NOTE

CAMPBELL COMMITTEE

Set out below are the main recommendations of the Committee Report with implications for SMD's responsibilities.

For ease of reference, they are broken up into "Market Operations", "Government Debt" and "Short Term Money Market". Items marked * may be of more direct relevance to other areas of the Bank but there are important SMD considerations.

Market Operations (including rediscounting)

- Greater emphasis on market operations (removal of most direct controls).
- Announcement of monetary targets.*
- Removal of government securities tranche for monetary policy purposes.
- The application of variable cash ratios to banks (as consolidated units).*
- A "near market" interest rate to be paid on required deposits with RBA.*
- Provision of rediscount facility for all Treasury notes and for some other designated Commonwealth securities within one year of maturity.
- RBA to deal primarily through authorised dealers and "accredited" brokers; direct dealing with banks in near-maturing bonds to remain.
- More information to be provided to the market on RBA operations, including rediscounting.

Government Debt

- Market rate to be applied to government balances with RBA.
- Market rate to be charged on Treasury bills discounted.

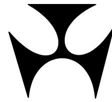
- Use of Treasury bills mentioned in paras 3.28 and 3.29 but not explored.
- Tender system preferred for sale of Commonwealth securities other than ASBs.
- 30/20 requirements to be removed without a transitional period.
- No formal portfolio requirements on banks aimed at supporting public securities markets (it seems likely that prudential requirements would require or encourage some holdings of government securities).
- Flexibility in considering forms of government securities.

Short Term Money Market

- Lifting of maturity restrictions on banks' interest bearing deposits.*
- * RBA should where possible recoup costs of services provided.
- LLR facility to be continued for the time being - more flexibility to be examined (e.g. seven day rule). (Line of credit preferred to repurchase or purchase agreements).
- Specialised "market makers" in government securities to be recognised and encouraged by RBA, i.e. as authorised dealers or accredited brokers.
- No restriction on number of dealers - any organisation with capacity to undertake substantial dealings in government securities and willing to accept conditions should be authorised.
- Dealers to maintain at least 70% of portfolios in CGS; remainder in specified assets without relative proportions being specified.

- Restrictions on bank ownership of authorised dealers to be retained.
- Foreign ownership of authorised dealers to be consistent with foreign investment policy.
- Regular reviews of dealers' performance.

Securities Markets Department
19 November 1981



RESERVE BANK OF AUSTRALIA

THE RESERVE BANK OF AUSTRALIA – POST WALLIS

John F Laker
Assistant Governor (Financial System)

Keynote Lecture to Monash University
Law School Foundation
Melbourne — 28 October 1999

THE RESERVE BANK OF AUSTRALIA – POST WALLIS

1. Introduction

I am pleased to continue the tradition of Reserve Bank involvement in the Monash Law School lecture series. And honoured, naturally, that my lecture is being dedicated to the memory of Dr H.C. "Nugget" Coombs, the founding and longest-serving Governor of the Reserve Bank of Australia.

Dr Coombs might not have recognised many features of the current financial landscape. When he retired from the Reserve Bank in 1968, there were less than half the number of banks — and only three foreign banks — compared with today, all heavily regulated for monetary policy purposes; the Australian dollar was pegged to sterling; Australia was walled off from global financial markets through exchange controls; and today's sophisticated financial instruments were still on the drawing board.

But Dr Coombs would have taken pride that his vision of a central bank at the centre of the economic policy debate in Australia has proved an enduring one. And although the language is different, he would have been very familiar with the mandate bequeathed to the Reserve Bank by the Government when it announced its response to the Financial System Inquiry (the Wallis Report).

In its response, the Government confirmed that the role of the Reserve Bank will be "… focused on the objectives of monetary policy, overall financial system stability and regulation of the payments system".[1] This wording has a more modern ring than the hallowed text of the *Reserve Bank Act 1959*, which sets out the Reserve Bank's broad responsibilities. However, there is nothing fundamentally new in this mandate. Central banks have traditionally had dual objectives of maintaining monetary (price) stability as well as financial stability; indeed, concerns about financial stability were in many cases, including our own to some extent, the driving force behind the establishment of the central bank. The two objectives, as we shall see, are closely linked.

Nonetheless, there are some special features of this mandate and of the Reserve Bank's post-Wallis role:

- first, the importance of a safe and robust payments system for overall financial stability has been explicitly recognised;
- to reinforce this linkage, the Reserve Bank has been granted extensive powers in the payments system, to be overseen by a new Payments System Board within the Bank; and
- at the same time, the Reserve Bank must now discharge its responsibility for financial stability at one remove from its previous "hands on" role as

[1] Ministerial Statement by the Treasurer, 2 September 1997.

prudential supervisor of banks. Prudential supervision, in a much expanded form, has passed to a new integrated regulator, the Australian Prudential Regulation Authority (APRA).

Australia's new financial regulatory regime has been in place for a little over a year now. Institutional change on this scale is not without its challenges, but the new arrangements have been bedded down successfully and, in our view, are already delivering on the Government's aspirations for "leading edge" financial regulation. True, some aspects — particularly the handling of financial crises — have yet to be tested in the heat of battle. We hope they never need to be!

The theme of my talk tonight is how the Reserve Bank approaches its mandate for financial stability. My starting point is to explain what is meant by safeguarding financial stability and why the task is almost universally entrusted to the central bank. Following from that, I look at how the Reserve Bank can best contribute to the main "building blocks" of financial stability. I would then like to offer some comments on the relationship between the Reserve Bank and APRA, and on the work of the Payments System Board, before finishing with a brief report card on the Australian financial system as it approaches the Year 2000.

2. The Goal of Financial Stability

The financial system provides Australia's financial arteries. It performs the essential function of channelling savings to the most profitable investment opportunities and reallocating risks to those willing to bear them. A stable and smoothly functioning financial system — one that sorts good borrowers from bad and exercises a discipline on those who use society's savings — is crucial to macroeconomic stability and economic growth. Conversely, if it does its job badly it can fritter savings away, as the corporate excesses of the late 1980s in Australia and elsewhere illustrate only too well.

Economists have no simple definition of financial stability.[2] However, two characteristics of the recurring bouts of financial turmoil globally over the last twenty years stand out — the speed at which threats to financial stability ("systemic risk") can materialise and the scale of the resulting damage. Drawing these characteristics together, one international think-tank, the Group of Thirty, has defined systemic risk as:

> "… the risk of a sudden, unanticipated event that would damage the financial system to such an extent that economic activity in the wider economy would suffer." [3]

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[2] For a discussion on the definition of financial stability, see Andrew Crockett, 'Why is Financial Stability a Goal of Public Policy?, in *Maintaining Financial Stability in a Global Economy,* a Symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, 1997.

[3] Group of Thirty, *Global Institutions, National Supervision and Systemic Risk*, Washington, D.C., 1997.

The occasional failure of a financial institution need not, of itself, be a source of financial instability. A loss of shareholders' funds and, ultimately, bankruptcy must remain the market penalty for poor management or the taking of imprudent risks; without that ultimate sanction, market participants will not have sufficient incentive to keep a close eye on the activities of the financial institutions with whom they do business. Systemic risk arises when distress in financial institutions or disturbances in financial markets threaten wider economic harm.

This broad line of thinking perhaps best describes the Reserve Bank's approach to its mandate for financial stability. The Bank cannot eliminate risk from the financial system, and its responsibilities do not require it to prevent unprofitable financial institutions from going out of business. Rather, its task is to help ensure that shocks to any part of the financial system do not ultimately threaten the health of the Australian economy.

There are two main reasons why central banks have been given this responsibility; that is, why governments do not allow normal market mechanisms to operate unfettered. The first is the view that, left to itself, the financial system is prone to bouts of instability, often caused by changes in market sentiment. The Wallis Report also acknowledged the vulnerability of the financial system to contagion effects because of the mismatch between the liquidity and maturity of the assets and liabilities of financial institutions, particularly banks, and the interconnections between financial institutions through the payments system. In brief, financial institutions are vulnerable to "runs', which can quickly spread if confidence deteriorates.

The second reason is that the costs of resolving financial crises can be substantial. The public purse bears the costs of government expenditure to recapitalise financial institutions and protect depositors. Asia may be freshest in our minds, but it is salutary to remember that, over the last twenty years, some 19 countries have had to devote more than 10 per cent of GDP to the resolution of financial crises. Not all were emerging economies — two industrial countries (Japan and Spain) are on the list. Australia is not, but it has had a hint of the problem in the failure of the State banks of Victoria and South Australia in the early 1990s, which cost their State Government owners dearly. The macroeconomic costs of financial crises — the resulting misallocation of resources and contraction in economic activity — can also be heavy. Japan is a clear example of how financial sector weakness can act as a debilitating influence on economic activity, and over a long period. Again, post-war Australia has avoided financial shocks on this scale, although pressures on the financial sector in the early 1990s did act as a significant drag on the economy around that time.

3. The pursuit of financial stability

The task of safeguarding financial stability draws on all the policy areas within the Reserve Bank. This was always so, but perhaps obscured by the attention

often directed to our role as "front line" supervisor of banks. The new regime has therefore not required any major change in strategy or in the marshalling of our resources. What it does highlight, though, is the importance of maintaining good "diagnostics" on the health of the financial system and a close working relationship with APRA.

The need for a broad policy approach by the Reserve Bank becomes apparent when the main "building blocks" of financial stability are reviewed. This review, incidentally, also illustrates the range of a central bank's involvement in the financial system — with or without prudential supervision — and why it is uniquely placed to take responsibility for financial stability.

Financial stability can be thought of as being built on four main foundations. These are:

- a stable *macroeconomic environment*;
- well-managed *financial institutions*, within a sound framework of *prudential supervision*;
- efficient and smoothly functioning *financial markets*; and
- a safe and robust *payments system*.

The last item — the payments system — is a vital part of which might be called the financial infrastructure. Other important elements include accounting standards, the legal system, bankruptcy provisions and corporate governance procedures. The Reserve Bank naturally takes a close interest in these other areas where they impinge on financial stability, but they are outside its immediate sphere of influence.

Let me take the four foundations in turn.

The Macroeconomic Environment

Experience everywhere shows that sustainable macroeconomic policies — in particular, the maintenance of low inflation — are crucial to financial stability. A low inflation environment is no guarantee, as Japan will attest. But it is less likely to be associated with credit-fuelled "bubbles" in financial asset and property prices, and with the painful process, for financial institutions and the economy generally, of rebuilding balance sheets when bubbles burst and the consequences of intemperate lending decisions come home to roost.

On this score, the Reserve Bank's most enduring contribution to financial stability is to preserve Australia's recent excellent track record on low inflation. Dr Coombs would no doubt mark us highly on that record.

Financial Institutions

Prudently managed and well-capitalised financial institutions are vital to the efficiency of financial intermediation. But achieving this does not rely solely on market disciplines. Financial institutions are highly dependent on public confidence and their creditworthiness may not be easy to monitor by those who lend them funds. For these reasons, governments intervene in some way, in the interests of depositors, to reduce the incentives of financial institutions to take on risks. In Australia, the Wallis Report recommended a regime of risk-based prudential supervision together with "depositor preference" in the event of the wind-up of an authorised deposit-taking institution. (Australia is one of very few countries without a formal deposit insurance scheme). This regime is the responsibility of APRA, which is now working to harmonise prudential standards across all types of deposit-takers.

In this post-Wallis world, the Reserve Bank is out of day-to-day prudential supervision. It no longer has the responsibility for protecting the interests of bank depositors; it has no powers to direct the affairs of a financial institution; and it does not receive confidential prudential data on individual institutions from APRA on an ongoing basis. From time to time, the Bank does take part in APRA's regular on-site visits to supervised institutions – not to second-guess APRA's assessments but to ensure that the Bank keeps abreast of financial developments and supervisory issues.

Having said this, the Reserve Bank is by no means a passive partner. When it sees the need, it will have its say on regulatory developments, within domestic and international councils. The perspective it brings to bear is its involvement in financial markets, its pivotal role in the payments system and its broad macro-economic responsibilities. Over the past twelve months and more, the Reserve Bank has been active in various international fora which are re-evaluating the international financial architecture in the wake of the Asian crisis and the activities of hedge funds. One issue which has come under critical scrutiny is whether the Basle capital standards have distorted international capital flows by favouring short-term lending over lending with longer maturities.

Financial Markets

In this globalised era, financial markets have become crucial to the process of financial intermediation and the distribution of risk. When they function smoothly, financial markets are a powerful force for the efficient allocation of savings. There is a down-side, however. The financial turmoil in mid 1998, triggered by the Russian debt moratorium and followed by the near-collapse of the hedge fund, Long-Term Capital Management, highlights the speed and intensity with which financial market disturbances can threaten financial stability. These markets can change course very quickly and liquidity can dry up sharply. Swings in investor sentiment can force the rapid sale of financial instruments — sometimes at distressed prices — as investors retreat to safety.

Price volatility, a lack of liquidity and the inability to roll-over debt can all have an unsettling impact on financial institutions.

Even so, financial markets are not normally subject to the same degree of regulation as financial institutions. Central bank involvement is often limited to a surveillance role, monitoring market behaviour and trading rules and conventions. This would describe the Reserve Bank's general approach. It closely monitors developments in, and the integrity of, the major financial markets in Australia — the money, bond and foreign exchange markets; orderly trading and liquidity in these markets are essential to the conduct of monetary policy. More recently, our market surveillance has had a sharper financial stability focus because of the activities of hedge funds. In the second half of last year, the presence of large hedge fund positions in the Australian dollar turned the foreign exchange market very one-sided, leading to a temporary breakdown in the structure of the market. The exchange rate fell below the level implied by the "fundamentals" — in particular, commodity prices and interest rate differentials. This period showed "herding" behaviour in action, that is, market participants uncritically following each other rather than making their own informed judgments. Market developments of this kind make the task of economic management more difficult and pose risks to market integrity.

The behaviour of hedge funds is further confirmation that financial stability has an international dimension as well as a domestic one. And the policy response to hedge funds — or "highly leveraged institutions" more generally — is unfolding at the international level. Under the aegis of the Financial Stability Forum, a G7 initiative but now with wider representation, a number of working groups are considering options. Australia is represented on the Forum by the Governor of the Reserve Bank and Bank staff are on key working groups. The options being discussed include increased disclosure and transparency by highly leveraged institutions, indirect restrictions on these institutions through the prudential standards of banks, and direct regulation. Whatever is finally agreed, the Reserve Bank has been a strong advocate of greater disclosure, so that counterparties and regulators are better placed to assess the risks that various institutions pose for the stability and integrity of financial markets.

Payments System

The final building block is a safe and robust payments system. This is an arcane area for many, but it is essential that Australia have a payments system in which difficulties in a single financial institution do not cascade more widely. Recognition of this fact is the basis for the Reserve Bank's new-found responsibilities in the payments system, to which I will come shortly.

Well before these new arrangements, the Reserve Bank had taken a leadership role in making the wholesale or "high value" payments system more risk-proof. The previous "deferred net settlement" system was, in the Bank's judgment, subject to unacceptably high levels of risk. Under that system, settlement

obligations between banks accumulated over the course of the day and were not finally settled until 9.00 a.m. the following morning. If, at that point, a bank found itself unable to meet its obligations, the consequence would have been a serious disruption to payment flows which would have created liquidity and even insolvency pressures for other banks. The Reserve Bank could have provided emergency liquidity to enable payments to be completed, but would have exposed its balance sheet (and the taxpayer) to substantial loss in doing so.

After a collaberative Reserve Bank and industry effort, that earlier system was replaced in June last year by a real-time gross settlement (RTGS) system. This new system works on the simple premise that if a participant does not have sufficient funds in its Exchange Settlement Account with the Reserve Bank, its payments will have to wait in a queue until it has funds available. No settlement funds, no payment! Settlement risk is eliminated, and the Reserve Bank's balance sheet is not put at risk by a participant's failure.

The RTGS system represents a major strengthening of the financial infrastructure and it has taken Australia to world's "best practice". Over 90 per cent of the value of payments exchanged between financial institutions in Australia now settle on an RTGS basis.

4. The Reserve Bank's Relationship with APRA

Building on these foundations of financial stability is often a slow and deliberative process. But threats to system stability, as we know, can materialise suddenly. In the post-Wallis world, the Reserve Bank needs full and timely information on the health of the financial system, from all sources. Close co-operation with APRA is therefore essential. Various mechanisms have been put into place to ensure this, some through legislation and others less formally.

The highest level of co-operation is at Board level. The Reserve Bank has two members (out of nine) on the APRA Board and APRA has one member (out of eight) on the Payments System Board. The APRA Board has gelled well and constructively. It draws on the Bank's market and policy perspectives, the corporate and legal experience of the Australian Securities and Investments Commission (ASIC) as well as the wide-ranging expertise of its other members and, of course, of the APRA staff.

The Reserve Bank, APRA and ASIC also form the Council of Financial Regulators, a non-statutory "umbrella" body chaired by the Governor. The Council provides a regular forum for sharing and collating the policy initiatives of the three main regulatory agencies. Because of their overlapping membership, a number of issues which come to the Council are likely to have their first airing at the APRA Board.

At the working level, a Reserve Bank/APRA Co-ordination Committee, chaired by the Bank, has been established to ensure that co-ordination arrangements are operating smoothly. The Committee deals with such matters as information

sharing, prompt notification of relevant regulatory decisions and arrangements for dealing with financial crises. These matters have been set out in a Memorandum of Understanding between the two institutions, published last year.

An early task has been to disentangle information flows within the Reserve Bank to ensure that information of prudential interest is not lost to the prudential supervisor. Informal networks often develop when the policy functions are all under one roof, and these have had to be replaced, unavoidably, by more formal mechanisms for sharing information. For its part, the Reserve Bank provides APRA with regular briefings on the Australian economy and relevant feedback from the payments system; our involvement in the RTGS system, in particular, leaves us well-placed to identify emerging signs of liquidity pressures in financial institutions. In turn, APRA supplies the Bank with data for the financial aggregates as well as prudential data in aggregate form. Information on capital adequacy, impaired assets, commercial property exposures, market risk and off-balance sheet exposures forms a critical input into the work now under way in the Reserve Bank, and other central banks, to develop and monitor "indicators" of financial stability.

The real test of any co-ordination arrangements, of course, is how they handle a financial crisis. Previously, the Reserve Bank was both "crisis manager", with powers to handle the wind-up of a financial institution, and "crisis lender", with its traditional lender-of-last-resort function. In the new regime, APRA would be the crisis manager and it has been given clearer and stronger powers to act decisively in the interests of depositors than were available to the Reserve Bank. But the Reserve Bank retains the cheque book.

If it were to provide emergency liquidity support, the Bank's preference would be to make funds available to the market as a whole through its domestic market operations. This leaves judgments about solvency and the allocation and pricing of loans to the market itself. However, our lender-of-last-resort responsibilities do not rule out lending directly to a financial institution facing liquidity difficulties.[4] The circumstances, though, would be highly unusual:

- the institution would have to be fundamentally sound;
- the potential failure to make its payments would have to pose a threat to overall financial stability; and
- the institution would have to be one supervised by APRA.

Fine judgments would be called for here. An argument heard overseas is that it is extremely rare for episodes of serious liquidity difficulties for a particular institution to be separable from pending insolvency problems, and that central

[4] See Ian Macfarlane, 'The Stability of the Financial System', Reserve Bank of Australia *Bulletin*, August 1999.

banks (even those with direct supervisory powers) would find it very difficult to make the distinction, particularly under time and market pressures. Liquidity support might be sought at the very time that the market itself has problems assessing the solvency of the institution. In the post-Wallis world, APRA's judgments about the fundamental soundness of a financial institution in distress would be critical to any Reserve Bank support.

The Reserve Bank has never, in fact, provided a lender-of-last-resort loan directly to a financial institution in distress. Our pen has not reached the cheque book. One has to go back to the Great Depression to find instances when the-then Commonwealth Bank gave liquidity support, in modest amount, to one troubled bank; however, it denied support to two other troubled banks due to concerns about their ongoing viability. Over the last twenty years, there have been some isolated runs on deposit-taking institutions, but supportive Reserve Bank press statements — "open mouth" policy at work — were generally sufficient to stem these runs.

5. The Payments System Board

The establishment of an integrated prudential regulator was one of the major innovations of the Wallis reforms. Another was the creation of the Payments System Board in the Reserve Bank, with a mandate to promote the safety and efficiency of the payments system in Australia.

This change has put the Bank in a rather unique position. First, it now has two boards! However, the respective territories are clearly marked and there are no border disputes, so this dual board structure is working well. Secondly, no other central bank or supervisory authority, to our knowledge, has our payments system powers. True, there is an emerging trend to give central banks explicit responsibility to oversee payments systems, but this has not been accompanied by the granting of appropriate back-up powers. Not surprisingly, there is considerable international interest in Australia's new arrangements.

The new governance arrangements in the Australian payments system arose from the Wallis Report's judgment that:

- there was need for a spur to efficiency and competitiveness in the payments system, without comprising its safety; and that
- the existing self-regulatory arrangements, in which the Reserve Bank had only a limited role, would not be guaranteed to deliver this spur.

There was nothing in Wallis to suggest that a Payments System Board was needed to reinforce safety and stability, and the Board has acknowledged that it inherited a very robust payments system by international standards. Safety concerns, of course, will never be far from the Board's attention, but an overbearing regulatory approach would rob the payments system of its

flexibility and dynamism. This is not what Wallis had in mind nor, in the long term, is it necessarily helpful to overall financial stability.

The Payments System Board has just released its 1999 Report outlining its activities during its first year.[5] The Board's strategy has been to treat its extensive powers as "reserve powers" to be exercised if other methods of persuasion and implementation prove to be ineffective. Where it can, it would much prefer to rely on information-gathering and consultation with industry participants to meet its objectives. This is the co-regulatory approach envisaged by the Government.

Much of the Board's initial work has been "fact-finding", building up a detailed picture of the characteristics of the Australian payments system and how it has changed over the past decade. A particular focus has been the retail payments system, where efficiency gains are most likely to be found. At the retail level, Australians are enthusiastically embracing electronic means of payment, particularly EFTPOS and credit cards. But the most expensive payments instrument — the cheque — remains the most frequently used non-cash instrument while the most efficient way of paying regular bills — direct debits — is greatly underused. Inconsistencies also seem to affect the pricing of some payments services. These latter observations confirm the misgivings in the Wallis Report and are the basis for the Board's initial work program on efficiency issues. Though an elusive concept, what the Board is looking for in an "efficient" payments system is one that meets the needs of those using it — including the need for quality service — at lowest resource cost and that provides users with appropriate price signals on which to base their decisions.

The Payments System Board took a number of steps during 1998/99 to address its wide-ranging mandate. On the safety and stability side, the Board lent its weight to efforts to have the Australian dollar included in the first wave of currencies to be settled by the CLS Bank, an important global initiative to reduce risks in the settlement of foreign exchange transactions. Having made excellent progress in domestic high-value payments systems, central banks are now focussing attention on the foreign exchange area where settlement risks can be substantial. The Board also took advantage of recent legislative changes to strengthen the legal underpinnings of the RTGS system.

On the efficiency and competition side, the Board announced the widening of access to Exchange Settlement accounts at the Reserve Bank to non-bank institutions; previously these accounts were largely the preserve of banks. The first new account under these arrangements is expected to be opened shortly. However, the Board's main thrust has been directed to the retail payments system. The Board's views on cheque-clearing times have probably received the most media attention. The Board has made it clear that it wishes to see a

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[5] Further background on the Payments System Board is given in John Laker, 'The Role of the Payments System Board', Reserve Bank of Australia *Bulletin*, July 1999.

three-day cheque-clearing cycle become standard in Australia. A number of financial institutions now meet the standard and customers who are not getting the full benefit of faster cheque-clearing are, of course, free to shop around.

Two other initiatives are still "work in progress". The first is a study of arrangements for interchange fees and access in debit and credit card schemes, which the Board is conducting jointly with the Australian Competition and Consumer Commission. The subject might seem a bit obscure, but interchange fees — the fees which flow between financial institutions to compensate for card services provided — are an essential part of the pricing structure in card schemes. They determine the revenue flows associated with card transactions, the costs ultimately borne by merchants and card-holders, the incentives to use and accept credit and debit cards and the terms of access to card networks.

The study will shine a spotlight on these largely hidden fees. Our aim is to understand how these fees are set and why they flow in particular directions, and to assess whether they encourage the efficient provision of card services. In other words, do the fees result in appropriate price signals to those who issue or use cards? The information gathering phase is now getting under way and will be followed by release of a discussion paper which will be open to public comment.

The second initiative is the promotion of direct debits to the Australian community. This is not unrelated to the interchange fees study. Interchange fees paid to credit card issuers appear to be an important source of revenue funding loyalty and other rewards programs and these programs, in turn, are encouraging use of credit cards rather than direct debits for routine bill payments. The price signals seem very inefficient. But there is more than pricing at work here — Australians are also uncomfortable with the notion that billers and financial institutions have their hand in their deposit accounts, so to speak. Consumers overseas may not be inherently more trusting, but they have been making much greater use of direct debits; the incentives to do so have included the offer of discounts and consumer safeguards such as guaranteed refunds if errors or disputes arise.

The Payments System Board would like to see whether these sorts of incentives can also find fertile ground in Australia. One way to proceed would be to have direct debit billers agree and commit to a set of "best practice" principles. These principles could enshrine appropriate flexibility and safeguards for consumers and provide the industry with a positive basis for a concerted promotional campaign. The Reserve Bank will be consulting with billers, financial institutions and customers over coming months to take this idea forward.

6. A first "report card"

All in all, the period since 1 July last year has been one of unprecedented change in Australia's financial regulatory structure — new institutions, new charters and a considerable reorganisation of resources. The transition also coincided

with a difficult global economic environment and turbulence in international financial markets. Despite these distractions and some legislative delays, the Wallis vision of regulatory reform — which the Government fully endorsed — has now taken concrete shape. A substantial commitment by all those involved helped to bring this about. On the Reserve Bank's part, some 65 supervisory staff — around 7 per cent of our total complement — became founding staff of APRA. This was a significant and occasionally uneasy exodus, but it should be seen against the loss of over 2 400 staff or more than two-thirds of our numbers since their peak in the early 1980s.

Throughout the transition period, the Australian financial system has remained in strong condition, underpinned by the robust growth of the Australian economy. The main indicators of financial stability which the Reserve Bank monitors have continued to flash green. For example:

- the capital ratios of authorised deposit-taking institutions are comfortably above minimum required levels;
- profitability in banking remains high, despite the continued compression of interest margins;
- banks' impaired assets are close to their low points for the past decade, even after some fall-out from the Asian crisis; and
- with the growth of property trusts and the improved management of financial institutions' property lending, the financial system is much less exposed to commercial property than in the late 1980s/early 1990s.

These indicators stand in marked contrast to the readings in that earlier period of financial stress.

One area which the Reserve Bank is monitoring closely is the growth in household debt, and in property and other asset prices. Households are borrowing more heavily, particularly for residential property. The household debt ratio has risen from low levels by international standards early in the 1990s to a position — at about 95 per cent of household disposable income — currently in the middle of the field. Some gearing-up of household balance sheets and rises in real property prices are a natural part of the adjustment to Australia's low inflation rate and improved access to credit. Households are also continuing to benefit from modest repayment burdens and strong growth in their financial assets. This indicator would flash orange, however, if gearing-up were pushed too far, leaving Australian households much more exposed to any adverse turn in financial conditions.

Surveying the landscape after the first full year of Australia's new regulatory arrangements, we concluded in the Reserve Bank's 1999 Annual Report that "… there were no discernible threats to system stability". All of the essential building blocs — the macroeconomic environment, the state of our financial

institutions and markets and the payments system — have contributed to this positive assessment. And it received strong endorsement recently from Alan Greenspan, Chairman of the US Federal Reserve, who acknowledged that Australia's well-developed capital markets as well as its "sturdy" banking system enabled it to avoid contagion from the Asian crisis.[6] We are confident that our financial system has the flexibility and resilience to weather other such shocks which might threaten in the future, and we remain on vigilant watch to ensure this.

Reserve Bank of Australia
SYDNEY
28 October 1999

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[6] Alan Greenspan, 'Do Efficient Financial Markets Mitigate Financial Crises?', Remarks before the 1999 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Georgia, October 1999.

The Financial System Inquiry (Wallis Report)

On 30 May 1996 the Treasurer Peter Costello announced the establishment of an Inquiry into the Australian financial system to report by 31 March 1997. Dubbed "the daughter of Campbell", this was the first major inquiry into the Australian financial system since the Campbell Committee report in 1981 but it was not to be as comprehensive in scope or as lengthy as the original. In the lead up to the election there was a consensus that the time was ripe for a review of the financial system and its regulatory structure. In November 1995 Costello (then Shadow Treasurer) announced that a Howard Government would establish a new inquiry and Willis proposed an inquiry along similar lines the following February. Over the past decade considerable change had occurred within the financial system. Following deregulation the financial system had grown considerably in both size and complexity as a result of technological innovation, globalization of financial markets and strong competition in wholesale financial markets. The emergence of smart cards, the growth of derivatives trading, the growth of superannuation and the associated funds management industry and the emergence of mortgage originators raised doubts over the efficiency of supervision. The emergence of conglomerates coupled with the prospect of future developments in the financial system further complicated the task of financial supervision and called into question the issue of regulation.

The Inquiry was charged with providing a stock-take of the results arising from the financial deregulation of the Australian system since the early 1980s. The forces driving further change were to be analysed, in particular, technological development. The Inquiry would produce recommendations on the nature of the regulatory arrangements that would 'best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness'.[1] It sought to establish a common regulatory framework for overlapping financial products and propose ways for dealing constructively with further financial innovation. Its objectives were to 'deliver more efficiency at lower cost in the financial system, whilst at the same time maintaining or improving the safety and stability of the system'.[2] The Inquiry was to 'complement but not duplicate concurrent

[1] Financial System Inquiry- terms of reference and membership, Press Release, SD96-00300.
[2] Professor Jeffrey Carmichael, Financial System Inquiry Address to AAPBS, 16 April 1997, FS97-00202.

developments in Government policy affecting the financial sector and regulatory practices' and thus the taxation of financial arrangements and institutions, the conduct of monetary policy, retirement income policies and the regulation of companies were not to be included in the scope of the inquiry.[3]

A Committee was appointed in June 1997 with Stan Wallis, an Australian businessman and Managing Director of Amcor Limited between 1977 and 1996, in the chair. The other members of the Inquiry were Linda Nicholls, consultant and company director; Bill Beerworth, a Sydney merchant banker; Jeffery Carmichael, Professor of finance and director of the Centre for Banking and Finance and Chairman of the Australian Financial Institutions Commission and Ian Harper, Professor of international finance at the University of Melbourne's business school. Greg Smith, seconded from the Treasury as Secretary to the Inquiry, headed a 12 person Secretariat based in Canberra. Chris Gaskell, Senior Manager Surveillance, Financial System Department, was seconded to the Secretariat from the Bank. The Committee met with experts, finance industry participants, regulatory agencies and consumers and held its first meeting on 18 June.[4] The Inquiry was to be as open as possible. Public consultations were held in mainland capital cities and submissions from the public were made available on the internet. [5]

The Bank supported the Inquiry, deeming it timely to review regulation given the developments that had occurred following the deregulation of the financial system in the early 1980s.[6] Nevertheless, it was feared that some issues 'could generate a lot of heat but little improvement'.[7] Following the announcement of the Inquiry the Bank adopted a highly cautious approach, arguing for a maintenance of the status quo with only minor changes. It dismissed calls for radical reform, believing that there was no evidence that the financial system would experience fundamental change in the coming years. According to the Bank the existing regulatory system did not need a major shake-up. In a speech to a Canberra business gathering Governor Fraser urged evolutionary change in

[3] Financial System Inquiry- terms of reference and membership, Press Release, SD96-00300.
[4] David Alan Craig, Note OECD Committee for Financial Markets Background Paper- Inquiry into the Australian Financial System, 29 May 1997, FS97-00255.
[5] Financial System Inquiry, Speaking Notes July 1996, FS96-00417.
[6] Draft, Review of the Financial System, 28 February 1996, FS96-1051.
[7] Draft, Review of the Financial System, 28 February 1996, FS96-1051.

the regulation of the financial system rather than any radical restructuring. Fraser prompted the Inquiry to 'concentrate on actual problems, and to resist the temptation to dwell on things which are not really broke'.[8] The Governor rejected the notion that the supervisory system was out of date and that prudential arrangements had not evolved with the rapid change in Australia's financial system.[9] According to the Governor the prudential system was not outmoded and that the extent of blurring between product offerings from different types of financial institutions had been exaggerated.[10] In the Bank's view there was no case for "reshuffling the pack". The Governor emphasised 'renovations to the existing regulatory structure' than to 'completely demolish that structure and construct something new in its place' and highlighted the costs of shifting to a radically different framework.[11]

Central to the Bank's uneasiness was the emerging debate over mega regulators and the prospect of separating banking supervision from the central bank. Australia's financial system was supervised by a mix of institutional supervisors. As well as the RBA there existed 3 other bodies: the Insurance and Superannuation Commission (ISC), the prudential supervisor of the insurance and superannuation industries; the Australian Financial Institutions Commission (AFIC) which set prudential standards for building societies and credit unions; and the Australian Securities Commission (ASC), responsible for the administration of the Corporations Law with a primary focus on rules for investor protection and participation in the market.[12] Academic debate on the efficacy of regulation and the role of the central bank in supervision as well as the continuing trend towards financial conglomeration and heightened awareness of notions of blurring distinctions between financial products/institutions sparked debate on the notion of some form of mega-regulation.[13] Costello questioned the relevance of Australia's institutional

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[8] Financial Regulation and the Financial System Inquiry. Remarks by Bernie Fraser, Governor of the Reserve Bank at "Trends" Luncheon Organised by Advance Bank, Canberra, 5 July 1996, GBF-92-1.
[9] Financial Regulation and the Financial System Inquiry. Remarks by Bernie Fraser, Governor of the Reserve Bank at "Trends" Luncheon Organised by Advance Bank, Canberra, 5 July 1996, GBF-92-1.
[10] Financial Regulation and the Financial System Inquiry. Remarks by Bernie Fraser, Governor of the Reserve Bank at "Trends" Luncheon Organised by Advance Bank, Canberra, 5 July 1996, GBF-92-1.
[11] Financial Regulation and the Financial System Inquiry. Remarks by Bernie Fraser, Governor of the Reserve Bank at "Trends" Luncheon Organised by Advance Bank, Canberra, 5 July 1996, GBF-92-1.
[12] 'The Wallis Inquiry into Australia's Financial System: Options for Reform', July 1996, FS96-00482.
[13] Fitz-Gibbon, The current debate on 'mega-regulation'- its origins and evolution', September 1996, FS96-00633.

based approach to supervision arguing that it had reached its shelf life and therefore favoured a single and possibly separate regulatory body.[14] However, Fraser argued there was 'no value in forcing everything into a couple of simple moulds just for the sake of tidiness, or looking for a reduction in the number of regulators unless this made for better arrangements'.[15]

The Bank's first submission

The Bank made its first submission to the Inquiry in September 1996. The Bank examined the main financial system trends, the types of financial regulation, prudential supervision and its recent criticisms, payment system issues and competition and consumer regulation. In its 150 page submission, lodged just in time to meet the inquiry's 9 September deadline, the Bank's key focus was prudential regulation. At the core of the Bank's approach to prudential supervision was the distinction between bank deposits and insurance on the one hand and investment products on the other. Prudential supervision applied to banking and insurance whereas the type of regulation appropriate to fund managers and mutual funds was considered 'product disclosure or advice regulation' 'because the solvency of the institution is not at risk'.[16] Thus, according to the Bank, 'the centerpiece of financial regulation should be the clear separation of regimes for prudential supervision and product disclosure regulation'.[17] The supervisor of deposit taking institutions should not also supervise investment-linked products such as superannuation.[18] There was no merit in combining the regulation in one institution or mega-regulator. A mega-regulator also increased the risk of moral hazard. If all financial products were under a mega-regulator the public could deem them all to be equally safe and would be encouraged to take greater risks to maximize returns.[19] Looking abroad the

[14] Australian Financial Review, 31 May 1996 in FS96-00482.
[15] Financial Regulation and the Financial System Inquiry. Remarks by Bernie Fraser, Governor of the Reserve Bank at "Trends" Luncheon Organised by Advance Bank, Canberra, 5 July 1996, GBF-92-1.
[16] RBA, Submission to the Financial System Inquiry, 6 September 1996, para 131.
[17] RBA, Submission to the Financial System Inquiry, 6 September 1996, para 44.
[18] Discussions with Mr Wallis 23 December 1996 (Notes of conversation phoned in by Governor), SD96-00300.
[19] RBA, Submission to the Financial System Inquiry, 6 September 1996, para 8.

few countries that had a mega-regulator model- Norway, Sweden, Denmark and Japan' had all experienced considerable financial instability.[20]

The Bank argued against the creation of a separate regulator. Monetary policy and the prudential supervision functions of central banks should not be separated since 'a thorough knowledge of the health of the banking system contributed to better monetary policy'.[21] The Bank maintained that there did not exist serious conflicts between the two functions but rather there were 'important synergies' in having them together in the one institution.[22] Further arguments included: a new regulator would be less effective at doing its job than the current one; that the subsequent narrower bank would be worse at doing its job of monetary policy; and that there would be serious co-ordination problems in the event of a financial disturbance.[23] The Bank maintained that the supervision of insurance companies should not be combined with the bank supervisor since 'the risks in the insurance and superannuation business require a different type of analysis than those in a deposit-taking operation'.[24] The insurance companies and superannuation funds therefore justified a specialised supervisor such as the ISC. The Bank was more open to the suggestion that it could take on the supervision of building societies and credit unions because there was 'some potential for greater efficiency and cost savings' but were not convinced that merchant banks and finance companies should be made subject to RBA supervision.[25]

Other arguments in the submission:

- 'The anomalous situation on international banks operating here as non-banks should be resolved by requiring them to become authorised banks'.[26]
- The "six pillars" policy preventing mergers between the banks and the two biggest life offices should be reviewed.

[20] RBA, Submission to the Financial System Inquiry, 6 September 1996, para 9.
[21] RBA, Submission to the Financial System Inquiry, 6 September 1996, para 88.
[22] RBA, 'Review of the Financial System', March 1996, FS96-1051 CINFS 28.
[23] GJT, Opening statement to Wallis Inquiry, 31 January 1996, FS96-1051 CINFS82.
[24] Para 148.
[25] Paras 150-6.
[26] Para 160.

- There was scope for rationalization on consumer regulation.[27] The Bank favoured the establishment of a national consumer authority which would take over the various finance sector consumer related activities of the ASC and ISC.
- The Bank wanted to rid the "merchant bank" status of many foreign bank subsidiaries in Australia and bring them within the licensed bank regime under its supervision. The Bank advocated a streamlined process of granting authorisation for banks whereby the RBA would be responsible for authorisation and not the Treasurer and Governor-General.[28]
- The RBA favoured amendments to the Banking Act to clarify the powers of the Bank should it assume control of a bank as a result of a crisis. The Act should also be amended to make clear that depositor protection did not imply an official guarantee.[29]
- In considering the authorisation of foreign exchange dealers the Bank favoured removing the separate licensing regime, allowing an entity to buy or sell foreign exchange without limitation.[30]
- There would be no major gains to be made from imposing a general licence fee on banks.[31]

Discussion Paper (November 1996)

Having received 268 submissions the Wallis Inquiry released a discussion paper on 28 November 1996. The paper did not provide preliminary or draft recommendations but rather outlined the themes addressed in the various submissions. The paper provided an overview of the Australian financial system and its regulation, identified some of the forces for change and the regulatory challenges posed by such developments. The regulatory arrangements and implications of mergers and acquisitions in the financial services sector were examined along with consumer protection, competitiveness and regulatory co-ordination. Globalisation, technology, consumer needs and demands and

[27] RBA, Supplementary Submission, executive summary, para 23. .
[28] Para 182.
[29] Para 188.
[30] Para 203, 205.
[31] Para 215.

financial innovation were identified as the key factors driving change.[32] Essential attributes of an effective regulatory structure included competitive neutrality; cost effectiveness; transparency; flexibility; and accountability.[33] According to the discussion paper a large majority of submissions that addressed the regulatory structure suggested that credit union and building societies should be under the same regulator as banks.[34] Several major life companies and the NAB advocated the establishment of a mega-regulator and separation of moving regulation of banks outside the responsibility of the central bank. 'The Treasury saw advantages in an evolution towards separation as part of a strategy to minimise the moral hazard to government and promote market discipline'.[35]

The Bank's Supplementary Submission

In its supplementary submission in January 1997 the Bank expanded on three topics raised in the Inquiry's discussion paper: the development of the financial system in the next ten years; the implications of technology, financial innovation and the entry of new competitors which were previously the preserve of banks; and depositor protection. Looking to the future the Bank believed 'the Australian public would still choose to hold a substantial proportion of their financial assets as a deposit-type instrument'.[36] Banking would therefore remain a 'very important part of the economy'.[37] Although banking was likely to decline in relation to the total assets of the financial system, it would still represent a substantial part of that system and there was little evidence to suggest that 'non-banks will make significant inroads into banks' domination of the provision of deposit-type instruments'.[38] Consequently, 'the level of risk of the financial system, and of banks, will not be significantly different to what it was over the past decade…while there are a number of influences that will increase risks in the system, there are also a number that will reduce them'.[39] The use of new technology resulted in 'a more efficient and competitive system' and overall the level of risk of the financial system and of banks

[32] Financial System Inquiry Discussion Paper, November 1996, para 3.2.
[33] Financial System Inquiry Discussion Paper, November 1996, para 4.52.
[34] Financial System Inquiry Discussion Paper, November 1996, para 7.26.
[35] Financial System Inquiry Discussion Paper, November 1996, para 7.79
[36] RBA, Supplementary Submission, para 11.
[37] RBA, Supplementary Submission, para 26.
[38] RBA, Supplementary Submission, para 37.
[39] RBA, Supplementary Submission, para 37.

was not deemed to be significantly different in the next ten years than the past decade.[40] In discussing protection of depositors the Bank highlighted that its approach to depositor protection in the Banking Act was unclear and there was no guarantee that depositors would receive full repayment.[41] The Bank therefore suggested changes to the Banking Act to make it clear that the Act did not provide a guarantee of bank deposits. The elimination of depositor protection was deemed undesirable and thus the alternative was to either clarify the existing arrangements or replace them with a system of deposit insurance. The Bank favoured the former.

Final Report and Recommendations

Released on 9 April 1997, the final report of the Financial System Inquiry contained a detailed analysis of the state of the Australian financial system, analysing both the changes that had taken place over the previous decade and the forces for change for the future. In the report the analysis of forces driving further change in the financial system primarily focused on technology, globalization and competition between markets and institutions. Key changes likely to occur in the next decade were: the entry of more specialist players into a variety of financial markets, the emergence of new payment instruments and payment services; and the continued evolution of large financial conglomerates. In examining deregulation the report concluded that it had been successful and the financial system was increasingly showing signs of being more competitive and capable of dealing with the pressures of the current decade.[42]

Overall, 115 recommendations were made for reform across the entire financial services industry. The report's major recommendations covered regulatory structure; competition; access to the payments system; and consumer protection. Mergers and acquisitions; licensing, disclosure and dispute resolution; and co-ordination and accountability of regulators were also considered. Although the Wallis Repot was essentially conservative in regard to the techniques of prudential regulation its recommendations were far-reaching in relation to the institutional structure of financial

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[40] RBA, Supplementary Submission, para 37.
[41] RBA, Supplementary Submission, para 117.
[42] David Alan Craig, Note OECD Committee for Financial Markets Background Paper- Inquiry into the Australian Financial System, 29 May 1997, FS97-00255.

regulation in Australia. The key recommendation of the Wallis Committee was its proposal for a more streamlined regulatory framework, 'founded on the premise that the financial system should be more strongly competitive and efficient'.[43] It was important that the regulatory framework would be able to accommodate change and encourage innovation and competition. The existing system of numerous supervisory agencies had resulted in 'inefficiencies, inconsistencies and regulatory gaps' that were 'not conducive to effective competition in financial markets'.[44] Regulation was to be organized according to broad regulatory functions instead of on institutional lines and the existing agencies would be condensed. The Bank would be responsible for monetary policy, financial stability and the payments system. Two new bodies, the Australian Prudential Regulation Corporation (APRC) and the Corporations and Financial Services Commission (CFSC) would take over the financial supervisory activities carried out by the ASC, the ISC and the Bank. The CFSC would be responsible for market integrity and consumer protection and would monitor new technologies, whilst prudential supervision would be undertaken by the APRC which would supervise and regulate all deposit taking institutions, not just licensed banks but also insurance, superannuation and life companies. The new regulatory arrangements would provide 'greater competitive neutrality across the financial system' and 'a more clearly focused and accountable structure'.[45] The key arguments put forward in the Wallis Report in support of the APRC structure was that it would offer regulative neutrality, greater efficiency and a sounder basis for regulating conglomerates. The APRC would be separate from the RBA to enable the Bank to focus on its primary objectives. Inclusion of non-deposit taking institutions under the RBA's system of prudential regulation would provide an 'unacceptable distraction from its main roles of monetary policy and overseeing systemic stability'.[46]

[43] Financial System Inquiry Final Report Overview, March 1997, p.26.
[44] Financial System Inquiry Final Report Overview, March 1997, p.17.
[45] Financial System Inquiry Final Report Overview, March 1997, p.29.
[46] Professor Jeffrey Carmichael, Financial System Inquiry Address to AAPBS, 16 April 1997, FS97-00202.

Other recommendations included:

- A new Payments System Board within the RBA would determine criteria for admission to the payments system.
- Access to clearing systems should be liberalised. (No.69)
- Merger regulation should be administered by the Australian Competition and Consumer Commission (ACCC). The six pillars policy should be removed as well as the ban on foreign takeovers of banks. (No.83 and 85).
- Interest on non-callable deposits should be reviewed (No.105).
- The creation of the Financial Sector Advisory Council (FSAC) with members appointed by the Treasurer whereby the Treasurer would be advised on progress of the implementation of the new regulatory arrangements. (No.110).
- The Council of Financial Supervisors should be renamed the Council of Financial Regulators.
- Institutions should have freedom to set fees and charges based on costs without government intervention or suasion.

The Bank's reaction

The Bank was in favour of the majority of the Wallis report recommendations and agreed with the proposal to open the payment system. Unsurprisingly, the Bank had 'a major conflict' with the proposals for the separation of bank supervision, having argued against the concept well before the first submission. Changing bank supervision would involve 'major political diversion and legislative effort for questionable political or practical gains'. The Bank also highlighted problems of large regulatory overlaps.[47] 'In summary, the Wallis proposals on moving responsibility for bank supervision are risky and a wasteful diversion and duplication of resources when the main benefits of reform will come from efficiency gains and creating more contestable markets as outlined in other FSI proposals'.[48] Subsequently the Bank and most major banks lobbied to prevent the partitioning of the Bank's functions. Three of the four major banks (Commonwealth

[47] No Author or date, Coordination comments on organisational framework for prudential regulation, FS97-00276.
[48] No Author or date, Coordination comments on organisational framework for prudential regulation, FS97-00276.

Bank, Westpac and ANZ) and the Australian Bankers' Association wanted the supervisory role retained by the RBA. The Commonwealth Bank opposed the APRC concept, describing it as a "Wally World" model likely to increase moral hazard and make more difficult the Bank's responsibility for system stability and payments integrity.[49] In the Bank's first public response to the Wallis report Governor Macfarlane questioned the Wallis report's assertion that the new body would be more efficient.

The Bank was given the opportunity to consider draft Cabinet submissions covering aspects of the FSI recommendations. The Bank had strong objections over the Cabinet's submission on organizational framework for prudential regulation maintaining it was an 'unbalanced review of the arguments/options, and (like Wallis) is over reliant on assertions'.[50] The Bank argued that there was no evidence to support the theory that a new regulator would deliver more effective regulation and questioned the Cabinet's proposal that placing all supervisors under one regulator would reduce moral hazard.[51] The Bank was in broad agreement with the main propositions in the Cabinet's other submissions on the payments system; depositor and investor protection; ownership and acquisition; and licensing. The Bank considered an alternative to the Wallis model whereby the Bank would become the sole supervisor of banks and all non bank deposit takers. The CFSC would still be created and the supervision of insurance and funds management would be retained within the ISC. The paper argued that 'in the medium term, the Bank would probably deliver a better standard, and more coordinated approach to supervision, whatever its breadth, than we have a (sic) present or is likely to be achieved under the Wallis model. We would be a far more market orientated supervisor, and provide a better balance between prudential concerns and financial system efficiency, than APRC is ever likely to achieve'.[52] On 26 August 1997 Mcfarlane met with the Treasurer and then Prime Minister in Canberra. On the issue of depositor protection Mcfarlane felt there was 'still a fair bit of confusion in Canberra about what is needed on depositor protection and what is achievable'. McFarlane argued that APRC would have to be a statutory authority to be considered 'a first rate institution'. Although the Prime

[49] DW Emery/DA Craig, Reaction to Wallis: 15 May-11 July (Post UK regulatory reforms announcement), 15 July 1997, FS97-00202.
[50] Bryan Fitz-Gibbon, Proposed redraft of cab sub on the regulatory framework, 9 July 1997, FS97-00202.
[51] Austin to Smith, Financial System Inquiry: Cabinet Submissions, 11 July 1997, FS97-00202.
[52] BL Gray, An Alternative Regulatory Structure, 26 June 1997, FS97-00255.

Minister had a 'high opinion' of the Bank he was not willing to argue against the Wallis proposals 'unless he could be convinced that bank supervision outside the central bank would lead to disaster'.[53]

Results of the Committee- Government's reactions

On the Report's release, the Government immediately announced two policy changes: the removal of the six pillars policy and the lifting of the ban on foreign takeovers of major banks. Nevertheless, although mergers of banks and insurers was possible a new "four-pillar" policy prevented mergers between the Big Four on mergers and acquisitions.

On 2 September 1997 Costello announced a set of financial system reforms in response to the recommendations of the Inquiry. This was the 'most ambitious overhaul of the financial system since the early- 1980s'.[54] Despite the Bank's objections the Government established two new regulatory bodies. Costello announced that the role of the Bank would be 'focused on the objectives of monetary policy, overall financial system stability and regulation of the payments system'. Responsibility for bank supervision was moved from the Bank to the newly established Australian Prudential Regulation Authority (APRA). It was no longer the duty of the Bank to assess the health of financial institutions and the Bank ceased its obligation to protect the interests of bank depositors or to direct the affairs of an individual financial institution. Prudential supervision of banks, non-bank deposit taking bodies, life and general insurance and superannuation became the responsibility of the single regulator APRA. The Government appointed Thompson as Chief Executive Officer of APRA, reducing the number of Deputy Governors in the Bank to one. The Australian Corporations and Financial Services Commission (ACFSC) was established to 'cover market integrity, disclosure and other consumer protection issues'.[55] Regulatory responsibility for self-managed superannuation finds were transferred from the ISC to the Australian Taxation Office and

[53] Macfarlane, Diary Note, Discussions with the Treasurer and the Prime Minister, 26 August 1997, FS97-00276.
[54] Australian Financial Review, 3 September 1997, p.1 in FS97-00082.
[55] Statement by the Treasurer, Reform of the Australian Financial System, 2 September 1997, FS97-00276.

a Financial Sector Advisory Council was established to provide the Treasurer with ongoing advice on financial sector developments and policies.[56]

Resulting from the transference of supervision to APRA the Bank established a new System Stability Department 'to conduct analysis and research on financial stability issues, including developments in financial products, technology and risk management, and to support the Reserve Bank's involvement on the APRA Board and the Council of Financial Regulators'.[57] The Bank had two members on the APRA Board to further aid close relations and effective co-ordination Furthermore, a bilateral Reserve Bank/APRA co-ordination committee was established to ensure co-ordination arrangements worked smoothly notably in responding to threats to system stability.[58] This was the 'biggest single change to the Bank's structure since the abolition of the Exchange Control Department following the float of the Australian dollar in 1983'.[59]

The Government also accepted recommendations for further measures to promote efficiency and competition in the payments system and thus a new Payments System Board replaced the Australian Payments System Council to supervise the opening of the payments system to non-banks, including companies outside the financial sector. This coincided with the commencement of Australia's real-time gross settlement (RTGS) system for high-value payments, making the payments system considerably less vulnerable to risk.[60]

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