The Wallis Report on the Australian Financial System: Summary and Critique

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The Wallis Report on the Australian Financial System: Summary and Critique

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<tr>
<td>ACCC</td>
<td>Australian Competition and Consumer Commission</td>
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<tr>
<td>AFIC</td>
<td>Australian Financial Institutions Commission</td>
</tr>
<tr>
<td>APRC</td>
<td>Australian Prudential Regulation Commission</td>
</tr>
<tr>
<td>APSC</td>
<td>Australian Payments System Council</td>
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<tr>
<td>ASC</td>
<td>Australian Securities Commission</td>
</tr>
<tr>
<td>ATM</td>
<td>Automatic Teller Machine</td>
</tr>
<tr>
<td>BBP</td>
<td>Basic Banking Product</td>
</tr>
<tr>
<td>CFSC</td>
<td>Corporations and Financial Services Commission</td>
</tr>
<tr>
<td>DTI</td>
<td>Deposit Taking Institution</td>
</tr>
<tr>
<td>EFTPOS</td>
<td>Electronic Funds Transfer/ Point of Sale</td>
</tr>
<tr>
<td>ESA</td>
<td>Exchange Settlement Account</td>
</tr>
<tr>
<td>ISC</td>
<td>Insurance and Superannuation Commission</td>
</tr>
<tr>
<td>NBFI</td>
<td>Non Bank Financial Institution</td>
</tr>
<tr>
<td>OTC</td>
<td>Over the Counter</td>
</tr>
<tr>
<td>PSB</td>
<td>Payments System Board</td>
</tr>
<tr>
<td>RBA</td>
<td>Reserve Bank of Australia</td>
</tr>
<tr>
<td>RTGS</td>
<td>Real Time Gross Settlement</td>
</tr>
<tr>
<td>SME</td>
<td>Small and Medium Enterprise</td>
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</table>
Major Issues Summary

The Wallis Report has proposed that some fundamental changes be made to financial regulatory arrangements in order to increase the efficiency and effectiveness of the system and build upon the existing achievements of financial deregulation. The Australian financial system is experiencing ongoing change in response to changing customer needs, new technology and other economic policy reforms. It is argued that financial regulatory reform will allow the financial sector to better respond to these pressures.

It is recommended that a Corporations and Financial Services Commission (CFSC) be formed to provide Commonwealth regulation of corporations, financial market integrity and financial consumer protection. The current regulatory structure in these areas is argued to be inconsistent with the broadening direction of markets, has resulted in inefficiencies, inconsistencies and regulatory gaps, and is not conducive to competition in the financial system. The new structure will help to overcome these problems.

The Australian Securities Commission (ASC) would be abolished and its current functions folded into the CFSC, while the administration of financial consumer protection would be taken away from the Australian Competition and Consumer Commission (ACCC) and placed with the CFSC. Some functions of the Insurance and Superannuation Commission (ISC) would also be incorporated into the CFSC. The CFSC should have powers provided by legislation which are commensurate with its responsibilities.

It is also recommended that a single prudential regulator, the Australian Prudential Regulation Commission (APRC), be formed for the entire financial system to provide integrated and consistent supervision of financial institutions for safety purposes. A single prudential regulator offers regulatory neutrality, greater efficiency and responsiveness, greater resource flexibility, economies of scale and lower costs in regulation, and more flexibility to cope with likely future changes in the financial system.

Bank supervision would be taken away from the Reserve Bank of Australia (RBA) and given to the APRC, while the supervision of building societies and credit unions, now done by the state-based Australian Financial Institutions Commission (AFIC), would also be incorporated into APRC, as would the remaining functions of the ISC. However, the APRC would have a close cooperative relationship with the RBA, with RBA officers having places on the APRC Board. The APRC should have powers provided by legislation which are commensurate with its responsibilities.

In regard to the failure of financial institutions, it is recommended that the depositor protection mechanism which currently applies to banks be extended to all deposit taking institutions under APRC regulation. Here, depositors have priority over other stakeholders
in the disposition of remaining assets of the institution after liquidation. Explicit deposit insurance schemes do not seem to be practicable or workable. Existing forms of prudential regulation, such as capital and liquidity requirements, should continue to operate.

It is proposed that the Trade Practices Act continue to apply to the financial system and that the ACCC be the sole competition policy arbiter on mergers and acquisitions in the sector. The current ‘six pillars’ policy, prohibiting mergers between the four largest banks and two largest life offices, should be abolished and such decisions left in the hands of the ACCC. It is not possible to say much of any value about merger proposals in the abstract and each requires its own particular examination.

It is recommended that the blanket prohibition on foreign takeovers of the four largest banks be lifted and that proposed foreign investments in the financial system be reviewed in terms of the general guidelines of the Government’s direct foreign investment policy. While large scale transfer of ownership of the financial system into foreign hands would be contrary to the national interest, because it would restrict options about the future development of the financial system, it is argued that some increase in foreign ownership could bring benefits such as injections of new capital, access to new skills and technologies and enhanced competitive pressures in domestic financial markets.

It is argued that the widespread existence of cross-subsidies between products, channels and customer groups reduces efficiency in the financial system by creating divergences between costs and prices. Such cross-subsidies can be unwound by allowing institutions full freedom to set fees and charges on their services and products according to cost-relevant criteria. It is therefore argued that governments should not intervene in, or otherwise try to influence, this process. Other ways should be sought, such as through the tax/transfer payments system, to provide low cost transaction services to groups such as social security recipients.

Financial regulatory agencies should have operational autonomy to pursue their legislated objectives in the most efficient and cost effective manner possible. They should finance their operational costs through levies upon the institutions they supervise.

It is proposed that a Financial Sector Advisory Council be formed to advise on regulatory arrangements and other matters, while the RBA, APRC and CFSC should constitute a renamed Council of Financial Regulators to facilitate cooperation across the full range of regulatory matters. It is argued that further amalgamation of these three agencies would be unnecessary and counterproductive at this time.

Many of the Report’s recommendations can be, and have been, challenged. First, the proposed formation of the CFSC might be challenged on the grounds that it entails removing the administration of financial consumer protection from the ACCC. It could be argued that this policy change will create disparities in consumer protection with the rest
of the economy, because of the tendency for the industry-specific CFSC to come under ‘undue’ influence from the finance sector. If this occurred it could be viewed as both unfair and likely to generate some loss of economic efficiency.

Second, it could be argued that the formation of a single prudential regulator for the entire financial sector, the APRC, will reduce the effectiveness and efficiency of prudential regulation. It is argued that this will arise because of the size and complexity of the regulatory task set for the APRC. The proposed single prudential regulator might also be criticised on the grounds that it will encourage non-deposit institutions, and their customers, to increase their risk exposures in the belief, albeit mistaken, that Commonwealth Government protection for bank deposits has been extended to other financial assets.

Third, separating prudential regulation from the RBA might be challenged on the grounds that it might dangerously slow down the provision of emergency loan assistance to institutions in times of distress, since such assistance would, under the Report’s proposals, require mutual agreement and coordination between the APRC and the RBA. Separation might also be criticised for closing off the option of the coordinated deployment of monetary policy and prudential policy instruments.

Fourth, it could be argued that the Report’s advocacy of more efficient pricing of fees and charges by financial institutions clashes with equity concerns about the rights of citizens to the provision of ‘basic banking services’, especially for low-income, low-wealth customers. If compensation through the tax/transfer payment system is not implemented, then legislation to ensure the continued provision of such services might be argued to be warranted. Similarly, it could be argued that the community has rights of access to financial institutions which should constrain the ongoing rationalisation of the distribution channels of financial institutions. Thus, it could be argued that the Commonwealth Government should ensure that the geographical coverage and range of type of access does not fall below some minimum limits.

Fifth, it could be argued that the issue of mergers between the four largest banks is of such national importance that it justifies the continuation of explicit Commonwealth restrictions in this area. The Commonwealth Government has already announced such a position.

Sixth, the Report’s rather ambivalent attitude towards direct foreign investment in the finance sector might be criticised on the grounds that it sits very oddly with concerns with increasing financial sector efficiency and does not explicitly deal with current issues such as the role of foreign bank branches in Australia. As an alternative, it could be argued that one strength of explicit deposit insurance schemes is that they facilitate a better role for such branch operations. Well-designed deposit insurance schemes might also generate efficiency, equity and safety gains in the finance sector. It could be argued that these issues were not adequately discussed in the Report.
Introduction

Australia has a long history of conducting public inquiries into its financial system. The Campbell Committee reported in 1981 and advocated substantial financial deregulation. Their Report’s conclusions were largely validated by the Martin Review Report of 1983. Financial deregulation, and its impact on banking, was reviewed by the House of Representatives Standing Committee on Finance and Public Administration (the Martin Committee) in 1991. In the same year, the Industry Commission examined the financial system in terms of the availability of capital for investment. Now, the Wallis Committee has published its own review of financial deregulation and of ways to build upon past achievements through further regulatory reform.

This paper provides a concise summary of the arguments and recommendations of the Wallis Report using, wherever possible, the actual language and sentences of the Report. All 115 recommendations of the Report are mentioned and each of its chapters is summarised individually. In order to fully and fairly cover the debate on the policy changes advocated by the Report, the paper concludes with a survey of arguments opposing some of the key conclusions and recommendations of the Report.

Summary of Part One: Forces for Change

Chapter One: Changing Customer Needs

Changing customer needs are helping to reshape the financial system by influencing choices on distribution channels, financial products and financial suppliers. In turn, such needs have been primarily influenced by changes in demographic structure, work patterns, the financial assets and liabilities of households, awareness of value and willingness to adopt new technology.

The Australian population is ageing. This increases the importance of assets to fund consumption in retirement. The Commonwealth Government has sought, through superannuation initiatives, to encourage private asset accumulation and thus to encourage reduced dependence upon the age pension in retirement. This has led to a shift in household financial assets into market-linked investments, meaning that households are bearing more investment risk than in the past. Improved financial advisory services and increased efficiency in funds management are thus required.
The number of people working extended hours continues to increase. Thus, many people may now have less leisure time and less time available to manage their financial affairs. Such people will have a greater need for financial products which offer convenience and ease of access. At the same time, many consumers will experience greater variability in the timing of income. Those spending longer periods in education, those in part-time employment, the unemployed and those in early retirement will generate a greater need for financial products which smooth cash flows and spending over their life cycles.

Households continue to accumulate both assets and liabilities. Thus, households now rely more on the financial system and have greater exposure to financial institutions. They will be more concerned with issues of financial efficiency and safety. Those with greater net financial wealth will tend to shift their assets towards more risky, higher return products such as holdings of market-linked investments. Consumers are becoming increasingly aware of value for money in financial products and services. Information sources on the financial system have proliferated. Rising fees and charges on transactions services have increased customer value awareness. The rising range of housing loan products has encouraged consumers to shop around for the best deal. There is also an increased willingness to take up new technologies providing financial services. This is related to increased familiarity with the new technologies in the workplace and in the home.

Chapter Two: Technology Driven Innovation

Improvements in communications infrastructure and technology are breaking down physical constraints and cost barriers to the transmission, storage and use of information. Information networks are expanding rapidly. Pressures for standardisation, interoperability, ease of use and cost effectiveness are increasing. Enhanced authentication of users and more secure transmission of information will accelerate network use.

Electronic channels for payments and financial service delivery are increasingly taking advantage of networks. The expansion of Automatic Teller Machines (ATMs) and Electronic Funds Transfer/Point of Sale (EFTPOS) access points have generated a large shift towards electronic retail transactions and away from reliance upon access to the branches of financial institutions. Telephone banking is also encouraging such trends. Once security is improved, the conduct of financial transactions through the Internet will expand rapidly. Operating costs per transaction are much lower through these new electronic mediums.
Risk assessment relating to financial products has become much more sophisticated through advanced data analysis capabilities made possible by technological advances. Technology has profoundly influenced the conduct of financial markets and exchanges. Organised markets and exchanges are facing competition from the availability of information and trading systems which threaten the value of their business. Organisations standing between the customer and the ultimate supplier of financial services must increasingly justify their value in the delivery process.

Chapter Three: Regulation as a Driver of Change

Changes in regulation have strongly affected the financial sector. The four most important policy changes have been the liberalisation of trade and capital flows, the development of
The Wollis Report

compulsory superannuation, the removal of direct government participation in the financial services industry, and changes to taxation.

Economic globalisation is proceeding apace. Markets are becoming more internationally integrated and the economies of different nations are becoming more interdependent. These trends have been partly due to technological advances and broadening planning horizons of firms and investors. They have been also much assisted in the case of Australia by policy relaxations such as the lifting of restrictions on outward investment by Australian companies, the floating of the Australian dollar and the abolition of exchange controls, the liberalisation of restrictions on inward direct foreign investment, and the progressive opening of the Australian banking system to foreign banks.

The development of compulsory superannuation contributions has led to the rapid growth in aggregate assets in superannuation funds. The great bulk of these have been invested in more risky market-linked assets rather than in capital guaranteed assets on the balance sheets of financial intermediaries.

In recent years the Commonwealth and State governments have corporatised and then privatised many of their financial enterprises. This has been motivated by the desire of governments to exit commercial businesses (including non-financial enterprises) to ensure that competitive neutrality is achieved in those markets, and has also been prompted by losses in certain state-government-owned businesses and the resultant burden on their taxpayers.

Taxation arrangements in Australia, like those in many other countries, contain a wide range of economic distortions. Taxation has been a key factor in the creation of legal and organisational structures specifically designed to minimise taxation liability. Progress has been made in reducing distortions in some areas but many remain. Variations in effective taxation rates across assets and saving vehicles remain substantial, while the rates and scope of transaction taxes also distort financial flows.

Chapter Four: The Changing Financial Landscape

The financial system has undergone, and will continue to undergo, four central types of structural change. There is an increased focus upon efficiency and competition, globalisation of financial markets is continuing, financial market widening and the development of financial ‘conglomerates’ has arisen, and there has been a further shift from financial institutions to direct connections between capital suppliers and final users, through financial markets.

Financial institutions have improved their ability to identify costs and profits entailed in the products and services they offer. The use of customer and product profitability models
allows institutions to price products and services more accurately. As these methods come to be more widely used, they will combine with enhanced competition to generate pricing which more accurately reflects the underlying cost of supply, thus raising the economic efficiency of the financial sector. Specialist financial providers have overcome barriers to entry in the most profitable financial markets and have thus intensified competition in these areas. Such intensified competition has increased pressure to abandon inefficient pricing in other financial services which have been traditionally used to ‘cross-subsidise’ other products. More efficient pricing will encourage consumers to use lower-cost channels of access to products and services, thus reinforcing the trend to greater efficiency in the financial system.

Australian markets have become increasingly global over the last decade and now have a relatively high level of integration with international markets. Australian businesses and markets have responded in four ways. Fundraising by corporations and institutions is becoming increasingly global. Foreign inward and outward investment are both growing. Trading on share, bond and foreign exchange markets is becoming increasingly more international. The location decisions of many financial services corporations reflect an increasingly international perspective. However, at this stage the globalisation of retail financial services is still relatively undeveloped.

Increased globalisation intensifies competition for domestic financial suppliers, increases pressures for rationalisation and international harmonisation of financial regulation in Australia, and heightens the exposure of Australia to world financial trends and shocks.

The Australian financial system is already predominantly composed of financial conglomerates. These are groups of companies under common control whose predominant activities consist of providing at least two different classes of financial services. For example, many Australian banks have operations in funds management and insurance. Underlying trends are resulting in conglomerates which focus on a wider spectrum of activities. Heightened competition is encouraging a reconfiguration of conglomerates to achieve more cost efficient structures. Conglomeration is also assisted by product innovation where products are designed to be offered by a range of financial entities, and by commercial strategies of ‘bundling’ of financial products across traditional market boundaries.

Financial markets are increasingly challenging financial intermediaries for the provision of finance and the management of risk. Large corporations have had direct access to financial markets, for debt and equity fundraising, for some time. Developments in ‘securitisation’ (the bundling of loan assets and their sale as marketable securities) now allow markets to provide finance to retail borrowers. An increasing range of risks can be managed through an array of market-based ‘derivative’ financial instruments (e.g. options, swaps and futures contracts), while the needs of savers are also increasingly being met through financial market products. Financial intermediaries will continue to perform an important
role in meeting the financial needs of their clients but the form of their participation is likely to change.

Summary of Part Two: Key Issues in Regulatory Reform

Chapter Five: Philosophy of Financial Regulation

Regulation of all markets for goods and services can be categorised according to three broad purposes. First, regulation is to help ensure that markets work efficiently and competitively, and thus to overcome sources of market failure. Second, regulation can prescribe particular standards or qualities of service, especially where the consumption of goods and services carries risks, so that safety is a focus of concern. Third, regulation can help achieve social objectives such as, for example, 'community service obligations' which typically take the form of price controls.

More particularly, general financial system regulation can be motivated by four considerations. Financial market integrity regulation aims to promote confidence in the efficiency and fairness of markets. Financial market prices can be sensitive to information and this raises the potential for misuse of information. For this reason regulators impose specific disclosure rules (such as prospectus rules) and conduct rules (such as prohibitions on insider trading) on financial market participants. Consumer financial protection arises from the complexity of financial products and the consequent scope for deception, misunderstanding and dispute. Competition regulation of financial markets arises from concerns over the anti-competitive effects of market concentration and collusion between financial market participants.

A case for regulation also arises from the risks attached to financial promises (such as the promise to repay borrowed funds). As a general principle, financial regulation for safety purposes will be required where promises are judged to be very difficult to honour, difficult to assess, and likely to produce highly adverse consequence if breached. Financial promises which rank high on all three characteristics (e.g. promises to repay retail deposits) are called 'high intensity' promises.

In markets for intense financial promises, two sources of market failure have long been recognised. First, there is the risk of third party losses due to systemic instability. The most potent source of the risk of systemic instability is financial contagion, where financial distress in one market or institution is communicated to others and eventually engulfs the entire system through a general loss of confidence. Second, there is the problem of information asymmetry facing most consumers, which means that they cannot reliably assess risk, particularly the creditworthiness of the financial promisor.
Financial regulation for safety purposes is called ‘prudential regulation’ and is intended to prevent the emergence of problems which threaten the viability of financial institutions. Once such problems have emerged, the task falls to the central bank and government to restore stability through the provision of liquidity and other policies.

Overall, it should be noted that there are five broad principles of good financial regulation. First, competitive neutrality requires that regulation apply equally and to all who make particular financial commitments. It further requires that there be minimal barriers to entry and exit from markets and products, that there be no undue restrictions on institutions or the products they offer, and that markets be open to the widest possible range of participants.

Second, cost effectiveness requires that regulation be no more onerous than necessary to achieve its goals, minimise overlap and duplication and conflict amongst regulators, properly balance efficiency and effectiveness, distinguish the goals of financial regulation from broader social objectives, and allocate regulatory costs to those enjoying its benefits.

Third, transparency of regulation requires that all government guarantees be made explicit and that all purchasers and providers of financial services be fully aware of their rights and responsibilities. Fourth, flexibility requires that the regulatory framework must be able to adapt and cope with changing institutional and product structures without losing effectiveness. Fifth, accountability requires that regulatory agencies operate independently of sectional interests, be subject to regular reviews and evaluations and be open to scrutiny by their stakeholders.

Chapter Six: Cost and Efficiency

It is estimated that in 1995 the total cost to users of the Australian financial system was about $41 billion. This is more than the residential construction sector or the costs of the entire retail sector. Banks made up about $22 billion of these financial system costs.

In general, significant improvements should be able to be achieved through the removal of inefficient regulation and the enhancement of competition in financial markets; these required reforms are discussed in later chapters.

In regard to the banking system, where potential improvements are estimated to be large, most of the efficiency and cost reduction gains can be achieved by changing the mix of transaction channels in favour of electronic transactions, by reducing the density of the branch network and by using more differentiated branch formats (e.g. kiosks versus full branches).
Figure 2: Bank Branch Density

Branches/10,000 inhabitants

<table>
<thead>
<tr>
<th>Country</th>
<th>Branches</th>
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<tbody>
<tr>
<td>Spain</td>
<td>9.8</td>
</tr>
<tr>
<td>Belgium</td>
<td>7.9</td>
</tr>
<tr>
<td>Switzerland</td>
<td>6.3</td>
</tr>
<tr>
<td>Germany</td>
<td>4.9</td>
</tr>
<tr>
<td>Netherlands</td>
<td>4.9</td>
</tr>
<tr>
<td>France</td>
<td>4.5</td>
</tr>
<tr>
<td>Finland</td>
<td>4.2</td>
</tr>
<tr>
<td>Italy</td>
<td>4.1</td>
</tr>
<tr>
<td>New Zealand</td>
<td>3.9</td>
</tr>
<tr>
<td>Australia</td>
<td>3.8</td>
</tr>
<tr>
<td>Norway</td>
<td>3.6</td>
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<tr>
<td>Canada</td>
<td>3.3</td>
</tr>
<tr>
<td>Sweden</td>
<td>3.3</td>
</tr>
<tr>
<td>United States</td>
<td>3.0</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>2.7</td>
</tr>
<tr>
<td>Japan</td>
<td>2.1</td>
</tr>
</tbody>
</table>

Note: The range of included institutions may vary slightly due to national differences in classification. Figures for Australia include banks and building societies.


In regard to insurance, where potential improvements are estimated to be of medium magnitude, while there is scope to improve the cost structures of individual insurance companies, this is best achieved through competition rather than through regulation. In regard to the funds management industry, where potential improvements are estimated to be large, regulation and taxation rules have contributed to its high cost levels by creating barriers to foreign entry and by failing to encourage the consolidation of the fragmented superannuation industry. Further unnecessary cost is added by the lack of low-cost distribution channels.

The costs of the payments system, where potential improvements are also estimated to be large, are driven directly by the frequency of use of different instruments and by the proportion of electronic transactions. Despite the rapid uptake of some forms of electronic payments instruments such as EFTPOS, Australia still depends heavily on cheques. As a result, total payments system costs are relatively high by international standards, constituting between $5 billion and $7.5 billion annually.
Figure 3: Automatic Teller Machine (ATM) and EFTPOS Penetration (1995)

Note: Not all systems have the same functionality (e.g. on-line capabilities) as those in Australia.


Chapter Seven: Conduct and Disclosure

Financial markets cannot work well unless participants act with integrity, to ensure mutual trust, and unless there is adequate disclosure to facilitate informed judgements. Regulation is necessary to ensure that these conditions hold. Market integrity regulation seeks to ensure that markets are sound, orderly and transparent, users are treated fairly, the price formation process is reliable and markets are free from misleading, manipulative or abusive conduct. Consumer protection regulation seeks to ensure that retail customers have adequate information, are treated fairly and have adequate avenues for redress.

Such conduct and disclosure regulation is currently undertaken by several Commonwealth agencies, such as the Insurance and Superannuation Commission (ISC), the Australian Securities Commission (ASC), the Australian Competition and Consumer Commission (ACCC), and the Australian Payments System Council (APSC). Most such regulation is
based on the institutional form of the service provider, although market integrity regulation is conducted on a functional basis by one agency alone, the ASC. This regulatory structure is inconsistent with the broadening structure of markets, has resulted in inefficiencies, inconsistencies and regulatory gaps, and is not conducive to competition in the financial system.

In order to overcome these problems, it is recommended that a single agency, the Corporations and Financial Services Commission (CFSC), should be established to provide Commonwealth regulation of corporations, financial market integrity and financial consumer protection. It should combine the existing market integrity, corporations and consumer protection roles of the ASC, ISC and APSC. The tasks of these three roles are more complementary than conflicting. The CFSC should take over the administration of consumer protection in the financial system from the ACCC, and especially monitor the use of new technology in relation to consumer protection. On the other hand, the States and Territories should retain and review their consumer credit laws.

The CFSC should have powers to use a combination of regulatory approaches. In addition to its framework legislation, the CFSC should have the power to adopt detailed codes which prescribe appropriate conduct and disclosure in particular industries or to allow the industry to develop such codes. Given these broad powers, the CFSC should have the discretion to decide the best approach to regulation to be used in particular circumstances. The CFSC should have an explicit mandate to balance the efficiency and effectiveness of its regulatory approaches.

It is recommended that a number of specific current regulatory practices also be reformed. Disclosure requirements for retail financial products should be reviewed by the CFSC to ensure that they provide information that enables comparison between products. The disclosure codes of conduct applying to banking, building societies and credit unions should be made consistent wherever possible, while 'due diligence' defences should apply to positive disclosure requirements. As well, the law should be amended to require the issue of succinct profile statements about offers of retail financial products, including initial public offers. In order to avoid information overload for consumers, the CFSC should encourage shorter prospectuses where applicable. Financial institutions' financial reports should meet both Corporations Law and prudential supervision requirements, while the accounting standards of financial institutions should be harmonised with international standards.

The CFSC should establish a single regime to license advisers providing investment advice and dealing in financial markets. There should be separate categories of licence for investment advice and product sales, general insurance brokers, financial market dealers, and financial market participants. However, the CFSC should have power to delegate accreditation responsibilities to industry bodies.
On the other hand, the CFSC should develop a single set of requirements for investment sales and advice concerning minimum standards of competency and ethical behaviour, the disclosure of fees and adviser’s capacity, rules on handling client property and money, financial resources or insurance available in cases of fraud or incompetence, and responsibilities for agents and employees. In particular, real estate agents providing investment advice should be required to hold a financial advisory licence unless a review clearly indicates otherwise. However, professional advisers, such as accountants and lawyers, should not be required to hold a financial advisory licence if they provide investment advice only incidentally to their other business and rebate any commissions to clients. Additional prudential regulation of financial market licence holders is not required at this time.

Broader regulation of ‘financial products’ should replace current, less flexible, securities and futures law. The CFSC should authorise financial exchanges (such as the Stock Exchange and the Futures Exchange) under a single regime, while the ACCC and the CFSC should coordinate their examination of exchange rules. The regulation of exchanges should not be excessive compared with Over-the-Counter (OTC) markets which involve more specialised transactions between buyers and sellers. In particular, prohibitions on retail participation in OTC derivative markets should be discontinued. OTC markets may be conducted by appropriately licensed financial market dealers, while exchange clearing houses should be appropriately authorised. A central national gateway for dispute resolution for all consumers of retail financial services and products should be established.

Overall, the CFSC should have broad enforcement powers and resources which are adequate for carrying out its responsibilities. In particular, it should have adequate powers over investigations, protection from liability for those providing regulatory assistance, the imposition of administrative sanctions such as disqualification and banning orders, the initiation of civil actions in the courts, and the referral of matters to the Director of Public Prosecutions for criminal prosecution. The CFSC should also participate in global regulatory programs to provide consumer protection for cross-border financial transactions.

Chapter Eight: Financial Safety

Financial safety is fundamental to the smooth operation of the economic system. Government intervention through prudential regulation provides an added level of financial safety beyond that provided by conduct and disclosure regulation. The intensity of prudential regulation should be proportional to the degree of market failure it addresses, but it should not involve a government guarantee of any part of the financial system.
The current framework for prudential regulation is institutionally based, with separate agencies regulating the activities of each class of institution. The Reserve Bank Australia (RBA) covers banks and the payments settlement, the ISC covers life and general insurance and superannuation, while the state-based Financial Institutions Scheme, coordinated by the Australian Financial Institutions Commission (AFIC) covers credit unions, building societies and, it is expected, friendly societies from 1 July, 1997.

Prudential regulation should be imposed on institutions licensed to conduct the general business of deposit taking from the public, or offering capital backed life products, general insurance products or superannuation investments. A single Commonwealth agency, the Australian Prudential Regulation Commission (APRC), should be established to carry out regulation for all these products. That is, it should conduct prudential regulation throughout the financial system. The APRC should be separate from, but cooperate closely with, the RBA.

A single prudential regulator offers regulatory neutrality and greater efficiency and responsiveness, provides a sounder basis for regulating conglomerates, offers the prospect of greater resource flexibility and economies of scale in regulation that should enhance the cost effectiveness of regulation, and provides the flexibility and breadth of vision to cope with changes that seem likely to occur in the financial system in the coming years.

Separating the prudential regulator from the RBA recognises the supervision functions for non-bank institutions which the regulator will be taking on, clarifies the nature of the assurance provided by prudential regulation to customers of financial institutions, and enables each organisation to focus clearly on its primary responsibilities and clarifies the lines of accountability for their regulatory tasks. It also removes a potential conflict of interest for the regulator in cases where institutions require emergency liquidity assistance and the prudential regulator might be too willing to provide it in order to bolster its own reputation for preventing institutional failure. Allowing this function to remain with the RBA, as is recommended, avoids this problem.

However, the RBA should have three ex-officio members on the APRC Board, and provision should also be made for full information exchange between the RBA and the APRC and for RBA participation in APRC teams inspecting financial institutions. The RBA should retain responsibility for reporting under the Financial Institutions Act 1974. A bilateral operational coordination committee should be established between the RBA and the APRC. The three financial system regulators—the RBA, CFSC and APRC—should also continue to pursue operational cooperation through a joint council chaired by the RBA. This is discussed in a later chapter.

The APRC should be empowered under legislation to enforce prudential regulations on any licensed or approved financial entity. Unlicensed entities would be prohibited from offering financial products for which approval had not been given. Licenses could be
revoked or made conditional on certain courses of action. However, the intensity of prudential regulation needs to balance financial safety with consideration of its possible adverse effects upon efficiency, competition, innovation and competitive neutrality. This balance should preserve a spectrum of market risk-and-return choices for retail investors, thus meeting their differing needs and preferences.

Prudential regulation of all licensed Deposit-Taking Institutions (DTIs) should be consistent with standards approved by the Basle Committee of Banking Supervision and should aim to ensure that the risk of loss of depositors' funds is remote. Quantitative prudential requirements such as capital adequacy, liquidity requirements and large exposure limits should apply. Regular on-site reviews of risk management systems should form an integral part of the approach to prudential regulation.

The APRC should be responsible for the licensing of all DTIs subject to prudential regulation. Only those entities which meet minimum capital requirements and hold an exchange settlement account (ESA) with the RBA should be entitled to use the name 'bank', while only those entities which are mutually owned (where each depositor has an equal share of ownership) should be entitled to use the names 'credit union', 'credit society' or 'mutual'. Any licensed DTI should be entitled to use the name 'building society' and licensed DTIs should be entitled to use any other business names provided they are not, in the view of the APRC, misleading to depositors. Deposit taking by unlicensed entities (such as finance companies) should be subject to the fundraising provisions of the Corporations Law and be regulated by the CFSC.

The APRC should regulate life companies and general insurers, while the regulation of friendly societies should be shared between the CFSC and the APRC. The APRC should regulate superannuation in accordance with retirement objectives, while other APRC regulated institutions should have the right to offer Retirement Savings Accounts (RSAs). However, 'excluded' superannuation funds (with less than 5 members) should be exempt from APRC regulation. Overall, the APRC should promote transparent disclosure of institutional activities and performance in order to strengthen risk assessment by customers and shareholders.

The general principle of a wide spread of ownership of regulated financial entities (or holding companies where part of a conglomerate) should be retained. This protects against undue influence by a major shareholder and also guards against contagion risk that may otherwise occur if a financial institution is damaged by adverse changes in the fortunes of its major shareholder. Existing legislation and rules should be streamlined through the introduction of a single Acquisitions Act with a common 15% shareholding limit. The APRC should have power to approve, subject to prudential requirements, an exemption allowing an existing licence holder to acquire more than 15% of an institution. Any other person may acquire more than 15% of a licensed institution only if the Treasurer approves the acquisition in the national interest.
Current policy generally requires the separation of the ownership of DTIs and life companies from other sectors of the economy. This is justified principally on the basis of the need to ensure that the safety of the financial sector is not compromised by the influence or fortunes of other entities. The general principle of separation of regulated financial activities from other activities should be retained but applied with greater flexibility than at present. Mutual entities should be permitted to hold all classes of licences. New applicants for licences are currently required to meet certain capital requirements. In general, these should be retained but the APRC should be flexible in granting exemptions under some circumstances.

Financial conglomerates raise the issue of the most appropriate legal structure in which they should operate. It is recommended that, subject to a financial conglomerate meeting prudential requirements, the APRC should permit adoption of a non-operating holding company structure. The structure must satisfy the APRC in the areas of capital management, adequacy of firewalls, reporting of intra-group activities and independent board representation on subsidiary entities. A conglomerate should not be prohibited from obtaining a number of classes of licences or conducting non-regulated financial activities. The APRC should have clear powers to verify intra-group exposures and otherwise satisfy itself as to the adequacy of the separation of the regulated financial entity from other financial operations of the group.

Turning to some other financial entities, fundraising by money market corporations and finance companies should be subject to CFSC surveillance but not APRC regulation.

Finally, in regard to dealing with the failure of financial institutions, the depositor protection mechanism that currently applies to banks should, subject to appropriate transitional arrangements, be extended to all regulated DTIs. Associated resolution arrangements should be transferred to the APRC and clarified by legislative amendment. Current depositor protection provisions would provide a greater level of security, in the event of collapse and liquidation, than an explicit deposit insurance scheme and are to be preferred on these grounds.

To facilitate depositor protection, restrictions on the classes of debt and equity that may be issued by DTIs, particularly mutual institutions, should, as far as possible, be removed (in order to expand non-deposit sources of funds). In regard to insurance companies and superannuation funds, the APRC should be empowered to replace management or trustee control of regulated financial entities in the event of their actual or likely failure. Existing policy holder preferences applied to statutory funds of life companies should be retained and extended to benefit funds of friendly societies.
Chapter Nine: Stability and Payments

In any financial system a limited range of financial claims can be used as a means of payment to settle transactions. For example, notes and coins, the deposit liabilities of banks (mobilised by instruments such as cheques) and credit cards backed by lines of credit, can all be used to settle transactions, and thus form part of the payments system. There is scope for increased competition in the payments system which will help to lower its costs of operation. However, this must be balanced against the need to maintain stability in the financial system. The payments system provides one central way in which instability can be generated. The RBA should retain overall responsibility for the stability of the financial system, the provision of emergency liquidity assistance and for regulating the payments system.

Large scale instability (called systemic instability) can arise from default on settlement of transactions, especially for high value transactions on bonds, foreign exchange and derivatives products where receipts and payments may not be synchronised. Initiatives such as the ‘real-time-gross-settlement’ (RTGS) system should mitigate domestic sources of settlement risk; here, each high value transaction is settled as it occurs. Time lags in other settlements are also being shortened. However, substantial risks remain, especially for international transactions. The RBA should give high priority to promoting further cost-effective control of both domestic and international settlement risks. On the other hand, the CFSC should be responsible for regulation of financial exchanges in these matters.

Apart from settlement risk, financial system instability may also have its origins in generalised disruption to financial and other markets. Confidence in some financial market participants may plummet and this may generate a broader market crisis. The policy responses to such developments will vary with their particular circumstances but may include the provisions of emergency funds (i.e. liquidity) to markets generally or to particular sectors. These should remain the responsibility of the RBA (in consultation with the Treasurer), in its role as both monetary authority and manager of systemic risk.

Increased competition in the payments system is possible without jeopardising systemic stability. A new institutional framework is necessary to achieve this. Existing arrangements should be dissolved and a new Payments System Board (PSB) should be formed within the RBA to regulate payments with a view to increasing efficiency and competition. It should set performance benchmarks for these goals and its membership should reflect this. The RBA’s regulatory activities in these areas should be clearly separated from its commercial activities, such as acting as main banker to governments.

In regard to specific reforms to increase competition and efficiency, the right to issue cheques in their own name should be extended to all licensed DTIs. The ACCC and the PSB should monitor the delivery fees charged on credit and debit cards while the ACCC
should monitor the rules of international credit card associations to ensure they are not overly restrictive. Access to final clearance for financial transactions should be liberalised, its efficiency upgraded, and the Trade Practices Act 1974 should continue to apply to it. Access to ESAs with the RBA should be liberalised, while non deposit-taking institutions should be able to directly settle consumer electronic and bulk electronic payments through an ESA.

In regard to increased financial system security, RTGS benchmarks should be established, the PSB should issue payments system approvals and the PSB and the APRC should establish close coordination arrangements, while holders of ‘stores of value’ for payments instruments such as traveller’s cheques and smart cards should be subject to prudential regulation. High-value settlement providers should be regulated to international standards.

Chapter Ten: Mergers and Acquisitions

A competitive financial system is in the best interests of Australia and the laws and administration of policies on mergers and acquisitions play an important role in achieving this. The Trade Practices Act 1974 provides a set of economy-wide laws on competition. It is recommended that Section 50 of the Act should continue to apply to the financial system, so that a merger is prohibited where, in a substantial market, a substantial lessening of competition would be likely to result. Indeed, the Trade Practices Act should provide the only competition regulation of financial system mergers. The ACCC should continue to administer competition laws for the financial system. However, the APRC (and not the Treasurer) should be given powers to regulate mergers and acquisitions on prudential grounds.

In particular, the current ‘six pillars’ policy should be abolished. Under this policy, mergers are not permitted between the four largest banks (National Australia, Commonwealth, ANZ and Westpac) and the two largest life insurance institutions (AMP and National Mutual). There are no persuasive arguments for continuing to separate out such possible mergers from the general operation of competition policy and then to impose a blanket ban upon them.

On the other hand, this Report makes no recommendations about particular merger scenarios and it is not possible to comment definitively on assessment criteria in the abstract. However, the methodologies used in recent ACCC examinations of proposed bank mergers need review. Competition in retail transaction accounts and small business finance, currently at relatively low levels, is likely to be crucial in future assessments of merger proposals. The ongoing formation of national markets in some banking products and the competitive effects of the presence of regional banks will also be important.
considerations. In general, assessments of merger proposals should always take account of changes occurring in that sector.

In regard to foreign investment, the current policy position prohibiting the foreign takeover of any of the four major banks should be explicitly removed and replaced with a policy which provides that all foreign acquisitions in the financial system will be assessed through the general provisions of foreign investment policy under the *Foreign Acquisitions and Takeovers Act 1975*. While a large scale transfer of ownership of the financial system to foreign hands would be contrary to the national interest (since it would restrict options for the future development of the financial system), some increase in foreign ownership of aspects of the Australian financial system could generate significant benefits such as injections of new capital, access to new skills and technologies and enhanced competitive pressures in domestic financial markets.

Chapter Eleven: Promoting Increased Efficiency

The funds management industry is composed of funds collectively invested in life insurance, superannuation, equities and unit trusts. It has both retail and wholesale dimensions. Funds management fees in Australia appear to be higher than those in comparable countries. One of the potential reasons for higher costs in Australia is the fragmentation of the managed funds industry.

Regulatory reform can improve the performance of the managed funds industry. The following specific reforms are recommended. Foreign investment regulations restricting foreign owned or controlled managers of collective investments should be reviewed. The *Corporations Law* should be amended to provide for the application of takeover provisions modelled on Chapter 6 of the *Corporations Law* for public unit trusts, and to provide for streamlined merger and reconstruction provisions for collective investment scheme. The Australian Stock Exchange should amend Listing Rules 15.14 to permit the exercise of sanctions in trust deeds designed to provide unit holders with the protection embodied in Chapter 6 of the *Corporations Law*.

Superannuation fund members should have greater choice of fund. Employees should be provided with choice of fund, subject to any constraints necessary to address concerns about administrative costs and fund liquidity. Transfer costs should be transparent and reasonable. Regulation of collective investments and public offer superannuation should be harmonised. The States and Territories should give urgent priority to establishing a modern, uniform, national regime for trustee companies. There is also considerable scope for rationalising and standardising the taxation of collective investments, although this is outside the Report's terms of reference.
A regulatory framework which is responsive to technological innovation will also promote increased efficiency. Relevant legislation should be generally amended to allow for, and facilitate, electronic commerce. Regulation should not differ between different technologies or delivery mechanisms in such a way as to favour one technology over another. Australia should also adopt international standards for electronic commerce, and international harmonisation of law enforcement and consumer protection should be pursued, especially in regard to electronic commerce. Financial regulators should keep abreast of technological developments as they affect the financial system and liaise with each other as well as government departments and other agencies on these issues.

The existence of cross-subsidies between products, channels and customer groups is pervasive in the financial system. Profits from higher prices for some transactions are used to provide prices which are lower than they would otherwise be for other transactions. Cross-subsidies are derived from historical product bundling, earlier difficulties with apportioning costs, and community expectations that institutions should meet community service obligations. The unwinding of such cross-subsidies can increase efficiency in the financial system. Institutions should have the freedom to set fees and charges on their services and products based upon costs, without government intervention or suasion. Governments should expedite the examination of alternative means of providing low-cost transaction services for remote areas and for recipients of social security and other transfer payments.

In regard to the mortgage insurance market, which is of great importance to mortgage lenders, the Housing Loans Insurance Corporation should be privatised to eliminate its undercharging, in comparison to private insurers, which is derived from the Commonwealth Government's guarantee of its activities.

Improved flows of market information can also increase efficiency. In regard to small and medium-sized enterprises (SMEs), debt markets are not seriously deficient, while equity markets are improving. The current low investment by superannuation fund managers in this sector will probably increase and there should be no compulsion on funds managers to invest in SMEs. However, compared to the United States, Australia lacks benchmarking and performance measurement data on investment pools in the SME sector. This discourages institutional investment there. The CFSC and the Australian Bureau of Statistics should take into account the specific requirements of credit-rating agencies and funds managers when reviewing SME data collection.

In regard to privacy issues, current credit reporting for lender institutions is restricted to negative reporting of defaults and delinquencies. The Privacy Act prevents positive credit reporting (i.e. the successful completion of debt repayments). The latter would be very useful in making more efficient credit assessments of potential borrowers. This restriction should be reviewed. In a similar vein, credit information sharing amongst group entities should be allowed unless the customer withdraws consent. In general, reforms to the
privacy regime should balance protection, choice and efficiency, be responsive to market changes, be national in scope, avoid duplication and deal sensibly with information collected under previous privacy regimes. The administration of privacy laws in the financial system should be done by the Privacy Commissioner rather than the financial consumer protection regulator.

Chapter Twelve: Coordination and Accountability

The regulatory agencies should be established under legislation with substantial operational autonomy. The APRC and the CFSC should establish their own staffing and remuneration structures in whatever form will be most conducive to their effectiveness and efficiency. They should locate their headquarters in the main financial capitals, rather than Canberra. Inspection staff should be located in the cities where the financial industry operates. It is only under these conditions that regulation can be as effective and efficient as possible. Regulatory agencies' charges should reflect their costs, subject to approval by the Treasurer, so that they fund themselves. In this context, the current below-market rate of interest paid by the RBA on its holdings of banks' non-callable deposits is distortionary and should be reviewed. Regulatory agencies should thus be 'off-budget' in their treatment by the fiscal authorities.

APRC, CFSC and PSB should all have boards of directors responsible for their operational and administrative policies, the fulfilment of their legislative mandates and their performance. The key principles in the composition of these new boards are that there should be majorities of independent members and that there be substantial cross-representation. The chairpersons of the APRC and CFSC boards and the PSB should be appointed by the Treasurer from among the independent members. Each agency should report annually to Parliament and should seek continuous improvement in reporting quality. Reports should include results of internal assessments of efficiency, compliance costs and cost effectiveness. Where possible, comparisons with international best-practice should be provided. Legislation should authorise the exchange of confidential information amongst the financial regulatory agencies.

A Financial Sector Advisory Council should be created to provide independent advice on implementation of the new regulatory arrangements, their relevance and cost effectiveness, the compliance costs imposed upon financial market participants, the international competitiveness of the financial sector and new and potential financial developments. The Council of Financial Supervisors should be renamed as the Council of Financial Regulators and reconfigured with the aims of facilitating the cooperation of its three members (RBA, APRC and CFSC) across the full range of regulatory functions.
Further amalgamation of financial regulators is not warranted because it would be premature, would reduce the benefits of specialisation and thus undermine efficiency, and would create an agency which might be excessively powerful.

Chapter Thirteen: Managing Change

A staged approach should be adopted to implementing this Report’s recommendations, commencing with an announcement of the Government’s position in principle on the main recommendations, and followed by establishing the new regulatory agencies and investing them with existing regulatory powers. It is highly desirable that the Government announce its position on the mergers and acquisitions recommendations as soon as possible, in order to quell speculation and provide commercial certainty.

Negotiations with State and Territory Governments would also need to proceed on the transfer of regulatory powers which are currently the responsibility of the state-based AFIC regime. As well, a Panel for Uniform Commercial Laws should be established to pursue uniform Commonwealth, State and Territory commercial laws. The Panel should complete its task by no later than the end of 1999.

Summary of Part Three: Stocktake of Financial Deregulation

Chapter Fourteen: Stocktake, Historical Perspective

Tight control of the banking system in the post–World War Two era encouraged the growth of non–bank financial institutions (NBFIs). Life companies were actively engaged in mortgage lending to satisfy demand unmet by banks. Building societies and credit unions also expanded. Merchant banks developed to satisfy unmet demand for corporate borrowing. The banks themselves established subsidiary finance companies to overcome the strict regulation of their own lending and borrowing activities.

By the late 1970s pressure for regulatory reform was mounting through a combination of inflation, exogenous shocks and the declining effectiveness of a monetary policy system which was reliant upon control of banks' balance sheets, despite the importance of NBFIs in the financial system. It was in this context that the Campbell Committee was established in 1979; it issued its report in 1981. Its recommendations were targeted at both improving the efficiency of macroeconomic management and at the abolition of direct interest rate and portfolio controls on financial institutions. Although the Campbell Committee was
concerned to remove barriers to entry to the financial system, its recommendations also included strengthened prudential measures to preserve system stability.

As of mid-1996 the majority of the Committee's recommendations had been implemented. Most importantly, interest rate and bank lending controls were relaxed, barriers to entry in banking were liberalised, controls on capital flows were abolished, and the exchange rate was floated. These policy changes are usually called 'financial deregulation'. In the period since Campbell, many other important policy changes have occurred, such as the privatisation of financial institutions, the development of compulsory superannuation and economy-wide microeconomic reform. These changes make it difficult to assess the effects of financial deregulation.

Chapter Fifteen: Stocktake, The Financial System

The Campbell Committee believed that less intrusive regulation and greater competition would lead to greater efficiency in the financial system, and that consumers would benefit from these changes. However, the expected increase in competition, particularly in the retail deposit taking sector, has been slow to arise. Only in more recent times have some retail financial markets (e.g. home mortgages) become obviously more competitive. On the other hand, efficiency has improved in several areas since deregulation. Increased pricing efficiency, in securities and foreign exchange markets in particular, has improved the efficiency of resource allocation. The productivity of financial market participants has also risen in many cases, with technological innovation playing a major role in this.

International competitiveness was not a major focus of the Campbell Committee. The limited data available provide some support for the view that underlying competitiveness has increased since deregulation in some areas but deteriorated in others. On the other hand, product choice has clearly widened since the early 1980s. This is attributable to deregulation as well as to technological developments, government superannuation initiatives, and increased integration with international financial markets. The quality of financial products has also risen. However, one exception to the improvement of financial products and services is the provision of information and advice, which still appears to be in need of further development. Overall, although deregulation has yielded benefits in the above areas, there is room for further improvement.

Chapter Sixteen: Stocktake, Financial Regulation

In response to both the financial problems which occurred in the late 1980s (such as increased loan default rates and heightened financial institution distress) and the expansion of superannuation, prudential regulation was upgraded through tougher capital
requirements and structurally reformed through consolidation, refocusing and better coordination of regulatory agencies. The greater range and complexity of financial products and, in some areas, concerns about more aggressive selling practices, have also led to an increased focus upon consumer protection. This has resulted in new consumer credit regulation and new rules for disclosure, codes of conduct and dispute resolution.

Globalisation has created an increasing need for global harmonisation of, and cooperation in, the conduct of financial regulation. In the face of new technologies, alliances and market structures, increased regulatory attention has been given to ensuring competitive conduct in all segments of the market and to providing a competitively neutral policy environment.

However, the ad hoc nature of some new regulation has created a quite expensive regulatory framework. Over 800 staff are now involved in financial regulation in Australia, resulting in direct and compliance costs which appear to be high by international standards.

Chapter Seventeen: Stocktake, The Economy

While the difficulty of determining the effects of financial deregulation on the economy has been noted, some observations can still be made. The removal of exchange controls accelerated the integration of Australia with world capital markets. This expanded the opportunities for both Australian-owned capital and foreign-owned capital in Australia. In both cases this is likely to have been beneficial to Australia.

Indeed, measures on productivity in the Australian economy suggest an upturn in the 1990s, which has bolstered economic growth. This may be attributable in part to greater efficiency resulting from financial deregulation.

However, the adjustment to a deregulated financial system was difficult, with a credit boom and asset-price inflation generating a subsequent correction in the early 1990s and associated bad debts and bankruptcies.

Exchange rate flexibility has increased Australian flexibility in responding to economic shocks, while financial deregulation has restored the power of monetary policy and allowed it to focus upon inflation control.

Increased scrutiny of government's economic policies by financial markets may be viewed either as an undesirable constraint or as a desirable source of discipline upon governments.

The weakness in national savings in the period since deregulation does not appear to be strongly associated with deregulation, since it is due mainly to low public sector savings,
especially as a result of Commonwealth Government budget deficits. Similarly, the impact of deregulation on long-term employment seems small and is likely to be dominated by its impact on economic growth. It cannot be blamed for enduring high levels of unemployment.

Critique of the Report: Some Opposing Policy Arguments

In this section we gather together some noteworthy arguments which can be, and have been, made against some of the policy recommendations made in the Wallis Report. This provides the counterbalance to the earlier sections which summarised the Report's arguments and recommendations. These opposing arguments are a 'smorgasbord of dissent' which are drawn from a variety of perspectives. Some of the arguments and perspectives are in conflict with each other, so that, as a whole, the following do not form a consistent, integrated set of alternative policies.

Consumer Protection

The main policy position opposing the construction of the CFSC would seem to be one advocating that consumer protection should be administered on an economy-wide basis by the ACCC while regulation of corporations and financial market integrity is done by another agency. We now present the main arguments in support of this view.

The central advantage of an economy-wide regulator in any policy field is that it can ensure standardisation of regulation across industry sectors and thus achieve competitive neutrality. Here, the burden of regulation is born equally by all industries affected, so that regulation does not create economic distortions by favouring some sectors over others, and thus changing the allocation of resources across industries. With more than one regulator in the field, there is a consequent danger that regulation will not be standardised, and differences in regulation will thus distort economic and commercial choices.

It could be argued that this danger is particularly relevant in the case where a regulator for one sector of the economy is to be constructed, for here the narrow focus of the specialised regulator's work, the corresponding focused industry opposition to it, and its limited ability to generate political support in other areas of the political economy, make it vulnerable to 'capture' by the industry. Here, the standards of regulation will often be less rigorous and demanding than for the rest of the economy, because the industry will ensure that regulatory policy is 'industry friendly'.

It could be argued that this scenario is very much applicable to the case of the construction of the CFSC since it is envisaged that financial consumer protection will be taken away
from the ACCC, the formerly economy-wide regulator, and given to a body which will not concern itself with consumer protection in other industry sectors. This danger could be reinforced if the CFSC is dominated by staff from the ASC who might thus have little interest in consumer protection and concentrate on their other responsibilities, while allowing financial consumer protection to be overly influenced by the wishes of financial sector firms.\textsuperscript{7}

The ACCC’s well-known rigorous standards for consumer protection could thus be watered down by the CFSC in relation to the financial system. Besides creating inefficiencies, this outcome could also be interpreted as unfair by those who regard rigorous consumer protection as a high social and political priority.

It could be argued that lodging the administration of all financial consumer protection with the ACCC avoids these problems. A CFSC might still be formed but its responsibilities would now resemble those of the currently existing ASC. As such, the argument for any institutional reform in this area would become much more tenuous.

The Mega Prudential Regulator

While there do not seem to be any substantial arguments against the formation of one regulator for all DTIs, there are a couple of noteworthy arguments against the formation of a single prudential regulator for the entire financial system.

First, it is clear that the nature of prudential regulation is different for products where a commercial promise of a capital guarantee of funds has been made (e.g. bank deposits) compared to products where no such promise has been made and funds are deployed and used on a ‘best–endeavours’ basis, often by a trustee structure (e.g. superannuation fund contributions). In the latter case, there is no institutional promise that investment mistakes and market fluctuations will not be sufficiently large as to wipe out some portion of the capital value of the investments.

Prudential regulation is, and will continue to be, very different in these two cases, and their conjoining in the one regulatory body will necessitate different divisions within the regulator to cope with the very different demands of regulation in the two classes of investments and institutions. This might undermine the advantages of policy specialisation which arise from giving public instrumentalities a few clear goals which they should pursue.\textsuperscript{8} The greater the complexity of the regulatory goals and practices set for any organisation the greater the danger that it will not fulfil any of them terribly well but will do only a minimally satisfactory job of each.

This might mean, for example, that the high standards of prudential bank supervision achieved by the RBA could be compromised through the formation of the APRC.
Second, it could be argued that the formation of the mega prudential regulator, the APRC, will generate excessive expectations about the safety of investments with non-deposit taking institutions especially. This might lead to problems of ‘moral hazard’ in which such investors and institutions engage in excessively risky behaviour on the assumption that there is a government guarantee of any investments made. This could create the very sort of financial collapse that prudential regulation is designed to avoid.

Large segments of the general public clearly believe that bank deposits are currently guaranteed by the government through the RBA. Official spokespersons may deny such a guarantee exists but it seems clear from mass financial behaviour and public opinion poll responses that this belief exists. The creation of a mega regulator might thus lead many individuals to believe that this guarantee has been extended to all investments and institutions supervised by the APRC. Such a belief might be quite immune to denials by official sources.

Indeed, the mere existence of such a belief could generate such powerful mass political sentiments, at times of financial institution distress or collapse, that governments are forced to step in and ensure that the retail investments in question are fully refunded. This could place enormous pressure on the Commonwealth Budget. Thus, it could be argued that the formation of an APRC will vastly increase these implicit and contingent liabilities for the Commonwealth Government, and thus, this regulatory change should be avoided.

One way to avoid such problems for the APRC might be to delete any explicit reference to deposit protection, by any government agency, in its defining legislation and to have this deletion well publicised by the Commonwealth and APRC officers. Alternatively, such problems could also be avoided under an APRC regime by ensuring that DTIs are clearly distinguished from non-DTIs, through the use of explicit, and compulsory, deposit-insurance schemes in the former. Such schemes are discussed later in this paper.

Separating Prudential Regulation from the RBA

There are a couple of noteworthy arguments against the view that prudential regulation should be separated from the central bank.

First, it should be remembered that the Wallis Report proposes that provision of emergency liquidity assistance to financial institutions in distress should remain with the RBA and not be given as responsibility to the APRC. It could be argued that this arrangement creates the danger that RBA decision-making responses may be too slow in times of financial emergency, precisely because it has not been dealing with the supervision of institutions on a continuing day-to-day basis and is thus not sufficiently familiar with the cases of financial distress which have arisen.
Placing RBA officers on the board of APRC reduces this danger somewhat, as would the formation of a bilateral operational coordination committee, but only to the extent that such RBA officers take their work with the APRC seriously and have sufficient influence within the RBA during times of emergency that decision-making is rapid enough to meet the needs of the institution in trouble. If not, then slowness of provision of emergency funds might allow a basically sound institution, in only temporary difficulties (e.g. in a ‘solvent but illiquid’ situation), to collapse needlessly.\textsuperscript{10}

This problem might be avoided by vesting control over emergency liquidity with the prudential regulator, so that rapid response can match the need of the institution for rapid emergency help. However, this raises questions of where such funds are to be raised and what volumes of funds will be necessary to cope with ‘typical’ problems of financial distress. One solution would be to give the APRC power to quickly draw such emergency support funds from the RBA when the former thought it necessary; here, the requests would be ‘compulsory’ in nature (i.e. much more like instructions) and the RBA would not have the power to delay, resist or refuse them.

Second, the separation of RBA responsibilities for monetary policy from prudential regulation gives up completely on the possibility of the coordinated deployment of monetary policy instruments (short-term nominal interest rates) and prudential policy instruments (capital requirements, liquidity requirements, etc.) to jointly achieve monetary policy goals and prudential soundness. That is, monetary policy may sometimes be useful in achieving prudential goals (e.g. in enhancing institutional soundness) while prudential policy may sometimes be useful in achieving macroeconomic goals such as inflation control (e.g. by affecting borrowing and lending flows).\textsuperscript{11}

There may be many occasions where such joint usage of instruments in a coordinated fashion will more effectively and efficiently achieve all these goals than the narrow specialised targeting of one set of instruments on one goal, as would occur under separation and as occurs now. Current RBA philosophy and policy practice does not advocate such joint deployment of policy instruments but this does not mean that such usage will not be possible in the future. Such policy coordination would be very difficult to achieve when policy is decided by two separate bodies.

Fees and Charges

The Report's recommendation that financial institutions be free to set fees and charges at efficient, profitable levels could be challenged on the basis of the following arguments.

Particularly in regard to transaction accounts, it could be argued that financial institutions have a community service obligation of offering at least the rudiments of low cost
services, often called a Basic Banking Product (BBP). These products are especially important to low-income, low-wealth customers of financial institutions. Such a BBP would allow the avoidance of fees below some threshold of usage, provide regular account information, and also offer some convenient and extensive bill-paying facility.

The nature of a BBP is such that its features necessarily imply that the financial institution is not pricing such a product according to efficiency principles of the marginal costs of operation. For example, efficient pricing would not allow any fee-free threshold of usage because each account transaction entails some cost to the institution which should, according to efficient and profit-seeking pricing, have a fee attached to it.

Transaction accounts quite closely approximating the concept of a BBP are now offered by the banks. These were introduced in the aftermath of the issue of the report by the former Prices Surveillance Authority in 1995 on the subject. They offer, for example, a fee-free range of usage, in exchange for generally not having to pay interest on account balances. It now remains to be seen whether they continue to be offered or are withdrawn in response to the coming policy changes which the Wallis Report will generate.

It is generally agreed that other policy approaches to providing a BBP, especially for low-income and low-wealth customers, can be more economically efficient than the operation of the budget accounts described above. One obvious option is to use the tax/transfer system to subsidise the account usage of such disadvantaged customers. Here, account pricing could be efficiently set but this would not reduce the real incomes of such customers, who will be recompensed for such costs. The Wallis Report advocates the further study of such compensation schemes.

However, the current reality of fiscal politics at the Commonwealth level is that ongoing moves to budgetary tightening over the next few years will almost certainly preclude the introduction of such schemes. Even in the medium to long term, the likelihood of such an introduction may be slight, given the many other claims which will be made upon the Commonwealth's revenue and spending systems.

In this situation, it could be argued that the Commonwealth should ensure that such basic transaction accounts continue to be offered by legislating to force all deposit taking institutions to offer them. The inefficiencies entailed in such compulsion would probably be small so long as institutions continued to offer a range of other accounts which had economically efficient pricing policies attached to them.

Access Points to Financial Institutions

Similar arguments can also be made in regard to the convenience of access to financial services. The Report argues that substantial cost savings are possible if financial
institutions rationalise their distribution systems so that high cost channels of distribution, such as bank branches, undergo some contraction while low cost channels, such as ATMs, undergo expansion. These changes will come about, both through direct management decisions by the institutions and as an automatic result of more efficient and cost relevant pricing of distribution channels. Branch transactions should be more expensive, in relative terms, while electronic transactions should become cheaper in relative terms.

The contrary argument would be that financial institutions have a community service obligation to provide a reasonable spread of their distribution channels, both in terms of geographic distribution and in terms of offering a range of types of transactions. This would mean that the configuration of distribution points should not just be determined by efficiency and cost considerations but also by the needs of the community. Thus, it could be argued that governments should liaise with financial institutions and apply relevant incentives and pressures to them to ensure a sufficiently wide and varied distribution system for financial services.

In particular, this argument probably implies that the branch systems of financial institutions should not be allowed to fall below some minimum breadth of coverage and that the fees attached to branch transactions should not be allowed to rise above some threshold. Alternatively, the provision of basic transaction accounts discussed earlier could be designed so that some branch transactions were always included as a part of the fee-free range of usage.

In regard to branches, this argument could imply allowing, or encouraging, explicit cooperation amongst financial institutions so that towns and suburbs were left with at least one or two of their branches for the use of customers, even if the full range of institutions was no longer present in each of them. This would allow cost savings for the financial system as a whole while preserving a minimum level of financial services.

The Six Pillars Policy

The Wallis Report recommended that the prohibition on mergers between the largest banks and life offices be abandoned so that the ACCC will be the sole competition policy regulator in these matters. The Commonwealth Government has already announced that while it now does not, in principle, oppose mergers between any life office and any bank, it will still maintain the ban on mergers between the four largest banks until such time as competition in key areas such as finance for SMEs, and transactions accounts, has intensified substantially.

Many sections of the community support the Government's move since they hold substantial grounds for disquiet over further bank mergers at a time when newly released
competitive forces are just finding a foothold in a quite concentrated financial system. While it appears somewhat unlikely that the ACCC would have approved such proposed mergers if allowed to, it can be argued that the issue is of such national importance that it warrants the Government's continued pre-emptive overriding of any ACCC views on these matters.

The operational autonomy of regulatory bodies is of considerable importance for good public policymaking, but on matters of high national interest it could be argued to be perfectly valid and proper for the elected government of the day to take matters into their own hands and make binding decisions, for which they will be answerable to the general public at the next election. This principle could also be applied to matters of high importance in regulatory matters conducted by other financial system bodies, such as the prudential regulator or the consumer protection agency.

Foreign Ownership

The Report's somewhat half-hearted support for, and ambivalent attitude towards, higher direct foreign investment in the Australian financial system, could be challenged from perspectives both of being too hostile to foreign investment, and then of being too trusting and naive in its attitude to foreign investment. The Report's position on this issue has been largely adopted by the Commonwealth Government. 18

As the Report notes, direct foreign investment in the financial system can bring with it the substantial benefits of new capital, skills, technologies and intensified competition. It might also lay the foundation for the outward expansion of Australian financial institutions into new markets. This, in turn, could generate benefits for their Australian operations in terms of economies of scale and world-best-practice operational efficiency.

However, the Report's warning that a substantial increase in foreign ownership would be against the national interest, because it might close off options for future development of the financial sector, could be viewed as fundamentally inconsistent with the great bulk of the arguments and recommendations it makes. The Report is very much in the mould of advocating greater freedom for market forces to improve efficiency and productivity in the financial system. However, in relation to foreign investment it proposes the continuation of restrictions which have the effect of shielding the sector, in large part, from the full force of international investor competition.

If, for example, all DTIs in Australia were open to takeover by overseas financial institutions then they would face intensified pressure for continued good performance in order to be able to ward off such potential threats to their independence. 19 This attitude of the Report on the dangers of foreign investment could thus be viewed as somewhat
paradoxical. Indeed, this very principle which supports investment restrictions might be applied to many other sectors of the economy and become the justification for imposing substantial restrictions on direct foreign investment there. But clearly, it is not at all the intention of the Wallis Committee that its argument should be used in this way.

It is also interesting to note that the Report is silent on specific foreign investment issues such as whether foreign bank branches should be allowed to enter retail markets directly by accepting small retail deposits in their Australian operations. The foreign banks which initially flowed into Australia in the 1980s were required to set up locally incorporated subsidiaries in order to facilitate full prudential supervision by the RBA. The previous Commonwealth Government allowed foreign banks to set up branches (i.e. directly controlled divisions of their foreign parent bank) operating in wholesale markets but not in retail markets. One concern about foreign bank branches operating in retail markets has been that in the case of their collapse and liquidation there might be substantial doubt about Australian depositors having any sort of preference over other creditors in the final distribution of remaining assets after liquidation. 20

Overall, it might be viewed as indicative of the Report's rather strange treatment of foreign investment that it failed to address this important current policy issue.

Of course, the Report can also be criticised from the opposite perspective that foreign ownership of key national assets such as its largest banks and insurance companies should not be allowed at all, for the Report's very own reason that it would close off options for future development of these industries in ways which might be against the long-term national interest of Australia. From this perspective, at the very least, foreign investors in these sectors should be subject to rigorous performance criteria to ensure that Australia gets a good share of the benefits which their presence might generate. 21

**Deposit Insurance**

Finally, the Report's abandonment of the idea of explicit deposit insurance for retail customers could be challenged. Such schemes are quite widely used throughout the world, in both advanced and developing countries. 22

As the Committee notes, the great advantage of such explicit, compulsory insurance schemes is that they give retail customers certainty that their deposits with financial institutions are completely safe. This would remove any lingering doubts about the current system which the Report describes as ensuring that the chances of losing depositors' funds is remote, rather than being zero. This certainty promotes policy transparency and provides a good environment in which efficient customer choices can be made about the allocation of their wealth amongst assets of differing risk and return characteristics. It also provides a
social equity value of safety for customers, especially low-income ones, seeking full security and unable to judge the varying security of the financial institutions on offer in terms of retail accounts. Thus, it furthers both efficiency and equity as financial outcomes.

After consideration of overseas schemes and the role of deposit insurance in the savings and loan fiasco in the United States, the Committee concluded that, for Australian financial circumstances, it was unable to devise insurance schemes which would not undermine incentives for institutions to take proper care of their depositors' funds. Thus, it dropped the idea.

However, it is well known that there are ways of designing such insurance schemes which encourage prudent use of deposit funds by institutions. These are schemes where the insurance premiums to be paid by institutions (either to public or private insurers) vary with the risk profile of the assets of the institution, with more risky lending to business, for example, attracting higher premiums than for other types of lending. Such insurance schemes have some likeness to the risk-weighted capital adequacy rules now widely applied by bank regulators throughout the advanced world, where more risky lending requires greater capital backing in order to better protect deposit funds from the greater dangers of default in these cases.

There have also been doubts expressed, in the Report and elsewhere, about whether governments will have the political will and commercial and actuarial sense to price the insurance premiums at levels that will fully cover any likely payouts from institutional collapse. There are two options to address this issue. First, for insurance schemes operated by governments, they could call upon private insurance expertise in designing and operating these schemes so that they are financially and actuarially sound. Second, governments could completely 'contract out' such insurance schemes by simply requiring all deposit taking institutions to take out private insurance to cover the refund of deposits in the event that the institution collapses and is put into liquidation.

Such insurance could be capped at some account balance level, for social equity reasons of ensuring that insurance payouts do not disproportionately benefit the wealthy. Other prudential regulatory measures aimed at deposit protection could be simplified and relaxed, in order to help institutions pay for such insurance premiums. Thus, it could be viewed as disappointing that the Wallis Committee did not investigate these insurance options in much more depth.

It is interesting to note that deposit insurance could provide a neat solution to the safety problems surrounding foreign bank branches in Australia. Such branches could be allowed to accept retail deposits provided they were insured. This would facilitate the benefits of the extra competition that branches would bring while at the same time guaranteeing full security, up to the capped level, for such retail deposits.
Appendix: Recommendations of the Wallis Report

Conduct and Disclosure

1. Corporations Law, market integrity and consumer protection should be combined in a single agency, the Corporations and Financial Services Commission (CFSC).

2. The CFSC should have comprehensive responsibilities.

3. The CFSC should administer all consumer protection laws for financial services.

4. Due diligence defences should apply to positive disclosure requirements.

5. The CFSC and the ACCC should coordinate examination of financial exchange rules.

6. States and Territories should retain and review consumer credit laws.

7. The CFSC should have powers to use a combination of regulatory approaches.

8. Disclosure requirements should be consistent and comparable.

9. Profile statements should be introduced for more effective disclosure.

10. Shorter prospectuses should be encouraged.

11. Financial institutions’ financial reports should meet Corporations Law and prudential requirements.

12. Accounting standards should be harmonised with international standards.

13. A single licensing regime should be introduced for financial sales, advice and dealing.

14. The CFSC should have power to delegate accreditation responsibilities to industry bodies.

15. A single set of requirements should be introduced for financial sales and advice.

16. Regulation of real estate agents providing financial advice should be reviewed.

17. Licensing of professionals providing incidental financial advice is generally not required.
Additional prudential regulation of financial market licence holders is not required.

Broader regulation of 'financial products' should replace current securities and futures law.

Prohibitions on retail participation in over-the-counter (OTC) derivative markets should be discontinued.

The CFSC should authorise financial exchanges under a single regime.

Regulation of exchanges should not be excessive compared with OTC markets.

OTC markets may be conducted by appropriately licensed intermediaries.

Exchange clearing houses should be appropriately authorised.

A central gateway for dispute resolution should be established.

Coverage of dispute resolution schemes should be broader.

The CFSC should have broad enforcement powers.

The CFSC should monitor new technologies.

The CFSC should participate in global regulatory programs.

Financial Safety

Prudential regulation should be imposed on deposit taking, insurance and superannuation.

A single Commonwealth prudential regulator, the Australian Prudential Regulation Commission (APRC), should be established.

The APRC should be separate from, but cooperate closely with, the Reserve Bank of Australia (RBA).

The APRC should have comprehensive powers to meet its regulatory objectives.

The intensity of prudential regulation needs to balance financial safety and efficiency.

Prudential regulation of DTIs needs to be consistent with international requirements.
36 A single DTI licensing regime should be introduced.
37 Deposit taking by unlicensed entities should be restricted and regulated by the CFSC.
38 The APRC should regulate life companies.
39 Regulation of friendly societies should be transferred to the Commonwealth.
40 The APRC should regulate general insurers.
41 The APRC should regulate superannuation in accordance with retirement objectives.
42 Compliance by excluded funds should be monitored by the Australian Taxation Office.
43 Other APRC regulated institutions should have the right to offer retirement savings accounts.
44 The APRC should promote more transparent disclosure.
45 The principle of spread of ownership should be retained and regulation rationalised.
46 The approach to sectoral separation needs to be more flexible.
47 Mutual entities should be permitted to hold all classes of licences.
48 New entrants should be subject to minimum capital and other requirements.
49 Non-operating holding companies should be permitted subject to certain requirements.
50 Multiple licences and other financial activities may be permitted.
51 The APRC should be empowered to access operations of other non-regulated entities in the group.
52 Fundraising by money market corporations should be subject to CFSC surveillance.
53 Fundraising by finance companies should be subject to CFSC surveillance.
54 There should be appropriate mechanisms for resolving failure of DTIs.
55 There should be appropriate mechanisms for resolving failure of insurance and superannuation.

Stability and Payments
56 The RBA should remain responsible for system stability.
57 The CFSC should be responsible for regulation of financial exchanges.
58 Regulatory agencies should monitor wholesale markets.
59 The RBA should promote control of domestic and international settlement risks.
60 Liquidity management responses should remain the responsibility of the RBA.
61 A Payments System Board should be formed within the RBA.
62 Membership of the PSB should reflect payments system efficiency objectives.
63 The PSB should set performance benchmarks.
64 The RBA’s commercial activities should be clearly separated from regulatory responsibilities.
65 The Australian Payments System Council should be disbanded.
66 Rights to issue cheques should be extended.
67 Interchange arrangements should be reviewed by the PSB and the ACCC.
68 The ACCC should maintain a watching brief over the rules of international credit card associations.
69 Access to clearing systems should be liberalised.
70 The Australian Payments Clearing Association should continue its role in clearing arrangements with wider membership.
71 The Trade Practices Act should continue to apply to payments clearing arrangements.
72 Stores of value for payment instruments should be subject to regulation.
73 Access to ESAs should be liberalised subject to appropriate conditions.
74 High-value payments settlement providers should be regulated to the international standard for banks.

75 Non-deposit takers should be able to settle directly consumer electronic and bulk electronic payments.

76 RTGS system benchmarks should be established.

77 The PSB should issue payments system approvals.

78 The PSB and the APRC should establish close coordination arrangements.

Mergers and Acquisitions
79 Section 50 of the Trade Practices Act should continue to apply to the financial system.

80 The ACCC should administer competition laws for the financial system.

81 The prudential regulator should assess the prudential implications of relevant mergers and acquisitions.

82 The Trade Practices Act should provide the only competition regulation of financial system mergers.

83 The 'six pillars' policy should be removed.

84 Merger assessments should take account of changes occurring in the sector.

85 General foreign investment policy should apply to the financial system.

Promoting Increased Efficiency
86 Foreign investment regulations for the funds management industry should be reviewed.

87 Takeover and merger provisions are needed for collective investments.

88 Superannuation fund members should have greater choice of fund.

89 Regulation of collective investments and public offer superannuation should be harmonised.

90 Regulation of trustee companies should be modernised and applied on a uniform national basis.
Legislation should be amended to allow for electronic commerce.

Australia should adopt international standards for electronic commerce.

International harmonisation of law enforcement and consumer protection should be pursued.

Regulators should coordinate on technology.

Institutions should have freedom to set fees and charges based on costs.

Governments should examine alternative means of providing low-cost transaction services.

Superannuation funds should not be required to invest in small and medium sized enterprises.

Data collection on SMEs should consider the needs of rating agencies and fund managers.

A working party on positive credit reporting should be established.

Information sharing among group entities should be allowed unless the customer withdraws consent.

The extension of the privacy regime should follow a number of principles.

The Housing Loans Insurance Corporation should be privatised.

Coordination and Accountability

Regulatory agencies should have operational autonomy.

Regulatory agencies’ charges should reflect their costs.

Interest on non-callable deposits should be reviewed.

Regulatory agencies should set their charges, subject to approval by the Treasurer.

Regulatory agencies should be off-budget.

Regulatory agencies should have boards, with majorities of independent directors.

Regulatory agencies should improve their reporting.

A Financial Sector Advisory Council should be created.
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111 Regulatory agencies need power to exchange information.

112 The Council of Financial Regulators should coordinate a broad range of activities.

Managing Change

113 A staged approach to change is required.

114 A panel for uniform commercial laws should be established.

115 There is a proposed sequence for implementing the recommendations.
Endnotes


