deregulation in Australia was provided by the publication of the Campbell Report in 1981 which recommended that the exchange rate should be floated; exchange and interest rate controls should be abolished; controls on the size and growth of lending should be removed; and there should be no restrictions on deposit-taking by banks, building societies, credit unions and/or other deposit-taking institutions. In addition, it recommended that prudential criteria only should prevent further domestic banking licenses, and foreign banks should be allowed full domestic banking licenses without necessarily having local equity. Finally, the Campbell Report recommended that greater protection should be provided for investors and depositors with financial institutions.

Successive Australian Governments have worked to implement these recommendations. Table 1 provides a summary of the main deregulatory measures which have occurred to the Australian financial sector, beginning with the Campbell Report and ending with the Wallis Report. The more recent developments can be construed as constituting somewhat of a move back towards reregulation and closer supervision of the financial system. Although this partly reflects the establishment of new policy for the deregulated environment, it also partly reflects disenchantment by the authorities with the deregulatory outcomes. For example, instead of deregulation providing convergence towards greater stability, there has been considerable instability provided by banking failures, mergers and exits from the banking industry. Some interesting questions arise as to why the authorities did not anticipate at least some of the problems which occurred in the economy following the substantial financial deregulation, whether the pace of deregulation in Australia was too rapid, and whether the regulators were sufficiently responsive or capable of responding to market changes.

It was in this context that the Martin Report in 1991 recommended that regulatory power over financial conglomerates should be centralized, which was achieved by the establishment in 1992 of the Council of Financial Supervisors (CFS). The CFS's objectives were to promote regular liaison among its members who have responsibility for supervising the bulk of the

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Table 1. Financial Deregulation since the Campbell Inquiry

1981	Campbell Committee Report published, First new banking license in more than 50 years.
1982	End of quantitative controls on bank lending, Reduced controls on banks' liability management, Introduction of the tender system for Treasury bonds.
1983	Exchange rate floated.
1984	Martin Review published, Stock exchanges deregulated, NBFIs allowed to become licensed forex dealers, Controls on banks' deposit rates lifted, Interest paid on cheque accounts.
1985	Monetary targets abolished, Banks' LGS ratio replaced by prime assets ratio.
1986	NBFIs allowed to issue payment orders.
1987	Reserve assets ratio reduced for savings banks, Australian stock exchange begins operations, Insurance and Superannuation Commission established.
1988	SRDs abolished, PAR reduced to 10 percent, Introduction of risk-weighted capital adequacy requirements.
1989	Distinction between trading and saving banks ended, Banking Act amendment empowers RBA's prudential supervision.
1990	PAR reduced to 6 percent, New solvency requirements for life offices and general insurers.
1991	Restrictions on foreign government borrowing in Australia abolished, Report of the Martin Committee.
1992	Formation of the Council of Financial Supervisors.
1993	Establishment of branches of foreign banks allowed, Collective Investments Review recommends greater control of collective investments, ASC draft Report on OTCs recommends legislation of derivative markets, Superannuation Industry Supervision legislation raises prudential supervision of superannuation.
1994	Establishment of first branches of foreign banks.
1995	RBA issues Prudential Statement on banks' impaired assets
1996	Insurance and Superannuation Commission issues guidelines to the life insurance and superannuation industries.
1997	Report of the Wallis Inquiry

This Table is an extended and amended version of similar Tables in a number of alternative descriptions of financial deregulation in Australia. It is designed to show the main financial deregulatory events rather than to be all inclusive.

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financial system; to enhance the overall quality of financial supervision, particularly by helping to avoid unintended inconsistencies and gaps in regulation; and to identify and publicize significant issues and trends affecting the financial system.

In reviewing the Australian experience with financial deregulation, The Wallis Report (1997) concluded that the overall effect on the economy has been positive. It is commonly agreed that the abolition of foreign exchange controls together with the floating of the Australian dollar on world currency markets has raised the efficiency of the foreign exchange market. It is also commonly agreed that the removal of interest rate controls has led to improved asset and liability management of domestic financial institutions which has empowered them with a better ability to compete with their international counterparts. The overall effects of these deregulatory measures has been to facilitate access by domestic corporations to both national and international sources of finance at the most competitive rates for their investment projects. However, it remains true that the Wallis Report treats the issue of the net benefits of financial deregulation to the overall economy in a somewhat simplistic fashion. It seems to take the point of view that the existence of positive net benefits is beyond question, whereas many analysts would prefer to have seen a more complete treatment of this important issue in the Report. Interested readers can obtain further analysis of this issue in, for example, Lewis and Wallace (1995), Batten and Kearney (1997) and Davis (1997).

The Wallis Report did, however, point to three main concerns in its assessment of the deregulatory experience. *First*, although competition and efficiency has improved in some markets and products, the benefits have been slow to emerge and have not been widespread. Although a wider product choice and better quality has improved the ability of consumers to manage their financial risk and return decisions, the level of available information and advice has not kept pace. This has impeded the ability of consumers to make satisfactory decisions about alternative products and strategies. *Second*, the deregulated environment caused an increase in the extent and complexity of prudential regulation and consumer protection legislation. This has also impeded the ability of consumers of financial services to reap the full benefits of enhanced competition and efficiency. *Third*, many financial institutions took time to adjust to the new deregulated environment. This partly caused the credit and debt expansion of the late 1980s and its associated correction in the early 1990s which escalated the number of bad debts and bankruptcies, and contributed to the depth of the recession.

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With respect to its second charge, ie., to identify the main factors likely to determine future changes in the financial system, the Wallis Report (1997) emphasised three main factors; namely, evolving consumer needs, (due to demographic and labour market developments such as population aging, longer working hours and more part-time work), continuing technological change (including the development of more sophisticated risk management products and enhanced telecommunications networks at lower costs), and further regulatory changes.

With respect to the third charge, ie., recommending changes to current regulatory arrangements, the main task of the Wallis Report (1997) was to:

> ... design a regulatory framework which would allow industry participants to adapt to and profit from change while at the same time preserving the legitimate public policy objectives of financial regulation. In doing so, the Inquiry sought as far as possible to promote efficiency and cost savings through enhanced competition and contestability while preserving financial system safety and stability [Harper, 1997].

This statement goes to the heart of what the Wallis Report (1997) was all about. That is, the Report sought to enhance the efficiency of the financial system by raising competition – subject to the condition that any changes should not impact adversely upon safety and stability. In the remainder of this article, we focus on the extent to which the regulatory changes contained in the Wallis Report do in fact guarantee the continued safety and stability of the financial system. We discuss these changes under three sub-headings, namely, systemic stability, depositor protection and the need for monitoring the outcomes of the regulatory proposals.

3. Safety, Stability and The Wallis Report's Regulatory Changes

The recommendations of the Campbell Report were enacted largely within the existing legal framework provided by the Reserve Bank Act (1959), the Banking Act (1959), and through a series of amendments called the Banking Legislation Amendment Acts (1989 to 1992). These latter amendments coincided with attempts at reregulation in the form of international prudential requirements as embodied in the Basle Accord 1988 and 1996 which sought to maintain the safety and stability of the financial system following the earlier deterioration in the quality of bank asset portfolios and the increasing risks associated with the rapid growth of derivative transactions. Indeed, it was in this context that the Martin Report (1991) recommended

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the centralisation of regulatory power to encompass the activities of financial conglomerates. This recommendation was achieved with the establishment in 1992 of the Council of Financial Supervisors (CFS) to assist with the regulation of financial conglomerates and to monitor the increasingly complex financial markets. This forum, chaired by the Governor of the RBA included representation from the Insurance and Superannuation Commission (ISC), the Australian Securities Commission (ASC), and the Australian Financial Institutions Commission (AFIC). The inclusion of the ISC is significant due to the expected drift of financial assets into non-banks and superannuation funds during the late 1990s. The CFS effectively integrated all aspects of the Australian financial system, but is not a supervisor in its own right, and its existence does not alter the separate statutory responsibility of its members.

The Wallis Report recommended further regulatory reform of the Australian financial system by proposing the establishment of three separate but cooperating regulatory agencies to oversee the smooth and efficient operation of the financial system. These are as follows;

- The Reserve Bank of Australia (RBA) should be responsible for systemic financial stability, regulation of the payments system, and the conduct of monetary policy,
- The Australian Prudential Regulation Commission (APRC) should be responsible for the prudential regulation of deposit taking institutions, life and general insurance and superannuation, and
- The Corporations and Financial Services Commission (CFSC) should be responsible for corporate behaviour, consumer protection and market integrity.

Systemic Stability

Systemic stability is an important and ongoing concern for financial market regulators. Many economic shocks have occurred in a number of countries during the past two decades which have lead to the awareness of real systemic risk. Many emerging markets throughout the world have experienced real financial collapse, and more than a dozen have experienced systemic shocks which cost more than 10 percent of GDP during the adjustment process. As the Group of Thirty (1997) document, amongst the larger OECD countries, France, Finland, Japan, Norway, Spain, Sweden and the United States have all experienced major financial problems during the past decade which were resolved by governments at substantial budgetary cost.

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A central focus of regulatory changes during the 1980s was the minimisation of systemic risk arising from the contagion effects of bank failure due to bank counterparty default (bad loans) as reflected in asset quality or credit risk (see Caprio, 1992), the withdrawal of bank credit (see Bernanke, 1983) and the globalisation of banking operations (see Group of Thirty, 1997). These concerns culminated in the Basle Capital Accord issued by the Basle Committee on Banking Supervision in 1988 which provided the prudential standards that have been adopted internationally. The convergence of prudential standards internationally was intended to overcome any regulatory arbitrage that might be possible within global banking operations, although arbitrage between financial sectors offering functionally similar but competing products has been a focus of some financial market participants. These prudential guidelines have provided much of the system stability framework since their implementation in 1988.

One of the most important recommendations of the Wallis Report is that the RBA should retain its responsibility for systemic stability, although the responsibility for the prudential supervision of institutions should be taken away from the RBA and placed in the hands of the APRA. This is recognised to raise some problems of coordination which could impact on the maintenance of systemic stability. As Neal (1997) points out, one possible outcome of this arrangement could be that the RBA possesses less of a feel for the development of potential problems. Any development that could impede or delays the regulator's response to some potential problem should be very carefully monitored indeed, particularly during the early stages of the new arrangements.

Depositor Protection

The Government has accepted the recommendation of the Wallis Report that the APRA will be responsible for the supervision of deposit taking institutions (DTIs) as well as for depositor protection. In this role, it is envisaged that the APRA will work closely with the RBA. The existing depositor protection arrangements which are contained in Division 2 of the Banking Act 1959 will remain in place, giving depositors priority over the assets of any DTI. Many analysts expected the Wallis Report to recommend changes to the depositor protection arrangements apart from their extension to all DTIs. The fact that this did not occur raises a number of points worth mentioning.

First, although the APRA will deal with institutions which cannot meet their deposit obligations, the RBA will retain its role of providing liquidity support to such institutions. Although it is perfectly possible that these

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arrangements will work effectively in practice, there are also some potential coordination problems. For example, there could arise a difference of opinion between the APRA and the RBA about the need for and/or the timing of liquidity support for a troubled institution. The differing objectives of the institutions could well cause them to take different approaches to the problem. As Neal (1997) points out, cooperation between institutions does not substitute for responsibility. This issue may be more important during the early stages of implementation of the arrangements.

Second, the depositor protection arrangements do not apply to important retirement income products which are associated with the DTIs. For example, retirement savings accounts (RSAs) are excluded from the depositor protection arrangements. This seems unjustifiable and inequitable with respect to age, because many older Australians may place funds in RSAs. It is not at all clear why these instruments should be singled out for exclusion from the depositor protection arrangements.

Monitoring the Legislative Outcomes

Although the Wallis Report provides a conceptual framework for the future development of the financial system, the detail associated with the implementation of the proposed reforms is largely absent. The proposal that there should be three separate but cooperating regulatory agencies based on functional lines requires new legislation and a staged approach to implementation which was recommended in the Report. The independent monitoring of the outcomes arising from implementation of the recommendations resides with a proposed Financial Sector Advisory Council (FSAC).

It is important that this Council develops a formal set of performance indicators which can be used to assess the extent to which the intended effects of legislation occur in practice. One of the lessons that has been learned by the history of financial deregulation in Australia is that legislators tend to be better at enacting legislation than they are at monitoring and evaluating its short-run and long-run outcomes. Legislators tend to focus on the big issues of the day, make their contribution by enacting legislation, and then move on to the next big issue. Given the enormous importance of securing and maintaining an efficient and systemically stable financial sector, however, this is not good enough. Legislative changes ought to encompass the requirement to formally monitor and evaluate their outcomes. If any unintended outcomes emerge, these ought to be addressed in revised legislation where appropriate. Given the prior history of financial deregulation legislation in Australia together with both its intended and

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unintended effects (some of which are mentioned in the Report and outlined above), the failure to appreciate the importance of developing formal mechanisms to monitor the effects of legislation constitutes a weakness in the Report. It implies that the regulators and their advisors have not fully appreciated the lessons that have been learned from previous deregulatory experiences.

Conclusions

The Wallis Report is a substantial document well worthy of a careful reading by all students of financial economics. It contains many useful insights into the workings of the financial system and its interactions with the regulatory and deregulatory process. In our view, the Report could have been improved by *first*, including a more sophisticated evaluation of prior deregulatory experience, *second*, providing a more thorough explanation of how its recommendations will work in the areas of system stability and depositor protection, and *third*, including recommendations for a formal and rigorous monitoring of the outcomes of the recommended legislative changes.

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