Philosophical Foundations of the Wallis Report

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Abstract

The Wallis Report, adopted by the Government in September of this year, contained a wide-ranging set of reforms that are likely to alter significantly the style and structure of financial regulation in Australia. This survey offers some reflections on the Wallis Report, its key recommendations and the thinking underlying them.

The Committee saw market failure as the primary rationale for regulation. Markets fail to produce efficient, competitive outcomes for one or more of the following reasons: anti-competitive behaviour; market misconduct; information asymmetry; and systemic instability.

The Committee's recommended reforms were designed to create a regulatory structure that matched the four motives for regulation. This will create a regulatory structure based on regulatory functions rather than institutions. The new structure should be more efficient, less duplicative and better able to cope with the regulatory pressures that are likely to emerge in coming years from on-going technological innovation.

1. Introduction

In September 1997 the Commonwealth Government accepted the Report of the Financial System Inquiry (The 'Wallis Report') virtually in its entirety. The Report recommended wide-ranging reforms to the structure of regulation in the Australian Financial system, including the amalgamation of existing regulatory bodies and a streamlining of the regulatory

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process. This survey offers some reflections on the Inquiry, its key recommendations and the thinking underlying them.

This survey does not detail particular recommendations, nor does it focus on the many specific areas in which the Report sought to foster competition and efficiency. Rather, it concentrates at the 'macro' level of the overall regulatory structure.

Section 2 outlines the background to the Inquiry. Section 3 outlines the case for reform. Section 4 reviews the Inquiry's philosophical framework. Section 5 highlights the key recommendations and Section 6 offers some thoughts on the implementation process.

2. Background to the Inquiry

The Financial System Inquiry was the first full-scale review of the Australian financial system since the Campbell Inquiry in the late 1970s. Despite their common foundations in both being established following a period of rapid change in financial markets, the motivations behind their establishment were remarkably dissimilar.

In the case of the Campbell Inquiry, the financial system was under intense strain as outdated regulatory structures were breaking down in the face of financial innovation and freedom. Importantly, the old framework was inhibiting good monetary and fiscal management as much as it was inhibiting financial efficiency. Against that background, the Campbell Committee faced an almost universally supported mandate for reform.

In contrast, the Wallis Committee was asked to propose reforms for a system that was coping adequately with existing pressures. Furthermore, large sections of both the financial industry and the regulatory community were quite vocal in expressing resistance to change.

The Treasurer's terms of reference for the Inquiry were broad ranging. In summary, the Committee was charged with:

- providing a stocktake of the results of deregulation since the early 1980s;
- analysing the forces for change in the industry; and
- recommending a regulatory framework to best ensure an efficient, flexible and competitive financial system.

The emphasis in the terms of reference was on change and the benefits of competition and efficiency. In this way, the Inquiry was asked to be forward looking in its recommendations, seeking to avoid a potential future crisis rather than being asked to deal with an existing one. These objectives

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of safety and efficiency were the guiding principles behind many of the Committee's recommendations. Indeed, with its emphasis on competition and efficiency, the Wallis Report, unlike its predecessor, is not primarily deregulatory. Instead, the focus of the Report is on realigning and streamlining regulation to make it more efficient and conducive to competition, rather than on removing regulations per se.

3. The Case for Reform

The case for reform ultimately rested on two factors – perceived inefficiencies in the Australian financial system, and changes that were occurring in international financial markets that posed potential problems for the regulatory structure in the future.

Inefficiencies in the Financial System

The Committee estimated that the cost to consumers and other users of Australia's financial system is currently in excess of $40 billion per annum.[1] This ranks the finance industry as one of the largest in the Australian economy. Of course, the importance of the financial sector extends well beyond its cost. The financial system is an essential component of the infrastructure of commerce, and the stability, integrity and efficiency of the financial system are critical to the performance of the entire economy.

The Committee found that, while some segments of the financial system appeared to be competitive by international comparison, the overall picture was not encouraging. At the broadest level, the cost of $40 billion represented a charge of around 4 per cent on the total asset base of the system. This ratio puts Australia at the mid to upper range of costs for comparable developed countries.

In comparison with these countries, the Committee found Australia to be relatively inefficient in its banking branch density, its banking branch costs, its payments instruments mix, its general insurance expenses ratios and its funds management costs.

While these inefficiencies were not all directly attributed to regulatory interference, the Committee identified a number of regulatory impediments to cost minimisation. Furthermore, there was an overall presumption by the Committee that Australia's fragmented regulatory structure, with considerable duplication and ambiguity did little to encourage competition or cost efficiency across sectors.

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In reviewing the evidence the Committee concluded that: '... there are many areas in the financial system which would benefit from a redesign of regulation, to remove impediments and stimulate competition'.[2] In emphasising that the impact of regulation on efficiency was indirect rather than direct, the Committee also noted that its recommendations in this area: 'will not automatically lead to the removal of all excess cost from the system, but they will facilitate the workings of competitive forces'.[3]

The Changing Financial Landscape

The second motivation for reform came from changes that have been occurring in the financial system. Change in the financial system implies the need to adapt regulations imposed on financial institutions and markets. Of particular concern was the potential for the existing regulatory framework to encounter problems associated with change that, in the limit, could challenge the integrity and stability of the financial system.

The Committee considered three main sources of change in financial markets: consumer needs; technological innovation; and regulation itself.

Changes in customer needs and profiles are gradual but powerful influences on financial sector developments. The impact of these changes is particularly strong in two areas.

Firstly, the role of the financial system in the economy is deepening, with households increasing both their financial asset holdings and their borrowing from the financial sector. The growing demand for financial services reflects increasing wealth and changing financial needs arising from demographic and life cycle changes, including:

- the ageing of the population and increasing expectations of higher retirement incomes; and
- increasing diversity in life cycle experiences, including greater job mobility, longer periods spent in training and education, shifts in work-leisure preferences and changes in family structures and experiences.

Secondly, customer behaviour is changing in two particular ways, which together are promoting a more competitive market place:

- better access to information and weakening of traditional supply relationships are raising consumer awareness of product and supplier value, thereby increasing competitiveness in markets; and

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- greater familiarity with the use of alternative technologies means that more households are pursuing lower cost and more convenient means of accessing financial services.

Technological innovation has been a major force shaping financial service delivery over the past two decades and appears likely to accelerate over the next few years. Systems for processing, communicating and storing information are an essential part of the infrastructure supporting financial activities. These are all undergoing substantial and irreversible changes as a result of technological advances.

Technology has made it easier to access markets and products both domestically and internationally. Technology has also made it possible to analyse and monitor risk more effectively, to disaggregate it on a broad scale, to price it more accurately and to redistribute it more efficiently. While the pace of innovation cannot be predicted, it is likely to accelerate over the next few years for two main reasons:

- the cost of technology will continue to fall; and
- innovations will increase the ease and security of electronic transactions.

These factors will facilitate the conduct of financial activities through homes, workplaces and other sites physically remote from service providers, further reduce cost and lower entry barriers for new suppliers.

Finally, the regulatory framework has itself been an important driver of change in the financial system. The governmental and regulatory environments profoundly influence the structure and scale of financial sector activities. The influence is by no means confined to direct financial sector regulation and includes:

- the increased opening of the Australian economy to the global market place, including the financial system;
- the introduction of compulsory superannuation;
- changes in the role of government - in particular, the almost complete departure of government from the financial services sector as an owner of financial institutions and the associated removal of explicit government guarantees of financial sector liabilities; and
- the impact of the taxation system on investment choices and the international competitiveness of the Australian financial system.

Deregulation has focused innovation on the delivery of financial services rather than on the unproductive activity of circumventing outdated regulations.

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Together, the forces arising from changing customer needs, technological innovation and deregulation have reshaped the financial landscape over the past two decades. In particular, there is now:

- a greater business focus on efficiency and competition;
- increasing globalisation of financial markets and products; and
- a growing trend towards conglomeration of financial services providers.

The regulatory implications of these changes are significant. In particular, the Committee was concerned that, as the trend towards global markets continues, there will be an increasing focus on competition and efficiency, with boundaries among products and markets continuing to blur. In such an environment, the capacity of the existing regulatory structure could be severely limited in its capacity to maintain financial safety and integrity.

In evaluating the capacity of the existing regulatory framework to cope with change the Committee considered two alternative views of the future of the financial system. At the conservative end of the spectrum, the Committee considered the view that change will remain incremental. According to this view, change will impinge less on the basic functions of the financial system than on peripheral issues such as the mode of service delivery (eg, electronic rather than personal) and on back-office type functions (such as the efficiency of data storage and retrieval).

At the more revolutionary end of the spectrum, the Committee considered the view that the financial system is undergoing a 'paradigm shift', involving a sharp discontinuity from the trend experience of the past. According to this view, financial processes and structures will be transformed by the rapid emergence of much lower cost information technology and its equally rapid dissemination into homes and workplaces. This shift would not only dramatically alter service delivery channels but could also redefine the character and boundaries of markets. This view incorporates developments that increasingly transcend existing institutional patterns. For example, financial claims, including loans and bonds, could bypass intermediaries to be bought and sold by electronic auction through global bulletin boards at minimal cost. Users and suppliers of financial claims may be networked together to exchange real time data and documents. Payments systems may extend beyond the present deposit based stores of wealth to broader credit based systems linked to the security of other forms of wealth, perhaps including illiquid assets such as real estate.

While the Committee did not take a position on the likely path of change between these two extremes, it did nominate a series of key changes that it

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saw as likely to occur over the next decade. These changes, if they occur, will not alter the rationale for financial regulation, but would shift much of its focus. These included:

- advances in information technology – which could erode the traditional roles of financial institutions;
- increasing entry of new participants offering financial services from abroad;
- emergence of new payments instruments and payment service providers - possibly divorced from traditional deposit products and using new technologies and delivery channels;
- continued evolution of large financial conglomerates, using their brand and other strengths to provide a wide range of financial services;
- continuous changes in the way services are designed and bundled - allocated among group companies to minimise regulatory costs; and
- an increasing share of household financial wealth held in the form of market claims, particularly through superannuation savings and retirement income products.

These trends are already evident and have provoked many ad hoc regulatory responses, such as efforts to harmonise conflicting disclosure regulations, efforts to tighten and extend credit laws, the establishment of codes of practice providing flexible but duplicated regulatory coverage, and lead supervisor protocols for financial conglomerates.

Given these considerations, the Committee saw its challenge as formulating an approach to the regulatory framework that responds to the changes that are either in place or known to be imminent, but which also has the flexibility to deal with more revolutionary change, if and when it occurs.

4. Philosophical Framework

The primary rationale for regulation is market failure. In broad terms, markets fail to produce efficient, competitive outcomes for one or more of the following reasons:

- anti-competitive behaviour;
- market misconduct;
- information asymmetry; and
- systemic instability.

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All markets face potential problems associated with the conduct of market participants.

Anti-competitive behaviour in the form of collusion or exercise of monopoly power has long been recognised as a source of inefficiency in free market outcomes. Competition regulation typically establishes laws to prevent these forms of anti-competitive behaviour from generating over-pricing of products and underprovision of services essential to economic growth and welfare.

Similarly, market integrity regulation typically seeks to minimise market misconduct in the form of market manipulation and consumer exploitation. Market integrity regulation aims to promote confidence in the efficiency and fairness of markets by ensuring that markets are sound, orderly and transparent. For these reasons, regulators around the world impose disclosure requirements (such as prospectus rules) and conduct rules (such as prohibitions on insider trading and market manipulation). In some cases the form of regulation may be pre-emptive (eg, where the regulator has the power to approve mergers). In others it may be punitive (eg, where the regulator has the power to pursue criminal sanctions for fraud or for providing false or misleading information).

These two forms of market failure are common to all markets, financial and non-financial. In many markets, these are the only forms of market failure and economy-wide regulation aimed at resolving the associated problems is considered adequate.

The remaining two sources of market failure are less common across markets. Information asymmetry arises where products or services are sufficiently complex that disclosure is, by itself, insufficient to enable consumers to make informed choices. To warrant regulation, products characterised by asymmetric information must also involve potentially serious consequences in the event that the promises contained in the product are not upheld.

Financial contracts contain promises to make payments at specified times, in specified amounts and in specified circumstances. Not all financial promises are equally onerous. Financial promises can be distinguished according to the following characteristics:

- the inherent difficulty of honouring the promise;
- the difficulty faced by the consumer in assessing the creditworthiness of the promisor; and
- the adversity caused by promissory breach.

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Some financial promises, such as common equity claims, are relatively easy to honour, in that they contain very general and flexible obligations. Other financial promises, such as demand deposits (a promise to pay a fixed nominal amount at the total discretion of the promisee) are very onerous. Similarly, the creditworthiness of some financial promises, such as unit trusts, are relatively transparent to consumers, while others, such as insurance contracts and bank deposits, are extremely difficult to assess. The consequences of promissory breach can also vary widely. The consequences of a failure of the payments system, for example, would be much more dramatic than the failure of a company to meet its equity obligations.

The Committee took as a guiding principle that institutions making financial promises warrant regulation only where their promises are judged to have a high intensity in all three characteristics outline above. This is the same principle applied to regulation in other areas such as air safety, drugs, and medical services. As with these other areas of the economy, there is still judgement required about when a promise reaches sufficient promissory intensity to justify regulation. The form of regulation in these cases involves interposing the regulator's judgement between the purchaser and the provider to ensure a high degree of promissory confidence. In financial markets, this form of regulation is usually referred to as 'prudential regulation'.

The final form of market failure is almost unique to the financial markets. It is a fundamental characteristic of parts of the financial system that they operate efficiently only to the extent that market participants have confidence in their ability to perform the roles for which they were designed. Third party, or systemic, risks occurs where failure of one institution to honour its promises can lead to a general panic as individuals fear that similar promises made by other institutions may be dishonoured. Bank runs are the most common example of this type of contagion. However, equally disruptive consequences can also flow from other types of market disturbances such as stock price collapses and even the failure of a single large institution where that institution is involved in a complex network of transactions including forward commitments.

5. The Key Recommendations

In all, the Committee made some 115 recommendations. The key recommendations were aimed at realigning and streamlining the Australian regulatory structure. The main elements of the proposed restructuring were:

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- sole administration of competition regulation for the financial system to be carried out by the Australian Competition and Consumer Commission (ACCC) - Recommendations 80 to 83;
- establishment of a new agency, the Corporations and Financial Services Commission (CFSC), to regulate corporations, financial market integrity and consumer protection - Recommendations 1 to 3;
- establishment of a new agency, the Australian Prudential Regulatory Commission (APRC) - renamed by the Commonwealth as the Australian Prudential Regulatory Authority (APRA) - to regulate all deposit-taking, insurance and superannuation - Recommendations 30 to 33; and
- strengthening of the systemic stability responsibilities of the Reserve Bank - Recommendations 56 to 61.

Many of the other recommendations in the Report relate to the powers of these four regulatory bodies and the way in which they should exercise those powers. The remaining recommendations deal largely with the transition process to the new structure and with specific issues relating to the efficiency of the financial system.

Roles of the Four Agencies

The role of the ACCC will change little under the reforms. The primary change will be the transfer of consumer protection in the financial services industry to the CFSC. The other main change recommended by the Report, removal of the Government's prohibition on mergers among the four largest Australian banks and the two largest life companies, was not adopted in full – since April 1997, the Government has retained its prohibition, but only in respect of the four banks.

The CFSC will take over responsibility for the integrity of market conduct, consumer protection and the regulation of companies from the existing Australian Securities Commission (ASC) and that part of the Insurance and Superannuation Commission (ISC) which deals with disclosure, sales and advice. The consumer protection codes presently overseen by the Australian Payments System Council (APSC) chaired by the Reserve Bank will also be transferred to the CFSC. The CFSC will also be given powers, exercisable within its jurisdiction, which mirror those provided under the consumer protection provisions of the Trade Practices Act.

The CFSC will be established by statute with power to administer the various conduct and disclosure laws that currently apply. The laws will be

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amended to ensure consistency of treatment of like products. Streamlined disclosure requirements will be introduced, including the right to sell products on the basis of short profile statements.

The Committee has recommended that the CFSC adopt a flexible approach to regulation. Where industry standards and performance suggest that the most practicable method involves self-regulation or co-regulation, such methods should be preferred. In other areas, where good conduct is not so well established, a stronger statutory style should prevail.

The APRA will undertake prudential regulation within the financial system, combining the existing prudential regulation functions of the Reserve Bank, the Financial Institutions Scheme and the ISC.

To achieve national coverage and remove artificial and anti competitive distinctions in the marketplace, all prudentially regulated financial corporations will be brought under Commonwealth jurisdiction. This will replace the existing State/Territory Financial Institutions Scheme for the licensing and prudential regulation of building societies, credit unions, and friendly societies.

The APRA will be empowered under legislation to:

- establish and enforce prudential regulations on any licensed or approved financial entity;
- issue or revoke authorities for deposit-taking institutions, including banks, building societies and credit unions, life and general insurance companies and friendly societies, and approvals for superannuation funds;
- administer and enforce retirement incomes policy requirements on superannuation products; and
- assume management control of any licensed financial entities that fail or are considered likely to fail, under clearly defined provisions and procedures for early resolution.

In exercising its powers, the APRA will cooperate closely with the Reserve Bank and, where applicable, the CFSC. Under the Committee's preferred approach, licences for banks, building societies, credit unions and other licensed deposit takers will in most respects be identical. Some differences will remain in the rights to use certain names, and the APRA will have the discretion to apply different intensities of regulation according to the characteristics of the individual institution.

Since instability can arise from a wide variety of sources and must be addressed by the monetary authorities, the systemic stability of the financial system will remain the responsibility of the Reserve Bank. The Bank will

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be responsible also for the payments system because of its central importance to stability.

Consistent with this systemic responsibility, the Reserve Bank will continue to have powers as a lender of last resort to those financial corporations operating exchange settlement accounts with it. However, the Bank will cease to have explicit responsibilities for the protection of depositors of banks, and will act instead only in the national interest. Depositor protection functions will transfer to the APRA, helping to make it clear that, while the Bank may intervene to maintain systemic stability, its balance sheet will not be available as a matter of course to guarantee deposits.

Philosophy Underlying the Structure

The recommended regulatory structure was designed to match the motives for regulation. Thus, the division of regulatory powers was constructed to correspond with each of the four sources of market failure. While the reforms may appear relatively modest on the surface, the philosophical change is quite dramatic. The current regulatory structure is institutionally based. For example, separate regulators have been established to deal with banks, non-bank deposit taking institutions, and insurance and superannuation. The rationale for regulation in each of these cases relates to the asymmetric information source of market failure. Under the recommended structure, all institutions offering financial products characterised by asymmetric information will be regulated by a single agency, the APRA.[4]

The new structure has been described as regulation by function rather than by institution. While this is an accurate description of the Committee's attempts to re-align regulation with the sources of market failure, it is important to recognise that prudential regulation is still imposed on institutions, and this is unlikely ever to change. The change in the new structure is that the institutions subjected to prudential regulation are defined by the products they sell and the functions they perform, rather than by the labels they carry.

An important motive for the proposed re-alignment of regulation by function was the Committee's view about the role of technological innovation in further blurring the boundaries between products and institutions. The next decade is likely to see new entrants into the financial services industry. Some of these will come from outside the existing industry (for example, from the telecommunications and software industries) while others will come from outside our national borders. Some will be full financial service providers, while others will specialise in providing com-

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ponents of the service delivery chain. These likely trends would make it increasingly difficult to pursue regulation on the basis of defined institutions. The shift to a functional basis should afford APRA much greater flexibility in assessing the need to include new providers under the regulatory umbrella.

A second important motive for the proposed re-alignment of regulators was the Committee's desire to reduce duplication. Not only is the existing regulatory structure fragmented by industry, it involves considerable duplication. Duplication was particularly evident in the area of consumer protection and market conduct regulation. An important element of the proposed reforms, and one that has been largely overlooked in subsequent discussions of the Report, is the extension of the CFSC's powers to all parts of the financial services industry. Thus, under the new structure, banks, for example, will be subject to the same conditions of disclosure and market conduct that apply to other financial market participants, whether or not they are prudentially regulated.

6. Implementation

A structure based on a coherent philosophical foundation, is a necessary but not a sufficient condition for regulatory success. The success of regulation ultimately relies on the quality of the individuals responsible for its implementation and their commitment to the philosophical foundations. The Committee offered a series of principles for implementing regulation consistent with the overall philosophy.

1. Competitive Neutrality

Competitive neutrality requires that the regulatory burden applies equally to all who make any given financial promise. Neutrality is best supported by:

- functional rather than institutional regulation;
- minimal barriers to entry and exit; and
- minimal restrictions on the products that particular institutions can offer.

2. Cost Effectiveness

Any regulation involves a natural tension between effectiveness and efficiency. Since regulatory reputation is damaged more by a failure of effectiveness than it is enhanced by recognition of efficiency, the natural tendency of regulators is to err on the side

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of effectiveness. The Committee noted that the legislation establishing the various regulators should not only provide them with enforcement capacity for regulatory effectiveness, but should also contain an explicit mandate to strike a balance between effectiveness and efficiency.

The Committee saw the direct allocation of regulatory costs to those enjoying the benefits of regulation as an important element in this process

3. Transparency

Transparency requires that all guarantees be made explicit and that all purchasers and providers of financial services be fully aware of their rights and responsibilities.

4. Flexibility

While it is not possible to forecast with certainty how the financial system will evolve over the next decade or so, it is relatively easy to forecast that there will be substantial change, both in products and providers. It is critical that the regulatory structure has the flexibility to cope with changing institutional and product structures without losing its effectiveness. It is equally critical that the regulators themselves have the flexibility to deal with changing situations and to maintain their balance between efficiency and effectiveness.

5. Accountability

Regulatory agencies should operate independently of sectional interests and with appropriately skilled staff. In addition, the regulatory structure must be accountable to its stakeholders and subject to regular reviews of its efficiency and effectiveness.

These principles of sound regulation influenced the Committee not only in their recommendations about reform, but also in their recommendations about implementation.

6. Summary

The ideal regulatory structure requires a balance between preventing market failure and allowing markets to perform efficiently the functions for which they were designed. While this general principle remains constant over time, the balance required and the environment in which the judgement is made will vary over time. Consequently, it is possible that a particular

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structure will not meet the objectives of regulation at all times and in all circumstances. The blueprint for reform presented by the Wallis Report and adopted by the Commonwealth Government is a measured response to the need for change. It is a response that maintains many of the features of current regulatory arrangements in Australia, but better equips that system to deal with the pressures that are likely to emerge in the financial system over the next decade.

Notes

1. The Committee's estimates of the costs and inefficiencies of the Australian financial system are presented in Chapter 6 of Financial System Inquiry 1997, Final Report, (Mr S. Wallis, Chairman), AGPS, Canberra.
2. Final Report, p. 233.
3. Ibid, p. 233.
4. The case for treating deposits and insurance as characterised by asymmetric information is relatively straightforward. The inclusion of superannuation in this category is less obvious. Ultimately, the Committee was convinced to include superannuation because of the consequences of promissory breach, the difficulty of assessing the quality of promises made and the additional commitment of Governmental promises in the form of tax concessions and compulsion. At the same time, the Committee acknowledged that the form and intensity of regulation involved in superannuation would be quite different than that applied to other prudentially regulated financial products (see the discussion on pp. 303-305 of the Final Report).

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