Financial System Reform: Regulatory Structure, Financial Safety, Systemic Stability and Competition Policy

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Abstract

The paper provides an assessment of the recommendations of the Financial System Inquiry and the Government's reform proposals relating to the regulatory structure, financial safety and the mega-prudential regulator, systemic stability, and competition policy in the financial sector. It is argued that key reform proposals are based on explicit or implicit assumptions relating to the workings of financial markets and institutions. The Report fails to test those assumptions against contemporary and prospective circumstances to determine the practical worth of the recommendations.

1. Introduction

On the 2 September 1997 the Treasurer, Hon. Peter Costello, announced the Government's response to the Final Report of the Financial System Inquiry (FSI, 1997), also known as the Wallis Report. For the most part, the proposed reforms mirror the recommendations contained in the Wallis Report. Thus any analysis of the reforms must rely on the justifications underlying the Wallis Report's recommendations.

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https://doi.org/10.1177/103530469700800209 Published online by Cambridge University Press

Within a time frame of only nine months, the five members of the FSI were asked to provide a comprehensive report on the results of financial deregulation since the middle 1980s, the forces determining further changes in the financial system, and then provide recommendations on regulatory arrangements to ensure a flexible and competitive system consistent with prudence, stability and fairness.

Given the broad scope of the terms of reference and the limited time frame, there was little opportunity for its members to establish a clearly defined analytical framework (Brown and Davis, 1997: 1) or to assess the likely effects of the recommended regulatory changes. Moreover, many of the key recommendations are based on explicit or implicit assumptions relating to the workings of financial markets and institutions. What the Report is lacking is a testing of those assumptions against contemporary and prospective circumstances to determine the practical worth of the recommendations.

Despite the time limitation, the Final Report of the Inquiry incorporates 115 recommendations relating to the regulation and operation of the financial system. They encompass five areas: (i) conduct and disclosure; (ii) financial safety; (iii) systemic stability; (iv) mergers and competition policy; and (v) promoting greater efficiency. Space limitations for this article preclude an analysis of all these reforms. Thus in Section II we provide a general discussion of some of the more important assumptions underlying the Report and the reform proposals. Then in Section III we discuss the proposed financial system regulatory structure which is to be based on three agencies. Sections IV, V and VI then evaluate aspects of the proposals relating to financial safety and the mega-prudential regulator, systemic stability, and competition policy respectively. A concluding section completes the article.

2. Assumptions

The FSI laid down some features which it considered to be desirable for any financial system to exhibit. Most of them were developed for the purpose of explaining a role for regulation of, or intervention in, a particular financial activity. Nevertheless the general presumption underlying the Report is that free and competitive markets bring an efficient allocation of resources and provide a strong basis for economic growth. However there is no attempt to spell out the basis for examining principles governing the workings of the financial system and the choices to be made.

Given this stance, most clearly specified in Chapter 5 of the Report, then the grounds for regulation of, or intervention in, markets reflect some type of market failure. However market failure alone is not seen as being sufficient to justify regulation of markets. What is needed is evidence on the benefits and costs of regulation to ensure there are genuine gains from regulation (FSI, 1997: 195). This requirement alone is a strong test for justifying regulation. However the provisions of this strong test are complicated further by the need to include in any estimates of genuine gains from regulation a calculation incorporating distribution themes reflecting 'fairness' concepts. It is not obvious what this provision implies other than equal accessibility to financial services.

The FSI set out to determine what were the underlying concepts for the workings of financial markets. It settled upon one concept as signalling more than any other the basic characteristic associated with financial transactions. This is 'the promise'. Promises can be about the conditions and pricing of loans, commitment to repay principal and interest by borrowers, meeting commitments at times specified in contracts, to list just a few major features of financial contracts. Hence the intensity of the promise might be taken as a measure of risk.

Unfettered, free and competitive markets may not develop in the presence of market imperfections. These may arise because of incomplete information so that all parties to transactions are not equally well informed. Handicaps to honouring promises would therefore be possible and may vary from one type of financial instrument to another. Eventually these handicaps are the basis on which distortions to the assessment of one type of risk or another can be generated, with credit and market risks most exposed of all. A very effective appraisal of the Wallis Report has been based upon the quality and intensity of the promise embodied in financial contracts (Brown and Davis, 1997).

The regulatory themes which emerge from this analysis based on promises are straightforward. Foremost, there should be competitive neutrality between financial instruments exhibiting the same risk/return choice or, in the context of Chapter 5, the same intensity of promise. This means that there should be effective provisions for entry and exit across all categories of financial contracts including new ones. There should be no restrictions on entry so long as newcomers can meet basic requirements.

In this context what is wanted is a set of requirements to meet perceived needs without bringing burdensome costs inhibiting the development of the activity concerned. In order to secure balance between gains from regulation and the costs of implementation, an important theme is the need for transparency in the conduct of intervention. Commitments should be explicit. Hence any notion of an implicit guarantee, as is claimed to be true for bank deposits in Australia, should be abandoned even though the RBA stands as guardian of depositors' interests rather than guarantor of deposits (Johnston, 1985). How the implicit guarantee is to be removed from public perception is not explained.

3. The Regulatory Structure

The Terms of Reference for the FSI charged it to make recommendations on the regulatory arrangements that will 'establish a consistent regulatory framework for similar financial functions, products or services which are offered by differing types of institutions' (FSI, 1997: 708). Such an approach to regulation is referred to as 'functional regulation' (Hogan and Sharpe, 1997a and 1997b) which is to be contrasted with the existing 'institutional' approach to regulation in which regulation is applied uniformly to institutions of a similar type.

Underlying functional regulation is the principle of 'competitive neutrality' whereby transactions that perform the same economic function should be subject to the same regulatory burden. The difficulty is to identify those particular financial functions that require regulation. In this respect there are six general functions performed by financial systems (Merton and Bodie, 1995): (i) payments services (clearing and settlement); (ii) pooling and divisibility of funds; (iii) resource transfers in time and location; (iv) risk management; (v) information provision relating to price and volume of financial transactions; and (vi) minimising incentive problems between parties to contracts.

One approach to functional regulation, known as 'narrow or transactions banking', argues that one function has come to dominate all others. That is clearing and settlement, the main feature of which is the payments system whereby the exchange of goods, services, assets and liabilities is completed. This is the specific activity which is essential to efficient performance in the real sector of the economy whether they be in the production and distribution of goods or the offering of non-financial services. By the same token households and business entities wish to ensure certainty in the completion of agreements or contracts to buy those goods and services. That certainty may be endangered if a participant were to fail to meet obligations for which it is responsible directly on its own behalf or in acting on behalf of its clients. Accordingly, there are firm grounds for adapting institutions to meet this need for safety and certainty in clearing and settlement.

https://doi.org/10.1177/103530469700800209 Published online by Cambridge University Press

Distinctions between this transactions or payments and clearing function and other functions may be clearly drawn (Hogan and Sharpe, 1997a and 1997b). Thus narrow banking proposals would protect the important payments function and thereby ensure the system stability objective by structuring regulation so as to make transactions deposits riskless (e.g. by having transactions deposits backed by, or invested in, government paper). Other types of deposits and financial claims would not be protected by regulation and would rely on market based discipline to limit risk-taking. Such a regulatory framework achieves competitive neutrality in payments and non-payments services respectively and avoids the moral hazard problems associated with extending regulation to non-transactions deposits.

In contrast with the narrow banking approach, the FSI had a different view of what constitutes 'functional' regulation. Thus the FSI recommended 'that the existing regulatory framework based on four institutional regulators (i.e. ASC, RBA, ISC and AFIC) be replaced by three agencies established on functional lines' (FSI, 1997: 25). The FSI viewed financial system regulation as performing three *regulatory functions,* with a single regulatory agency assigned responsibility for each regulatory function. Thus the RBA is to be responsible for ensuring systemic stability, the Australian Prudential Regulation Authority (APRA) for ensuring financial safety through prudential regulation, and the Australian Corporations and Financial Services Commission (ACFSC) for ensuring that financial markets work efficiently and competitively by regulating conduct and disclosure.

Although advocating a functional approach to regulation, the FSI's recommendations involve an institutional approach or focus (also see Brown and Davis, 1997: 1). Based on the intensity of the promise, APRA is to have responsibility for prudential regulation of all the activities undertaken by banks, building societies, credit unions, life and general insurance companies, and superannuation funds. These institutions undertake a broad range of activities encompassing many of the basic economic functions performed in financial systems as listed earlier. Thus the proposal involves a significant broadening of the regulatory safety net to encompass diverse non-bank financial institutions as well as banks. This will add significantly to the moral hazard problems of the existing bank depositor protection provisions.

4. Financial Safety

Convergence in Financial Markets

An explanation for the placing of all prudential regulation under one body reflects acceptance by the FSI of the notion of convergence. By convergence is meant a process whereby the financial instruments devised by a variety of financial institutions are more and more akin to each other. Whether in creation of liabilities or assets there is this convergence in the types and ranges of financial instruments on offer. The result is also to bring institutional convergence.

The dominance of the convergence theme as an explanation for market developments was accepted by the FSI with its decision to have APRA as a single prudential regulator. Nevertheless, the FSI also accepted the continuance of a significant role for niche participants in one part or another of the financial markets. What appears to be the main thrust of the argument stemming from the convergence theme is the loss of distinction between one type of financial institution and another. In turn this means the merging of the quality of the promise across institutions. On this basis there are deemed to be firm grounds for having one prudential authority.

Yet the distinctions drawn between, on the one hand, the payments system and settlement risk and, on the other hand, monitoring and supervision of all deposit-taking institutions and those akin to them, points to a distinction between the clearing and settlement function referred to earlier and the other five functions. Hence the perceptions of market developments and prospective ones lead to a confusion about functional and institutional roles.

Many submissions to the FSI made claims about the advantages enjoyed by financial instruments offered by one institution as compared with another. Either convergence is a convenient means of arguing the differential impact on agents and intermediaries in financial markets arising from different types of regulation or it is simply special pleading. Then again the differentiation may reflect tax impacts which no uniformity of prudential regulation will change.

Hence the discussion of convergence may best be treated as a surrogate expression of issues in regulatory arbitrage. This arbitrage is a process appropriate to all markets where there are regulatory boundaries decreed by legislation or administrative decision. All participants in markets will seek to adapt financial instruments and techniques in order to secure some competitive advantage. Any review of costs associated with regulatory arbitrage cannot be divorced from the impact of the taxation provisions on different financial instruments. The restrictions on tax themes embodied in the Terms of Reference Paragraph 3 ensured that the Report could not offer a comprehensive treatment of financial instruments.

This is just one approach to the convergence theme. Convergence should best be looked upon as representing something quite different. With the development of many new financial instruments, especially in derivatives and swaps, both individual and corporate participants have a much wider choice than a quarter century ago to match the risk-return requirements suited to their needs. This means viewing convergence as reflecting a much greater completeness of financial markets. This being the actual situation, then the scope for regulatory arbitrage will be mitigated only modestly owing to the possibilities of institutions and markets not subject to prudential supervision being able to offer comparable financial instruments at lower cost. What must be recognised is that derivative and swap markets provide for switching and adapting between debt and equity exposures. In effect the 'intensity of the promise' associated with any one financial instrument tells nothing in isolation but has to be placed in the context of the risk of a total portfolio, both on- and off-balance sheet.

In this alternative view of convergence, proposals to broaden APRA's safety net to encompass all DTIs, insurance and superannuation are likely to fail. The joint forces of enhanced information technology, regulatory arbitrage, and the development of new financial products will stimulate disintermediation in the form of a shift of funds from the heavily regulated 'safe' sector to unregulated markets and institutions. This has been witnessed in the past with one of many notable examples being the expansion of finance companies in the 1950s during a period of comprehensive qualitative and quantitative controls on banking activities.

A second aspect of this alternative view of convergence, or more correctly completeness of financial markets, is that with more and more instruments available there is less reason why contractual arrangements cannot be devised to share and limit risks amongst market participants. Most of all, the impact of insulating the payments system from credit and market risks of individual entities reduces the need to ensure the safety of those with access to the payments system. However, there would still be a requirement for regulatory monitoring and public dissemination of information about the risk management measures of each participating entity.

If completeness allows the payments system to be insulated from most idiosyncrasies of individual participants in it, then there are few obvious reasons for other DTIs and similar financial institutions to be put under regulatory scrutiny. Recourse to market disciplines to contain exposures to various risks should suffice. In these circumstances of completeness, any blanket extension of regulation as in the FSI's recommendations is misplaced.

The Mega-Prudential Regulator

As noted above, the reform proposals involve the creation of a mega-regulator, APRA, with responsibility for the prudential regulation of DTIs, insurance companies and superannuation funds. Arguments advanced by the FSI in support of this approach are that it would better accommodate the activities of financial conglomerates, enable a more flexible regulatory approach and thereby promote competition, and reduce regulatory costs through scale economies. These advantages are asserted and are not entirely credible. For example, large size is often associated with diseconomies in complex organisations. Moreover, the problems raised by conglomerate activities are merely internalised in a single regulatory organisation which will probably be structured around separate departments or divisions, each with responsibilities for regulation of one of the major institutional groupings (e.g. DTIs, life insurers, general insurers, or superannuation funds).

Another disappointing aspect of the FSI's Report in light of the very significant changes envisaged to the structure of prudential regulation and the extension of the regulatory safety net, is its failure to convincingly argue the case for prudential regulation of the institutions to be regulated by APRA. For example, in the case of DTIs it is merely asserted (FSI, 1997: 304) that, on the basis of information asymmetry and potential to cause systemic instability, they are 'clear candidates for prudential regulation'. Moreover the FSI appears to view the problem of systemic instability as one of contagion effects associated with 'the failure (of) any one institution' (FSI, 1997: 304). While the orderly managed exit of a failed institution is an important component of prudential regulation so as to maintain systemic stability, runs may also develop when creditors lose confidence in the ability of a solvent institution to redeem its claims (see Hogan and Sharpe, 1988). Not all creditors have the ability to liquidate their claims on demand.[1] Thus fixed deposit holders in DTIs, insurance policy holders, and superannuation fund members may face restrictions and/or high transactions costs on liquidating their investments prior to maturity, retirement age etc ... Thus on the basis of potential to cause systemic instability, APRA's safety net is much broader than necessary. Nor does the empirical evidence, none of which appears to have been considered by the FSI, support the view that systemic stability is endangered by runs or failures in DTIs, insurance or superannuation. In this respect, Kaufman's 1994 U.S. survey concluded that the costs of bank failures are relatively small and that bank runs are largely bank specific and a rational response to relevant information about the bank. Consequently it is likely that the expected moral hazard and regulatory costs generated by the extension of APRA's safety net beyond narrow or transactions banking far exceeds the expected savings from any reduction in systemic risk. Finally, the FSI largely ignores the potential for market based discipline and related disclosure requirements to limit risk taking by financial institutions in a cost effective manner (see Hogan and Sharpe, 1991). In light of these considerations, the FSI's case for a mega-prudential regulator, APRA, is unconvincing.

Depositor Protection

Recognising the moral hazard problem associated with deposit protection or insurance schemes, the FSI recommended against extending government guarantees or deposit insurance in the financial sector. Rather it argued that the level of protection should vary directly with the intensity of the promise and that the protection should take the form of 'depositor preference' on liquidation. In general, the higher the proportion of non-deposit liabilities on the DTI's balance sheet, the greater the degree of protection afforded by depositor preference in liquidation. As one of the FSI's reasons for imposing prudential regulation relates to asymmetric information and a perceived inability of depositors to evaluate risk of their deposits, it is somewhat of a paradox that it implicitly assumes depositors would be able to evaluate the degree of protection afforded by depositor preference.

Another puzzling aspect of the recommendations is the conflicting signals they convey relating to the uniqueness of banks. On the one hand, banks are to be able to continue to carry a 'bank' label if they are large, low risk institutions that are able to obtain an exchange settlement account at the RBA. That is, consistent with narrow banking, banks are unique because of their role in payments and settlements. On the other hand, under the APRA framework, non-bank DTIs are treated as equivalent to banks and this could be perceived by depositors as conveying common safety protection. This latter view is reinforced by statements from the Treasurer that 'there will be no lessening of protection for bank deposits from that which is currently provided' and that 'the existing depositor protection provisions will be retained under the Banking Act and extended to all licensed deposit takers' (Costello, 1997a: 3).

In light of the confusion in the community concerning the existing depositor protection provisions relating to banks and the extent to which it is perceived as providing an implicit guarantee of bank deposits, this confusion will be transferred into the APRA framework where it is extended to a broader range of financial institutions. Although APRA is to be established in such a way as to have no resources to bail out a failing DTI, there remains the likelihood that a government would do so particularly if the institution were a large player in DTI markets and its failure is perceived as having the potential to create systemic problems. Thus the problem of an institution being too big to be allowed to fail (TBTF) remains unresolved in the reform proposals. Because of TBTF, large DTIs will continue to have a competitive advantage in being able to attract lower cost funding through the public's perception of their deposits being implicitly guaranteed.

Finally we note that the vagueness of the deposit protection has implications for systemic stability. If deposits are guaranteed or insured, then the risk of a run on deposits is dramatically reduced. With partial or uncertain protection, as in the FSI's recommended depositor preference approach, depositors have a strong incentive (in the absence of an implicit guarantee) to be early in the queue to withdraw deposits from institutions rumoured to be incurring financial difficulties. This has the potential to snowball into a fully fledged run on deposit taking institutions and to generate financial instability.

5. Systemic Stability

A key feature of the FSI's recommendations and the reform proposals is the removal of responsibility for prudential regulation of banks from the RBA. Thus in the new framework the RBA would be responsible for systemic stability of the financial system, quite apart from its general conduct of monetary policy. Given these responsibilities for systemic stability, the responsibility for supervision and operation of the payments system rests with the RBA. Hence the FSI sees the workings of the payments system as inseparable from systemic stability and confirms the distinction made earlier between the transactions function and all the other functions performed in the financial services sector. However, a separate Payments System Board (PSB) is recommended to oversee the payments arrangements. Its main purpose would be to establish general access rules to apply to all participants in the payments system and its main task is to determine the conditions for holding an exchange settlement account.

However, the main challenge arising from the regulatory arrangements put forward in the Report is the separation of the RBA's role in the payments system and responsibilities for systemic stability from the prudential monitoring of the quality of a financial institution's liabilities and assets. The distinction drawn by the FSI may reflect some quest for equal treatment of similar exposures to risk and similar perceptions of safety. The intentions of the Federal Government on the division of powers between the RBA and APRA have been made clear. The new prudential authority, and not the RBA, will be responsible for dealing with financial institutions unable to meet their obligations (Costello, 1997a: 4).

What is not obvious is how this proposed division of powers between the RBA and APRA would work effectively. Under the new real time gross settlement (RTGS) system, the most likely source of failure will come with an inability on the part of a member firm of the payments system to meet its obligations. The impact of the failure would be immediate and the realisation widespread should that member firm be a publicly listed company. In the latter eventuality the member firm would be required to advise the Australian Stock Exchange immediately its predicament was recognised by its board and management. But this problem is not confined to payments system members. Similar possibilities apply to any of the institutions coming under the prudential regulator.

The RBA would have little time to consult APRA about actions it might take to forestall bank runs and systemic failure or devise means for rescue of the delinquent institution. The responsibilities of the RBA to ensure systemic stability would not be matched by necessary powers. Thus the taking away of prudential regulation of banks, and other members of the payments system, from the RBA as well as existing authority to administer and dispose of failing banks should add to systemic risk.

The new role for the RBA would be to provide liquidity support for the institutions, unable or likely to be unable, to meet their obligations. It is not obvious that this description applies solely to institutions unable to meet prudential requirements. This is too narrow an interpretation when taking into account the Treasurer's remarks about '... providing powers for early intervention in a financially troubled institution and by making clear that the regulator can wind up an insolvent entity' (Costello, 1997a: 5). This statement misses the whole point of the need to wind up troubled institutions before they are insolvent so that the RBA's liquidity assistance is recoverable and not an indirect charge to taxpayers (Hogan and Sharpe, 1988).

There would be no legal basis for the RBA to step in to administer a bank until its closure was secured or a merger with another institution arranged. The intention of the proposed arrangements is for the RBA to liaise with the new prudential body. However, responsibility for systemic stability requires powers to ensure the effective resolution of difficulties in a swift manner. It would be well to recall the quick resolution of the problems generated by the then failing Bank of Adelaide and its subsidiary, Finance Corporation of Australia, during 1979. There was no time for consultations with an Australian Competition and Consumer Commission (ACCC) or an APRA or the proposed Australian Corporations and Financial Services Commission (ACFSC).

6. Mergers and Competition

The Report favours the removal of any special restraints on merger and takeover between major institutions in banking and insurance. There is an ambivalence in this stance. Retention of the then current policy rejecting mergers between the major institutions was not recommended. This implies that competition would be sustained with fewer major participants in banking, insurance and funds management. The further implication is that such a greater concentration would not heighten prudential concerns for system stability and greater worries about these fewer institutions being 'too big to fail'. In fact the Report accepts the existing four major banks to be already too big to fail (FSI, 1997: 427). Thus there are substantial prudential concerns under existing arrangements so it is most difficult to envisage just how mergers between major banks or between a major bank and an insurance company could not but add to these concerns.

A startling feature of the Report is the hesitancy evident in other parts of the Report on the sources of gain from mergers. Claims about benefits from mergers are based on the greater economic efficiency gained through economies of scale and lower unit costs. Yet the Report is very circumspect as to the strength of these claims. This is most apparent in remarks as to how '... evidence from studies on bank mergers and efficiencies to date has been, at best, equivocal on whether or not there are efficiency gains to be derived from mergers and, on the whole, points towards there being no correlation between bank mergers and improved efficiency' (FSI, 1997: 464). The Report might well have reported rather than simply cited in a footnote a recent study of banks in the United States which showed how medium-sized banks were slightly more scale-efficient than either very large or very small banks (Berger et al, 1993). These reservations are sustained with some cautious remarks about costs. The reservations are specific and not subject to misinterpretation when stated, '... while some mergers may achieve significant cost savings they are not guaranteed and many mergers may not achieve them' (FSI, 1997: 467).

The recommendations on mergers and takeovers put forward by the FSI are hard to fathom given the available information and the uncertainty of outcomes acknowledged in the Report. The explanation may well lie in preconceptions about the validity of competition as the desired goal whatever the circumstances experienced or found in an economy.

The misgivings do not end with this ambivalent stance on economies of scale. The failure to examine in any way economies of scope is a further reflection of the narrow approach to examination of evidence and concepts relevant to the basis of the Inquiry. There is abundant evidence calling into question claims for economies of scope (Jagtiani and Khanthavit 1996).

The Government subsequently modified the FSI's merger recommendations when it decided to maintain a 'four pillars' policy whereby mergers between any of the four major banks would not be permitted (Costello, 1997b). However, mergers between a major bank and a major insurance company will not be opposed and nor would foreign ownership of a major bank. What the Government has effectively achieved in this decision is to ensure that market concentration in banking is not significantly increased (or competition decreased) by a merger between the four large banks while maintaining market discipline on those banks by creating the threat of a foreign bank takeover.

However, the FSI's recommendation is not readily reconciled with the theme of convergence of financial services activities into one single market. Here the FSI treats activities of large banks as being different from insurance activities. Yet this is not the case with major banks having substantial roles in funds management, insurance and superannuation. Thus the scope for a substantial reduction in competition arising from a major bank – major insurance company merger should not be ignored.

7. Conclusion

Given space restrictions our evaluation of the FSI's Report and the Government's response has been selective. Nevertheless in many of the areas we have surveyed the Report has obvious shortcomings. In general it is not convincing it its arguments on some of major recommendations and the assumptions on which they are based. The misgivings may well be explained by the very limited time available to members of the Committee to establish the bases for their investigations, to assess the various possibilities for change in institutional and regulatory arrangements, and to analyse the practical worth of their recommendations.

The shortcomings are particularly evident in the FSI's recommendations relating to regulatory structure, financial safety, and systemic stability. Although charged in its terms of reference to make recommendations to achieve regulatory consistency for similar financial functions, the FSI's structure involves an institutional focus that significantly extends the regulatory safety net. Its implementation will compound existing moral hazard problems of the current bank depositor protection provisions.

In part the FSI's recommendations for a mega-prudential regulator reflects a concern for the effects of institutional convergence as financial developments increasingly blur distinctions between different types of financial institutions. What has been overlooked, however, is the effect those developments are having on the convergence of functions performed by markets and institutions. Thus the ultimate impact of the mega-prudential regulator will be increased disintermediation in the form of a shift of funds from regulated institutions to unregulated markets and institutions. In general, the FSI's appraisal of prudential regulation across the financial services sector reflects some simple precepts not tuned to the practicalities of effective policy implementation. This is particularly evident in its focusing of depositor protection on depositor preference in liquidations, its lack of understanding of the causes of contagion and the role of government guarantees or insurance in maintaining systemic stability, and its failure to resolve existing uncertainties relating to the implicit guarantee of deposits.

Furthermore, the FSI's use of the convergence theme to justify the separation of systemic stability regulation and prudential regulation is flawed. Completeness of markets is about extending choices in markets for assets and liabilities, and its ultimate effect in creating a single financial market place. In such an environment there are grounds for reliance on market based disciplines, rather than an extension of regulatory provisions for monitoring and supervision of a broader set of financial institutions.

Moreover, the proposal for a single prudential regulator, APRA, would not help problems requiring immediate resolution to preserve systemic stability. The division of responsibilities between the RBA with its lack of direct powers for involvement in failing banks and APRA with its responsibility for the protection of institutions is not helpful for prompt action for stabilisation and halting contagion.

Evidence to support claims for the greater effectiveness of a single regulator, with a pliant central bank for liquidity support, is not strong. The Japanese authorities under the direction of the Ministry of Finance have been embroiled in a very drawn-out effort to stabilise the asset portfolios of financial institutions under their jurisdiction. Thus, the available evidence for the performance of the most identifiable single regulator in an advanced economy, namely the Japanese Ministry of Finance, does not lend confidence to the proposal. Should this example be considered too harsh a contrast then what of the Bundesbank with its division of powers whereby banking supervision is the responsibility of the Federal Banking Supervisory Office in Berlin. Any suggestion that the Bundesbank did not supervise the conduct of banks in relation to systemic risk would be ridiculed.

Note

1. Although the FSI, 1997, p. 373 acknowledges this feature of deposits, it has been ignored in its recommendations relating to the regulatory safety net and systemic stability.

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