A Perspective on the Wallis Report

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The Wallis Committee of Inquiry into the Financial System faced the unenviable task of investigating and delivering recommendations for restructuring the supervision of the Australian financial system within a time frame of less than one year. The task was unenviable because of the complexity of the issues involved, the absence of a generally accepted analytical framework for analysing financial system design (see Thakor, 1996), strong vested interests, and the ongoing pace of change in the financial system. In these circumstances, any report is unlikely to find favour with all observers and will attract criticism in abundance.

In this paper, we focus upon some perceived weaknesses in the Wallis Report which, we argue, arise from the lack of a clearly defined analytical framework and use of incompletely defined concepts. Among the issues we identify as inadequately resolved are many of long standing in the analysis of financial systems including: the question of whether banks are special; the determinants of the special characteristic of deposits; the sources of financial panics and bank runs; the special nature of the payments system; the measurement of output and cost of financial institutions; the case for separating banking and commerce. The fact that these issues have been batted around in the literature for many decades without complete resolution suggests that it would be unfair to expect a short lived Inquiry to resolve them completely.

However, the recommended supervisory and regulatory structure advocated by the Wallis Report hinges upon the Committee's views on these and other issues, and it is thus important that the approach taken is not inappropriate. As is well known, the financial system is not static in structure, responding to both external developments (changes in technology and user demands for example) as well as having its own internal dynamics. Kane (1981), for example, has emphasised the importance of the *regulatory dialectic* in which the interplay between regulation and financial innovation lead to ongoing change. Design of a regulatory structure needs to recognise this and allow for ready adaptability of the regulatory system to the changes in the financial system which it sets in process.

Some authors such as Merton and Bodie (1995) have argued that this inherent problem of regulatory design is best tackled by adopting a functional approach rather than an institutional approach to regulation. However, while the Wallis report emphasizes the need to understand the functions performed in financial markets, it ultimately recommends a regulatory framework which is primarily institutional in focus.

That institutional focus involves a distinction between deposit taking institutions (DTIs), within which banks form a special subset, and other financial institutions. Underpinning this distinction, and the regulatory framework emanating from it, is a recognition of the problems of separately considering functions and financial products from the institutions performing and providing them. However, the way in which an institutional distinction is

made based on some product characteristics, and the limited attention given to other functions and product characteristics raises some issues worthy of consideration. In what follows, we focus initially on the fundamental concept of "intensity of promise" utilised by Wallis for delineating institutional types, and then consider the merits of their suggested approach to depositor protection resulting from this. Then, the rationale for, and implications of, preservation of institutional restrictions such as special entry requirements into banking, separation of banking and commerce, and participation in the payments system are considered. In conclusion, we take issue with the Wallis Report's measure of the size and cost of the financial system - noting that the approach adopted in this measure focuses primarily on the asset side of intermediaries' balance sheets, in contrast to the liability side focus underpinning the bulk of the Report's recommendations.

Deposits and Depositor Protection

One of the principal regulatory distortions affecting the Australian financial system has been the general public perception of de facto government guarantee of bank deposits. In such circumstances, banks can continue to raise deposit funds at a risk free interest rate regardless of the riskiness of activities undertaken. Indeed, under the deregulation occurring since the Campbell Inquiry the extent of distortion can be argued to have increased. Banks have been able to undertake a much wider range of activities through their banking arms rather than through subsidiaries, thereby extending the domain of such perceived guarantees. Increased competition post Campbell, which through increased risk taking may bring with it more potential for bank failure, could also be argued to increase the value to banks of any such guarantees - although more stringent, risk based, capital requirements provide some offset.

To what types of financial claims should government prudential oversight, and possibly protection, apply. The Wallis Report used as its basis for analysis the concept of the *intensity of promise* inherent in a financial product. This concept is a difficult one to make precise. What does it mean?

Intensity of promise does not appear to relate to the character of the issuer of the promise, nor to the likelihood of the promise not being honoured. Identical promises made in one case by a highly reputable person known for honouring obligations and in another case by a person of dubious character know for reneging on obligations would be of equal intensity. The Report appears to be referring instead to the extent to which claims do not involve explicit stated exposure to market or credit risk, since it singles out deposits and payments instruments as having the greatest intensity of promise and refers also to capital backed investment products and term life and general insurance products as being of high intensity. The intensity of promise is an issue presumably because there is some probability of default on the promise, and because default on such a promise has some particularly significant adverse social consequences. If so, the credit worthiness of the institution making the promise is of concern, suggesting that there might be some regulatory focus on the nature and range of activities of intermediaries making high intensity promises, although the Wallis Report does not proceed down this path.

Thus while it is the financial claim which is of importance, it is the institution which is the promiser, and so after discussing their philosophy of regulation in a functional framework in Chapter 5 the report recommends an institutional framework where institutions are identified by the characteristics of those of their obligations which have the highest intensity of promise. On page 303 the Report argues that the focus of regulation must remain on the promising entity as a whole, that is, an institutional perspective. The regulation is to be linked to the highest intensity promise of the institution, and apply to the entire institution - unless specific promises can be effectively quarantined.

The dilemma and forces for change this creates is apparent. If regulation imposes costs on the institution, institutions offering both high and low intensity promises will incur excess regulatory costs. Organisational structures, such as holding company arrangements with subsidiaries offering different intensity promises and thus subject to different regulation, will be sought to minimise regulatory costs. However, given information asymmetries, it is unlikely that the general public will appreciate the subtleties of such structural arrangements. The ability of government to quarantine any public image benefits from prudential oversight to the relevant subsidiary is limited, and threatens the goal of competitive neutrality.

DTI's continue to be special because of the intensity of the promise. The acceptance of retail deposits without a prospectus is regarded as the most intense promise (and presumably the broken promise which has the most adverse social consequences) and the recommendations of the committee are that this privilege continue to be limited to banks, building societies and credit unions with the possibility of exception in cases similar to Pastoral Finance Companies [p. 323].

By identifying institutions by their highest intensity promise and designing a regulatory structure on that basis, the Wallis Report creates the possibility of institutions specialising in other areas, but having a deposit taking activity, being regarded by the public as similar to deposit taking specialists. Unless public perceptions of implied government support for such institutions are dispelled, the potential exists for this distortion to have more widespread effects in the financial system than currently. The Wallis recommendations in this area of depositor protection are thus particularly important.

Depositor Protection and Depositor Preference

If it is necessary to have prudential supervision of institutions issuing claims of high intensity of promise, because of the prevalence of asymmetric information which prevents purchasers of those claims assessing the risks, the question arises of what type of supervision and regulation makes sense. Logically, since the risks of nonfulfilment of the promise hinge upon the risks of the assets and activities of the institution, some focus on these appears warranted. However, apart from some restrictions on equity investments by DTIs, and use of risk based capital requirements, the Report pays little attention to this issue. The possibility of "narrow banking" is not advocated, even though this would create institutions who are able to credibly offer claims of high intensity. Indeed, if

anything, DTIs are given greater scope to pursue a variety of activities which would expand the range of assets financed by claims of high intensity of promise. Under the current regulatory regime, where bank deposits are generally perceived to be government guaranteed (thus ensuring the honouring of the high intensity promise), there is a distortion in favour of banks which would likely increase under the Wallis proposals to ease entry into banking and place banks and other DTIs under the single supervisor.

Since maintenance of public confidence in the safety of deposits and deposit taking institutions is a *sine qua non* of prudential regulation, resolving this distortion was a fundamental task for the Wallis Inquiry. The options available to them included the following: maintenance of the status quo, extending the range of defacto guarantees to other deposit taking institutions either by allowing them to become banks or placing them on the same footing as banks, clarifying the actual and perceived extent of government protection of depositors to remove or quantify any beneficial effect, explicitly limiting depositor protection to a narrowly circumscribed set of deposits (the narrow banking proposal), instituting a scheme of explicit deposit insurance, establishing industry contingency funds.

The Report eschewed a deposit insurance scheme, largely on grounds of poor public image and practical difficulty associated with design of a scheme which would not generate adverse incentives. Likewise, "narrow banking" proposals - whereby only deposits of institutions investing only in a collection of safe assets are guaranteed - received no support. Instead, the Report focused on the approach of clarifying the extent of depositor preference as claimants in the event of liquidation, with the apparent view that such an information based approach would overcome difficulties. Two problems can be identified with that approach.

First, if competitive neutrality is to prevail, depositors must believe that there is no ultimate government "bail out" likely for certain distressed institutions. In this respect, retaining the distinction between "banks" and other "deposit taking institutions" seems likely to entrench public perceptions of there being some difference between these types of institutions. While the Wallis Inquiry appears to argue that any such difference reflects size and other considerations which might be expected to lead banks to be less risky, it is far from apparent that the public perceptions are formed in such rational ways. It would be likely to take an inordinate amount of public education to change perceptions that "banks" are not in some way special.

The second problem with the Wallis approach is that it can only work if depositors do not believe that a "first come first served" approach applies in banking (and that would seem only likely to be the case if there was a belief that "bail outs" would occur). It is well established that bank runs can occur because of the sequential satisfying of depositor claims by liquidation of assets [Diamond and Dybvig, 1983]. The Wallis Report focuses on depositor preference over other creditors in the event of liquidation - but the problem for prudential regulation is that banking problems arise in the run up to liquidation. Uncertainty about the safety of deposits can create depositor runs which require the liquidation of assets at unfavourable prices and lead to the insolvency of an otherwise

viable institution. Depositor preference over other claimants in liquidation does not overcome the fundamental problem of intra-depositor preferences.

Given these problems, the success of the Wallis approach hinges on establishing conditions such that depositor concerns about DTI insolvency does not occur. Adequate capital standards are one necessary condition, and the proposals to increase the ability of mutual DTIs to raise alternative forms of capital which is subordinate to depositors is relevant here. (The suggestion for continuation /establishment of industry contingency / support funds is also relevant in this regard). However, minimum capital requirements while part of a solution do not ensure that crises of depositor confidence will not occur, nor in fact that depositor protection will be achieved - unless reported capital can be translated into realisable value in the event of crisis and /or liquidation. An information based solution, as proposed, would suggest that considerable attention would be paid to the nature of information available and that topics such as market value accounting, doubtful debt provisioning arrangements, etc which contribute to the reliability of such an information set would be addressed in some detail. This does not appear to be the case, raising the question of whether reliance upon depositor knowledge of their preferred position in the absence of reliable information on what that position is likely to mean, is a viable solution.

Institutions versus Functions: Are Banks Special?

The perception that banks are somehow special is fundamental to our current regulatory structure. This specialness is frequently highlighted by reference to the functions of the banking sector and the impact of bank failure on society. These functions range from individual specific services such as a safe haven for deposits and asset transformation through to economy wide factors such as credit allocation and transmission of the money supply. The Wallis report recognises that institutional forms are continually changing as the boundaries between products and institutions are blurring, and describes this phenomenon as "conglomeration and market widening" [p. 140].

However, the Wallis committee considers a continuing distinction between banks and other DTIs "remains relevant both in an international setting and in distinguishing those entities large enough to maintain an ESA with the RBA from other, smaller DTIs." [p. 323] Recommendations such as this do little to dispel the notion that banks are special. However, by reducing entry barriers into banking, the value of the privilege to use the label of bank may have been decreased somewhat. Indeed, it may be argued that the existing banks are potentially the big losers from the Wallis recommendations not simply because of the increased competition they face but because they face new entrants who also have the special tag of "bank" firmly applied. Moreover, these "banks" obtain this tag due to their liability structure which may comprise a very small proportion of deposits.

Separation of Banking and Commerce
Historically, financial regulation in Australia has encouraged a separation of banking and commerce both in terms of restrictions on ownership of banks by non financial businesses and in terms of bank ownership/ equity investments of non financial businesses. This segregation has reflected concerns about the potential conflicts of interest which might otherwise arise, and adverse spillovers from business financial distress to the financial institution.

Under the Wallis Inquiry proposals, it would appear that these barriers are being weakened. While the Report argues that "application of the spread of ownership objective as a general principle for DTIs" (p338) be maintained and that "separation ...be retained as a broad guiding principle" (p340), it advocates that the proposed APRC should be able to consider applications for bank /DTI licences from non financial corporations on their merits.

The arguments for a continued spread of ownership and separation principle are somewhat unconvincing. While spread of ownership may limit agency problems arising from the possibility of a major shareholder initiating wealth transferring activities, it is not clear that these cannot be prevented in other ways, nor that the agency problems which might be created by managerial independence due to a diffused ownership are of less concern. Likewise, the notion that contagion risk may exist when the fortunes of a major shareholder suffer an adverse move, while plausible, casts doubt on the underlying premise of the Report that DTI and Bank safety can be maintained by adequate capital standards and public articulation of depositor preference provisions.

Nevertheless, the Report provides for the possibility of integration of commerce and banking /deposit taking. This raises the possibility of significant changes in the structure of the financial system, particularly in the light of ongoing technological developments.

For example, under the Wallis proposals, it would be possible for a large retail chain (such as Coles Myer or Woolworths) to establish a bank or deposit taking subsidiary. With the availability of electronic payments technology and the wide branch network readily available to such retail chains, they constitute a significant potential threat to traditional retail deposit taking institutions.

Such possibilities do raise some concerns for the proposed regulatory structure. While the APRC can evaluate the merits of such proposals in terms of their effects on the financial sector, any such developments are likely to have competitive effects in the retail business sector. It would seem that a co-ordinated approach between the APRC and the ACCC would be required.

A further case where regulatory co-ordination would be required arises in the following, plausible, scenario. A major business enterprise could, for example, apply to establish a DTI and offer say, term deposit facilities, by advertising on the WWW. With ongoing advances in modern technology, funds could most likely be transferred from an account at one DTI to another electronically - avoiding the need for a physical premise for such a

DTI. Such advertising would presumably need to be considered by the CFSC making co-ordination between the APRC and that body necessary in considering such an application. A critical issue here also concerns the use of such deposit funds, in particular the extent to which they can be used by the DTI for investment in activities related to the business of the owner. For example, a large business enterprise might generate a significant amount of accounts receivable and use the DTI as the mechanism for funding those assets. While the Wallis Report refers to the need for consideration of appropriate regulatory and prudential issues, it does not appear to address whether there should be any inherent linkages between the asset and liability sides of the balance sheets of DTIs and Banks. DTIs and Banks appear to be special in some sense, but this appears to reflect some feature of their liability characteristics rather than of their asset portfolios or the link between liability and asset portfolios.

Given the emphasis of the Report on the cost of the financial system as being related to the asset side of portfolios (and fee income), the focus here on the liability side seems somewhat incongruous.

Reform of the Payments System

In the payments system area, technological advances have brought new product possibilities in terms of services and delivery; provided the potential to reduce operating costs; and increased the extent of competition from outside the banking and financial services industry [p. 109]. In developing recommendations for the regulation of, and access to, the payments system which promote both efficiency and stability, the committee faced the following conundrum. Their objective was to increase competition to reduce what they perceive as high operating costs particularly in the least efficient area of the cheques and paper system [section 6:3:1]. But, cheques carry a high intensity of promise so that an institution which issues cheques must meet the highest prudential standards. Therefore, the report recommends that the right to issue cheques should be extended, but limits this extension to deposit taking institutions. [Recommendation 66]. At present banks can issue cheques and building societies and credit unions do so through an agency arrangement. If this recommendation is adopted building societies and credit unions will be able to issue cheques in their own right, but other financial institutions could only do so by agency arrangements and subject to the approval of the APRC. Whilst regulation is functionally premised on the intensity of the highest promise an institutional approach means that only deposit taking institutions can issue cheques. (Cash management trusts are presumably excluded).

The inquiry also wished to increase competition in the right of access to settlement by liberalising access to Exchange Settlement Accounts [Recommendation 73]. However, any reform must be considered in the current environment of Real Time Gross Settlement for high value payments. To be eligible for access to the High Value Payments System the institution does not have to be a bank but must be “prudentially regulated to the intensity of the international standard for banks” [p. 409]. Although not explicitly limiting access to banks, this restriction reinforces the belief that banks are somehow special - even if only special by virtue of their special regulatory status.

Cost of the Financial System

Underpinning the interest in and importance of the Wallis Report is the significance attached to the efficient operation of the financial system. Not only is the sector a significant employer in its own right, but decisions made by participants have important resource allocation (and some distributional) implications for society.

The Wallis Report states (p202) that "the total cost to users of Australia's financial system in 1995 was approximately $41 billion....measured by total revenue generated...". The interpretation of such a calculation is open to question, particularly when it is realised that Australian GDP for 1995 was $454 billion, and the GDP attributed to the banking and finance sector was around $19 billion (and the imputed bank service charge was around $8.5 billion). Given total employment in that year of 4.67 million and employment in banking and finance of 317,000 million, either productivity in the sector is inordinately high or the $41 billion figure corresponds to something different to standard measures of output.

To understand the Wallis measure, it is useful to focus on banks and utilise the standard decomposition of operating profit as:

Profit = Interest Income -Interest Expense + Fees - Operating Costs

Studies of bank costs typically adopt one of two approaches. In the *intermediation approach*, cost is measured by focusing on operating costs including interest. In the *production approach*, cost is measured by focusing on operating costs excluding interest costs. Rearranging the equation above:

Interest Income + Fees = Interest Expense + Operating Costs + Profit.

Since the Wallis Report measures total cost as Total Revenue = Interest Income + Fees, it is clear that the Inquiry has adopted an intermediation approach to the interpretation of financial sector output. In this view, output is defined as some quantity such as loan volume, akin to the value of cars rolling off the production line. As this indicates, such a measure is not compatible with standard measures of value added used in national accounts.

By utilising such a measure, the Wallis Inquiry tends to overstate the relative "cost" of the financial sector to the community, since some part of that "cost" is in fact a transfer payment of interest to other members of the community. Moreover, the focus of the cost measure primarily on the asset side of balance sheets (via interest income) seems at variance with the thrust of the reports regulatory recommendations which appear mainly based on liability side activities and distinctions.

References

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