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# The Wallis Inquiry: Perspectives from the Reserve Bank

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*Talk by the Deputy Governor, Mr G.J. Thompson, to the Economic Society of Australia (Victorian Branch) Conference, The Financial System in 2010 and the Wallis Inquiry, 5 September 1996, Melbourne.*

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## Background

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Since deregulation in the first half of the 1980s, the pace of development in Australia's financial system has been dramatic. The size of the sector has more than doubled in real terms, while the range and sophistication of products and services have expanded rapidly. The availability and use of complex products such as derivatives have grown apace. Technological advances are revolutionising the delivery of financial services to customers. They are also making available much more sophisticated options in the payments system.

Meanwhile, a trend for the funds management sector to grow faster than intermediaries or credit institutions is evident, as in many other countries. Related to this, securitisation and capital markets are set to grow more quickly. Conglomerate financial structures are also becoming more important. Competitive pressures are intensifying.

It's against this background of change that the Wallis Committee is to consider, among

other things, the appropriateness of Australia's present regulatory and supervisory arrangements.

Regulation and supervision of the financial system come in several forms, with various objectives – product disclosure regulation, competition policy, regulation of market conduct and so on. I want to talk about prudential supervision, which has the objective of encouraging prudent, sound management of financial institutions. This is important not only because the failure of financial institutions can cause loss to savers but also because it can, in some cases, create more general damage to the stability of the financial system – which is a particular concern of central banks.

I'm not going to speculate about changes to prudential supervision arrangements which might be recommended by the Inquiry – or which, if proposed, might be acceptable to the Government. This is, of course, the main focus of commentary by journalists and others. And that's not surprising because the Inquiry was established in an atmosphere charged with the expectation of change, with the presumption that radical overhaul is needed.

This seems to be an odd starting place, because the deficiencies in present arrangements which would justify the costs of radical change have nowhere yet been demonstrated. Perhaps this will be done in submissions to the Inquiry, but what we have

so far are assertions of a rather general nature. I'd like to spend a little time talking about these and then say a few words on mega-regulators.

But the first point which ought to be recognised is that, on the whole, our supervisory arrangements have served us pretty well. The Australian financial system is sound, and enjoys a high level of community confidence. It suffered some instability early in the 1990s – in a hangover from the excesses and 'learning processes' of the early deregulation period. But this instability was less than occurred in many other countries at the same time. And recovery from that period of weakness has been remarkably rapid.

At the same time, as I've already described, our financial system has been innovative and dynamic. It's much more mature, flexible and open than systems in many larger countries.

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### Some Criticisms of Prudential Supervision Arrangements

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Let me turn to some of the criticisms.

One is that the *supervisory system is out of date*, past its 'use-by' date.

The fact is that our supervisory structure is relatively young, with considerable rationalisation and updating in the past decade.

The RBA's Bank Supervision Department was established in 1984. The Insurance and Superannuation Commission (ISC) was created from four separate regulators in 1987, and superannuation and life insurance legislation were modernised in 1993 and 1995, respectively. The Australian Securities Commission (ASC) took over from the previous Federal and State regulators in 1991, and the Australian Financial Institutions Commission (AFIC) was established in 1992 to upgrade supervision of building societies and credit unions. Supervision of all major financial sectors has been enhanced in recent years, and continues to evolve. Meanwhile, major reviews of the regulation of collective

investments, consumer credit, friendly societies, trustee companies and derivatives markets are currently in train. Last year, the ASC and ISC started rationalising their regulation of retail products and advice.

Moreover, the creation of the Council of Financial Supervisors – comprising the RBA, ISC, AFIC and ASC – in 1992 was a significant step in formalising high-level liaison and co-ordination among the main agencies. This will be an increasingly important player, both for harmonising supervisory requirements (where appropriate) and in the oversight of financial conglomerates.

Another catch-cry is that '*everything is blurring*' or '*converging*'.

One of the difficulties in evaluating such comments is that 'blurring' is rarely defined and appears to have more than one meaning.

In its broadest usage, 'blurring' implies that all financial institutions are converging to a single model from which all variants of financial services will be available. This is simply not so. Despite the substantial innovations of recent years, it remains possible – and important – to distinguish a small number of broad categories of financial institution, differentiated primarily by the sort of contracts they make with investors.

The first category is firms which, acting as principal, promise to repay initial investment or some other fixed sum and whose promise is backed by the holding of capital. The risk of loss lies in the first instance with the firm's equity holders.

The second category comprises firms which, as agents, offer to manage investors' money on a 'best endeavours' basis. The risk of loss lies with the investor.

This fundamental two-way classification is likely to be durable because there are severe practical difficulties in the one legal entity offering both types of product.

As a result of the different risk profile of the two types of institutions, the required form of supervision is entirely different. For the former group, prudential supervision has to concentrate on the health of the institution

and the adequacy of its capital. These institutions can fail. In the second group, the underlying institution is not at risk to any great extent and its capital needs are minimal. The investor bears the risk, and should not be under the misapprehension that the value of his or her investment is protected by the attention of a prudential supervisor. Consequently, the appropriate form of 'supervision' of investment products is based on disclosure of product characteristics, rather than on preserving the solvency of the institution offering them.

Accumulation superannuation funds do not fit neatly into this two-part division. Although essentially investment products in that their annual return varies with the market and can be negative, they *are* subject to a form of prudential supervision. They are required to operate within government rules for fund trustees in respect of their approach to risk, return, diversification and liquidity. This oversight reflects the compulsory aspect of superannuation, some lack of investor choice, taxation concessions, and the long-term nature of investments. These aspects add up to an implicit promise to pay back contributions plus, in the long term, a positive return not very different from the market average.

Beyond the broad two-way classification, capital-backed institutions fall into two distinct sub-categories:

- deposit-takers, such as the banks, building societies and credit unions; and
- insurance companies, which offer different sorts of capital-backed products. With some such products, the exact amount of payouts will depend on investment performance, but at any point in time there is a defined nominal-value obligation. (Life insurance offices also offer investment-linked products managed on a best-endeavours basis. However, their capital-backed and investment-linked products are segregated into different statutory funds.)

There are significant differences in the operations of these capital-backed firms and in the nature of the risks involved in their meeting their obligations.

Banks have relatively short-term liabilities which are fixed in value, and assets which are mainly long-term and difficult to value. These characteristics make banks particularly vulnerable to loss of confidence and to deposit runs. Such runs can be contagious. Banks are also particularly important as the main suppliers of finance to small and medium business. It can be difficult for such borrowers to find alternative finance quickly if their bank becomes unable to function. Finally, banks have extensive credit linkages with each other, both through the payments system and financial market trading.

Banks remain special in having this *combination* of characteristics, and while present processes of innovation are making some inroads into this, they are likely to remain defining characteristics well into the future. The continuing health of the banking system is, therefore, very important for financial system stability – which is why central banks need to take a particularly close interest in that sector.

In contrast to banks, insurance companies have mostly long-term liabilities which are valued actuarially, while their assets are generally marketable with readily ascertainable values. Their problems are much less threatening to financial system stability.

A narrower concept of 'blurring' refers to situations where firms offer particular products which have traditionally been the preserve of firms in another group, or products which at least have very similar features. An example of the former would be housing loans from life offices; of the latter, short-term investments with deposit-like features offered by unit trusts. This sort of development is not new; nor does its extent seem to have been increasing dramatically.<sup>1</sup> A variant is the provision of traditional products through

1. For instance, life offices had a much larger share of the housing loan market 25 years ago than they do now. As a ratio to bank deposits, cash management accounts were much more important a decade ago than now. Around 95 per cent of 'deposit-type' savings are with banks, building societies and credit unions, a proportion which has not changed in recent years.

altogether new channels, the main example being housing loans marketed by mortgage originators and funded through securitisation vehicles.

Such innovations clearly can have implications for *product* regulation. Consumers presumably wish to have the same information provided by all suppliers of products which are close substitutes – to assist with choice – and to have similar avenues of redress for complaints about poor service, regardless of source.

These developments do *not*, however, have any necessary implications for prudential supervision – which is concerned not with products, but with institutional viability and the risk that institutional problems could imperil financial system stability.

Prudential supervisors should be aware of any competitive effects of the standards they impose, but any such effects cannot be allowed to determine whether those standards should be tightened or eased. Only where the institutional features of new providers raise the same concerns which motivate supervision of established firms – for either the protection of investors' funds or for financial system stability – need they come under broadly equivalent prudential standards.

Is prudential supervision in Australia applied unevenly to similar institutions, posing similar risks?

#### Deposit-takers

The main deposit-takers are banks, building societies and credit unions. The RBA's prudential supervision of banks is very similar to AFIC's for the other two groups, both being built substantially on the capital standards developed by the Basle Committee on Banking Supervision, with only minor variations in asset risk-weights. The main differences in supervision relate to ownership rules, prime purpose requirements and supervisory style which largely reflect the community-based origins, narrower scope and smaller size of the AFIC institutions. (Some studies have also highlighted the additional costs in supervising building societies and credit unions because of its State-based

structure which involves some duplication of resources.)

There is a class of money market corporations (merchant banks) which take deposits in wholesale markets, and which are not subject to prudential supervision in their own right. They do not therefore have to observe local capital requirements, large exposure limits and PAR, or lodge non-callable deposits with the RBA. On the other hand, most of these are subsidiaries of foreign banks, and are supervised indirectly on a global consolidated basis by their 'home' bank supervisor. Moreover, they don't enjoy some of the advantages of branch status or direct access to the payments system. The fact that some of these institutions have chosen to apply for a banking authority, while others who would qualify have chosen not to, suggests that competitive advantage between the two categories is finely balanced with the net outcome depending a good deal on individual circumstances.

#### Banks and life insurance companies

Banks and life insurance companies are both subject to capital adequacy rules, but these are constructed quite differently. In large part, however, this reflects the differing natures of the contracts they strike with investors/savers and the risks in fulfilling those. For banks, the focus is on credit risks while, given their asset portfolios, market risk is more important for insurance companies. It's not apparent from financial flows that the different capital requirements create competitive advantage one way or the other in relation to the small set of savings products which are similar (not identical) between banks and insurers.

#### Funds managers and the others

Funds managers are not prudentially supervised in the way the capital-backed institutions are. Nor should they be – attempts to do so would constrict the spectrum of risk for investors and fundamentally alter their character.

All funds managers (other than the special case of superannuation funds) operate in a common framework of product regulation under the ASC. Where a funds management

operation has a bank parent, the RBA has certain requirements to emphasise to investors the separateness of the two, but these place no particular constraint on the funds management activity itself.

The upshot from all this is that we see no major instances of supervisory requirements making an 'uneven' playing field between similar financial institutions.

This is not to say there are no opportunities for tidying up – by, for instance, bringing all deposit-takers under the one supervisor. But tidiness for its own sake is not a particularly urgent objective.

Another, related, claim is that '*prudential supervision should be based on functions, rather than institutions*'.

Again, it is not crystal clear what this means.

If it means simply that all deposit-takers should be supervised alike, all insurers should be supervised alike and so on, there is nothing exceptional in that. Australia is already very close to having such a system.

At times, functional supervision seems to mean that each type of financial asset – a government bond or a housing loan, for instance – should be assigned a risk-weight which would translate to a capital charge which would, in turn, be invoked whenever and wherever that particular asset occurred in the financial system.

That this makes no sense is obvious if one contemplates the manager of a unit trust with a portfolio of government bonds having somehow to hold capital equivalent to that required of a bank with similar bonds on its balance sheet. (Even among deposit-takers it might, in principle, be appropriate for different capital charges to apply to similar assets. The community might wish its investments with one group to be very secure while, with another, it is prepared to accept more risk in return for higher earnings.)

Proponents of functional supervision sometimes go on to suggest that prudential supervisors – who, by definition, focus on institutions – would need to do no more than add up the capital allocations attached to the various assets in an institution's portfolio (and,

presumably, its off-balance sheet activities) to calculate the applicable overall capital ratio. But prudential supervision has to assess the risk of an institution taken as a whole, and this might not correspond simply to the sum of the parts. There might, for instance, be risks arising from geographic or industrial concentration in the loan portfolio which should be taken into account.

It's also important to recognise that prudential supervision is tending to rely more on assessing the quality of banks' risk management systems, as well as the historical monitoring of capital ratios.

Some claim that, regardless of competitive effects, *prudential supervision is just 'too costly'*.

It would be highly surprising if supervision did not entail costs for supervised institutions. The more relevant questions are about the *net* costs for individual institutions – taking into account the lower funding costs and other advantages which come with greater public confidence – *and* for the financial system in the broad sweep. The gross costs for the latter include restraints on innovation and efficiency; these need to be set against the benefits of a more stable and reliable financial system. Unfortunately, even at the institutional level it is difficult to measure objectively the net benefits or costs. It is virtually impossible to do so in this broader sense.

One indicator is to look at outcomes.

Focussing on the banking system, it's hard to sustain an argument that supervision has been unduly onerous on the basis that it has hindered expansion and change. The banking sector currently has, on balance sheet, its highest share of financial system assets since the mid 1970s. It also accounts for the vast bulk of transactions in securities, foreign exchange and derivatives markets. In contrast with some other countries, Australian banking groups have great flexibility in the business activities they may conduct – from 'traditional' banking to derivatives, and on to insurance, funds management and superannuation. Funds management subsidiaries of banks have increased their market share, now having around one-quarter of the total, compared with a fifth in 1990. The only significant

prudential requirement bearing on banks' 'non-traditional' activities is that they are conducted in separate legal entities. This ensures, as far as is possible, that the deposit business of the bank and the capital supporting it are insulated from those other activities. This 'separation' is probably not significantly greater than would have arisen naturally, given the different legal, financial and risk characteristics of these businesses and the different skills required to manage them.

The main balance sheet requirements for banks – leaving aside NCDs which have no supervision role – relate to capital and prime assets. Neither appears to entail significant costs for banks because, on average, they hold more capital and more prime assets than they have to. Currently, the capital ratio of the banking system is 11.6 per cent which, based on the standard minimum of 8 per cent, translates to 'excess' capital holdings of up to \$15 billion. This is not, of course, to say that the requirements will not bite from time to time. If they did not, they would be serving no purpose in protecting against risky behaviour.

Bank profitability has remained high, on average, which is at odds with the view that prudential constraints bear heavily on operations. While recent high levels of profitability are now being challenged, this is primarily the result of new competitors with much lower operating costs than the banks have.

Our overall assessment is that the supervisory burden on Australian banks is not excessive – and much less than in countries such as the United States and Japan which engage in extensive on-site examinations.

Even so, the RBA is conscious of the costs which undoubtedly come with supervision; and aims to minimise these, consistent with its statutory obligations. We have encouraged the recent international trend to base supervision more on banks' own risk management arrangements rather than to prescribe alternative parallel systems – an example is the recognition of banks' internal models for purposes of calculating capital to be held against market risks from end 1997.

This approach offers the promise that supervision could become more effective while also involving lower compliance costs.

Finally, one hears that *supervisory requirements overlap and conflict*.

Overlaps involving prudential supervision could arise in two or three ways.

The first is where an institution is subject to both prudential supervision and product regulation – which will have it answerable to two agencies. This is no doubt an irritant. But it is unavoidable – just as it is unavoidable that banks and others will be subject to the Corporations Law, to taxation law, privacy standards, anti-discrimination laws, and so on. The objectives of the agencies are, however, quite different and their requirements should not be duplicated or inconsistent to any great extent.

Overlaps would be more serious if an individual institution was answerable to more than one prudential supervisor. By and large, this is not the case in Australia – each supervised institution is clearly the responsibility of only one of the main supervisory agencies – the RBA, ISC or AFIC.

The third area of overlaps arises with *conglomerates*, where individual entities in a group have different supervisors.

Again, it is inevitable when a conglomerate comprises different types of institutions – deposit-takers, insurance, funds management – that different standards and reporting requirements will fall on those specialised entities. Generally speaking, reporting requirements will not overlap, but in some cases they can – for instance, with monitoring intra-group exposures. It is an ongoing objective of the Council of Financial Supervisors to see that the responsible supervisors – two, in most cases, with Australian conglomerates – do not get in each other's way, requesting the same information from different parts of the group or imposing inconsistent requirements in relation to group behaviour. More formal lead regulator arrangements will help here, with the lead regulator having responsibility for group-wide data.

I should say a little more about the Council of Financial Supervisors' work in this area, because it is not well-known.

A couple of years ago the Council agreed on guidelines for the supervision of financial conglomerates which emphasised the importance of information flows among the relevant agencies. It has since been pursuing legislative amendments to facilitate such information sharing, because present laws make it difficult in some circumstances. More recently, the Council proposed to Government a framework for the effective supervision of conglomerates headed by special purpose holding companies. This includes a formally nominated convenor or lead regulator, who would:

- oversee and regulate the holding company;
- disseminate information collected from the holding company to other agencies; and
- co-ordinate supervisory responses to any problems involving (or potentially involving) more than one entity in a group.

It's envisaged that this model will be suitable for other conglomerates as well. The need to formalise lead regulator arrangements for all Australian conglomerates has not so far been a priority matter because they have mostly been dominated by one supervised entity.

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## Mega-regulator?

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It's been suggested by some commentators that creating a single financial system supervisor would be a sensible response to the problems of blurring, overlaps, inconsistencies and competitive distortions supposedly afflicting the present system.

Such institutions do exist in a few countries, so the idea has some pedigree. It's also true that the track record of the genuine mega-regulators in protecting financial system stability in countries like Sweden, Norway and Japan has not been anything to write home about!

The question for Australia is whether there

are sufficient grounds for radical overhaul of an existing system which seems to be working reasonably well already, and which has the capacity to evolve further under the Council of Financial Supervisors.

It should be clear that I don't see any such compelling case in appeals to blurring, overlaps etc. To recap a few important points.

- If a mega-regulator oversaw capital-backed institutions and all funds managers, the public could come to perceive that the investment performance of the latter was 'protected' by supervision in the way it provides some comfort about bank deposits and other capital-backed products. This would carry the potential for a significant increase in moral hazard risk. To protect taxpayers from the potential costs in this investor expectation, the mega-regulator would be tempted to increase its oversight of funds managers and, perhaps, to constrain their activities. This would compress the spectrum of risk which is important to the efficient functioning of the financial system.
- A less grand mega-regulator – covering deposit-takers and the insurance industry – would offer no significant synergies or efficiency gains because supervision for the two groups is quite different. The general experience with overseas regulators overseeing banking and insurance is that the applicable supervisory techniques and standards remain distinct within those organisations. (To the extent that prudential requirements might sensibly be aligned for a small subset of overlapping products – such as RSA's – this can be sorted out under the umbrella of the Council of Financial Supervisors. Creating a mega-supervisor simply to deal with such overlaps would be using the proverbial sledgehammer to deal with a walnut.)
- Another claim is that a single supervisor would mean more efficient supervision of financial conglomerates. It's accepted that conglomerates will generally answer to more than one agency because of the different jurisdictions to which their constituent companies belong. While there

might be some administrative economies if only one agency was involved, these will be limited as long as different supervisory regimes apply to those constituents – as will usually be the case. It's also been suggested that one supervisor would be better able to handle the related tasks of limiting contagion risk within a conglomerate – and appraising the overall health of the group. Again, this is questionable as long as supervision of the different members remains specialised and communication among the key supervisors is effective.

Finally, it's certain that the financial system will continue to be marked by innovation, growth and diversification. It is much less certain what the details of these will be, and the Inquiry would be wasting its time with a lot of distant crystal-ball gazing. The aim should be a supervisory system which achieves its prime objectives of soundness and stability, while being as flexible and 'market-friendly' as possible. The idea that a monolithic supervisory bureaucracy is more likely to deliver this than a small number of specialist agencies working co-operatively on issues of common concern seems rather fanciful.