

# Who needs a review of the financial system in Australia?

## The case of the Wallis Inquiry

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## Abstract

The Howard government reorientated the then existing institutionally-based financial regulation towards a functionally-based regime with new prudential and disclosure regulators in 1998. This paper uses the governmental agenda setting framework of John Kingdon (1995) to explain this financial regulatory change undertaken in Australia following the Wallis Inquiry (1996). It also examines the role of the Inquiry in the policy process. It will show that the financial regulatory change was on the bureaucratic agenda of the Treasury Department. The abstract financial regulatory model (ie the 'twin peaks') was already out there. The Treasury sold this idea to the then Labor government Treasurer and Liberal Party opposition shadow Treasurer before the March 1996 federal election. However, Treasury's problem was that it had difficulty connecting its solutions to the political leadership during the years when Paul Keating was Prime Minister. A window of opportunity opened following the federal election with the new government, which was keen to achieve financial regulatory reforms to address future regulatory challenges proactively while the new Treasurer wanted to consolidate his power within markets and politics. Treasurer Peter Costello coupled the Treasury's solutions to problems and to political processes. The Wallis Committee was 'packed' by the government in accordance with its regulatory policy preferences. Its role was to legitimise the government's policy preferences publicly, and to transfer the 'governmental agenda' into the 'public agenda.' However, this was not a case of the government pressuring for its policy preferences over the financial services industry. In fact, the Inquiry was used as a 'venue' to generate industry and public support for the regulatory changes, and was used to build a network of alliances within and outside the parliament.

The statesman who nominates the [members of a] commission can almost always determine the course that it is going to take, since he will have a pretty good knowledge beforehand of the minds of the experts whom he puts on it, while of course, avoiding any appearance of 'packing' of [sic] his team.

*Dibelius 1930, quoted in Bulmer 1980, 3*

## Introduction

On 2 March 1996, the Liberal Party won its first federal election after 13 years of Australian Labor Party (ALP) rule. On 30 May 1996, one of the first acts of the Treasurer of the Howard Coalition government, Peter Costello, was to establish the third major national Inquiry to review the Australian financial system (later known as the Wallis Inquiry).<sup>1</sup> The Wallis Inquiry was important in the new era of financial change in Australia because it aimed to address the issues of whether, and if so how, the regulatory arrangements at the time should be reorganised to address future challenges.

The establishment of the Inquiry was interesting. The then existing regulatory system was apparently working well, and there was no visible external or domestic threat challenging the political authority of the then existing industry regulators – and/or economic interests of key private sector actors. In the words of a senior bureaucrat:

We did not need the [regulatory] change and in fact that is why the debate was funny. We can see there was no natural constituency demanding change because the system was working well ... [In addition] the Inquiry was not critical in the sense that there were not any pressures out of the market such as failures or anything else. (B2)

If the then existing regulators and regulated firms in the financial services industry were not pressuring for regulatory change, and there was no market failure necessitating a case

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<sup>1</sup> For comprehensive overviews of the Wallis Report, see Harding (1997); Harper (1998); Perkins (1998).

for the government's regulatory intervention, then why was it that the government established the Inquiry?

How governmental agendas are set, who affects them and why, and why some decisions, rather than others, are made by governments have always been among the central questions in policy analysis (Downs 1972; Kingdon 1984; 1995; Baumgartner and Jones 1991; 1993). The purpose of this paper is to discuss the main features of the agenda setting process in financial regulation in Australia with special references to those questions.<sup>2</sup> The context of the research concerns the key premise of the financial regulatory change proposed by the Wallis Committee (FSI 1997) and adopted by the Howard government: the reorientation of the then existing institutionally-based financial regulation towards<sup>3</sup> a functionally-based regime<sup>4</sup> with new prudential<sup>5</sup> and disclosure<sup>6</sup> regulators.

Specifically, this study takes a closer look at the governmental agenda setting process and the role of the Inquiry in financial policymaking.<sup>7</sup> The theoretical underpinning of the discussion emanates from John Kingdon's pioneering work on governmental agenda

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<sup>2</sup> Broadly speaking, here 'agenda setting' refers to the process by which issues rise to prominence in political discussion in society.

<sup>3</sup> Before the Wallis Inquiry, the Australian prudential regulatory structure was based on institutional supervision and was composed of four main industry regulators. The Reserve Bank of Australia (RBA) had responsibility for banks; the Insurance and Superannuation Commission (ISC) had responsibility for insurers and superannuation funds; the Australian Securities Commission (ASC) was responsible for the enforcement of the market conduct and disclosure requirements and the state and territory-based State Supervisory Authorities had responsibility for building societies, friendly societies and credit unions under the administration of the Australian Financial Institutions Commission (AFIC). For a detailed analysis of the institutional and functional changes in prudential regulation, see Goldsworthy, Lewis and Shuetrim (2000); Thompson (1998, 1999); Hogan and Sharpe (1997); Thompson and Gray (1999).

<sup>4</sup> There are two conceptual approaches to financial regulation and supervision: the institutional versus functional dichotomy (Hogan and Sharpe 1987, 1997; Mayer 1997; Valentine 1997). Functional regulation treats all providers of functionally equivalent products or services equivalently. The nature of financial products is important in functionally-based financial regulation. There are two categories of products: those which involve a binding contract on the part of the institution offering the product that will not fall in value (eg deposits) and those investment products where the investor bears the risk not the institution (eg managed funds). The first refers to prudential regulation while the second refers to the prevention of individual risks enforced by disclosure regulation. On the other hand, institutional regulation treats all similar institutions similarly.

<sup>5</sup> Prudential supervision is to do with systemic protection which aims to ensure the stability and soundness of deposit-taking financial institutions through supervising their risk-taking.

<sup>6</sup> Disclosure supervision relates to consumer protection rules which aim to ensure that retail customers have adequate information and are treated fairly.

<sup>7</sup> The term 'agenda' is defined as 'the list of subjects or problems to which governmental officials, and people outside of government closely associated with those officials, are paying some serious attention at any given time' (Kingdon 1995, 3).

setting (Kingdon 1984, 1995).<sup>8</sup> This will involve applying a framework of interpretation based on three policy streams within the process: problems,<sup>9</sup> policies and politics. Kingdon's framework will be introduced during the discussion.

The research methods used in this study have been qualitative. A combination of interviews and written sources was the main approach to data collection. The interviews were held with 14 people with intimate knowledge of the policy issues.<sup>10</sup> Submissions made to the Financial System Inquiry (1996) by some of the key private and public sector actors and the Final Report of the Inquiry (FSI 1997) were analysed. Daily newspapers and weekly financial press as media sources were also widely used. Other textual sources

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<sup>8</sup> Whereas a policy networks framework (Coleman 1996) and three phase adjustment model (Reinicke 1995) are traditionally used in the analysis of financial policymaking process, these approaches are not suited for the Australian context. These institutional approaches to policymaking assume that 'policy change generally took place only when the financial "policy community" [key regulatory agencies and regulated firms in a financial policy area] agreed it was necessary and consensus existed on the direction of change' (Richardson 2000, 1006). However, as will be detailed later, the key state actors (RBA, ISC, ASC, and AFIC) and key private sector actors (four major banks and two biggest insurance companies) did not mobilise for regulatory policy change in Australia. In fact, some of them strongly resisted the change. Accordingly, there are three main reasons why these two frameworks will not be adopted by this paper. First, a government may set and control the policy agenda, seize power over the policy community, and eventually change the relationships therein (ie the policy network). In fact, a policy community may lose control of policy framing and agenda setting and may react to an agenda set and controlled by a government. Accordingly, policy communities can be changed and new ones can be established by a government decision. Secondly, knowledge – '[a] well-probed belief, whether empirical or evaluative' (Lindblom 1990, 123)– may be a powerful exogenous change agent for the financial policy community. In particular, framing of a policy problem based on knowledge can be a strong change agent exogenous to the policy community especially if it does not emanate from the community itself. Thirdly, individuals (ie policy entrepreneurs) may also play a significant role in agenda setting and policy change rather than the policy communities (ie key institutional actors). Thus, a policy change may not necessarily be a function of the policy community/network but, at least in part, may be a function of the policy entrepreneurs who catalyse the change. In other words, it may be the result of individual entrepreneurship rather than the outcome of structural circumstances. These points are based on Richardson (2000).

<sup>9</sup> This study also looks at some of the rival policy proposals which competed during the policy debate, since the agenda setting also involves defining 'problems' (Bacchi 1999). As Bacchi (1999, 1) suggests, policy analysis 'includes identification and assessment of problem representations, the ways in which 'problems' get represented in policy proposals.' This perspective not only offers partly competing approach focusing on different types of empirical evidence (ie a focus on problem representation rather than problem identification and definition) but also complementary analysis looking at the same events from somewhat different angles (ie looking at the vested interests at stake in postulated solutions or policy proposals).

<sup>10</sup> Interviews included very senior Treasury, Australian Prudential Regulation Authority (all of whom previously were holding very senior positions at the RBA), Australian Consumer and Competition Commission officials, senior members of the Senate Economics Legislation Committee, and House Standing Committee on Economics, Finance and Public Administration, and a member of the Wallis Committee. The interviews took place in the three major Australian cities: Melbourne, Sydney and Canberra between January 2001 and October 2002.

included biographies, reports and press releases of the government bodies and private institutions. The data are ordered chronologically and linked to the theoretical framework.

The remainder of the paper is divided into six sections. The first section will summarise the current state of knowledge on the role of the Inquiry in Australian financial policymaking. The second shows that the bureaucratic agenda of the Treasury Department included financial regulatory change from institutionally-based arrangements towards one that was functionally-based with new prudential and disclosure regulators. The abstract financial regulatory model (ie the 'twin peaks') and its specific solutions were already out there. The Treasury sold this 'twin peaks' idea to the then Labor government Treasurer and Liberal Party opposition shadow Treasurer before the 1996 federal election. However, the Treasury needed political leadership to push its proposals. The third section argues that a 'political window' was opened following the federal election. The new government was keen to achieve financial regulatory reforms to proactively address future regulatory challenges and the new Treasurer wanted to consolidate his power within markets and politics. Costello, as a 'policy entrepreneur', coupled the Treasury's solutions to problems and to the political process. The fourth section argues that the Wallis Committee was a blend of 'representative' and 'expert' committees rather than an 'impartial' one. Thus, it was not independent of both government and business. In fact, it was 'packed' by the government in accordance with its regulatory policy preferences. Requesting advice from this apparently 'independent' Committee, the formal and transparent Inquiry process helped the government to appear more democratic in policymaking. However, as the fifth section argues, this was not a case of the government pressuring for its policy preferences over the financial services industry. In fact, the Wallis Inquiry was used as a 'venue' to generate industry and public support for the regulatory changes. It was used to build a network of alliances within and outside the parliament. The concluding section summarises these discussions.

## **Previous work on the role of the Wallis Inquiry in Australian policymaking**

The role of financial inquiries (or task forces) in government-business relations in Australia has not been subject to extensive research. However, one study by Chaudhri and Samson (2000) examined financial services (Wallis Inquiry) and wool (Wool Industry Future Direction Task Force, 1999) task forces to illustrate the dynamics of Australian

government–business relations in a game theory context. Regarding the Wallis Inquiry, they argue that:

The Wallis task force was conducted essentially *independently* of government, and involved wide and deep consultation with the major business players, as well as with consumer groups, government departments, and other stakeholders...Like the wool task force, the financial-services Inquiry provided a process in which the gaming of government and business could be considered *independently* of these players. (Chaudhri and Samson 2000, 25, emphasis added)

For Chaudhri and Samson (2000), task forces in Australia comprise people ‘generally *independent* of both business and government,’ and ‘the Australian government uses task forces as vehicles to periodically *intervene* in and adjust policy frameworks, and to create new policy and a new set of dynamics for business–government relations and behaviours’ (Chaudhri and Samson 2000, 19, 22, my emphases).<sup>11</sup> They are also explicit that the government could not make proactive decisions in the restructuring and regulation of business: it is the Australian companies that ‘*anticipate changes* in [the] business environment,’ not the governments which ‘are responsible for setting rules of competition and regulating the strategic games that the private sector plays’ (Chaudhri and Samson 2000, 21, emphasis added).

Although not discounting completely this perspective, this paper will show that the Wallis Inquiry and its members were not independent of both government and business, and the establishment of the Inquiry was the government’s anticipatory approach to adjust regulatory arrangements to cope with future changes in the industry.

## The Treasury Department: problems and policies

Many assume that:

There can be no denying that Treasury’s relative status and influence in Canberra has declined in the last twenty years. Although Treasury is still very powerful, it is no longer pre-eminent. (Bell 1997, 34-5; Shann 1987)

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<sup>11</sup> However, it is interesting to question that if a task force (eg the Wallis Inquiry as they argued) is independent of the Australian government, how does the government use it as a vehicle to intervene in markets?

Following Shann (1987, 24), Bell (1997, 34) argues that the '[Treasury] never dominated microeconomic advice [eg advising on financial regulation].' It is suggested that 'Treasury's relative position has been weakened somewhat by the rise in policy influence of the Reserve Bank of Australia [RBA]' (Bell 1997, 35; see also Shann 1987, 25, 27),<sup>12</sup> and the splitting off of Finance from the Treasury on 18 November 1976 by Malcolm Fraser, in part, ended 'its dominance over economic advice and expenditure policy' (Wanna, Kelly and Forster 2000, 95; Shann 1987; Bell 1997).<sup>13</sup> Conversely, the rest of this paper will show that the Treasury dominated the microeconomic advice and it was the pre-eminent bureaucratic institution in financial policymaking rather than the RBA during the Wallis era (1996-97).

The Treasury is the principal adviser of the Treasury Ministers and is directly accountable to the Treasurer.<sup>14</sup> One of its policy objectives is the 'promotion of an efficient, competitive and stable Australian financial system' (Treasury 1998, 11). In order to do so, it advises the government on financial system laws<sup>15</sup> and on 'policy processes and reforms' (Treasury 2001, 7). Its proposals are important relative to other agencies due to its traditional function as a financial controller, a combination of neutrality and superior knowledge monopoly, responsibility for the whole Australian economy, and a dedication to giving advice based on the public interest (Whitwell 1986, 20-4). Moreover, the Treasury is a public actor in its own right in the domestic policy processes (Whitwell 1986). As a former deputy Treasury head, David Morgan, stated in an interview with national ABC television

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<sup>12</sup> It is argued that deregulation of the 1980s, particularly the decision in 1983 to float the Australian dollar and abolish exchange controls, which the Treasury previously controlled itself, strengthened the role of RBA in economic policymaking while weakening that of the Treasury (see also Schedvin 1992, 548-9; Edwards 1996, 330-1; Macfarlane 1998; Bell 2001, 463).

<sup>13</sup> The Treasury opposed Fraser's desire for a substantial devaluation of the Australian dollar in 1976. The conflict resulted in major institutional change that undermined the Treasury's power: the creation of the new Department of Finance in charge of public expenditure issues. For detailed discussions on splitting the Treasury, see Wanna, Kelly and Forster 2000, chs.4-5.

<sup>14</sup> Toohey (1994, 150) uses the term 'official family' as 'the main economic advisory bodies ...[which]... include the departments of Treasury, Finance, and Prime Minister and Cabinet, the Reserve Bank and the Industry Commission' in order to point to actors who input into economic policy. However, as will be shown later, the family members do not have equal powers. In fact, the Treasury dominated and shaped the policy debate during the Wallis era.

<sup>15</sup> For example:

The Treasury through its Markets Group, is charged with advising the government on policies and a framework of legislation and industry supervision that assist in increasing the efficiency, competitiveness and stability of Australia's financial system. The Treasury is also responsible for advising government on retirement income policies, including in relation to superannuation. (Memorandum 1999)

in 1993: 'Treasury always had its own agenda, always will have' (quoted in Toohey 1994, 152).

A review of the regulatory structure of the financial industry had been on the bureaucratic agenda of the Treasury before the election (*Australian Financial Review* 5 February 1996). Why was the Treasury demanding a policy change? A very senior respondent makes the point:

The main bureaucratic interest of the [Treasury] department was due to its concern surrounding potential unstated liabilities associated with compulsory superannuation. The Treasury wanted more supervision of the superannuation sector. There was an agenda there. (R1)<sup>16</sup>

The Treasury had tried to transfer its nongovernmental, 'systemic' agenda to a governmental, 'formal' agenda through mobilising the then Treasurer and shadow Treasurer. Ralph Willis, the then Labor Treasurer, and Costello, the then Liberal opposition Treasury spokesman, adopted the Treasury's agenda for financial regulatory reform before the election in March 1996 (*Sydney Morning Herald* 3 January 1996). As the senior respondent observes:

The Treasury had actually pushed the opposition and the government. Before the time of the election both [Willis and Costello] agreed to have an inquiry. Whenever that happens you see hands of bureaucrats behind the curtain. (R1)

Specifically, Costello and Willis publicly favoured a functional approach to prudential supervision, and the consolidation of prudential regulators as opposed to the then existing institutionally-based regime (see *Sydney Morning Herald* 24 January 1996). To illustrate,

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<sup>16</sup> Superannuation is a key element of government policies to address the long-term consequences of an ageing population. The Wallis Report found that:

Australia's ageing population has led successive Commonwealth governments to mandate compulsory superannuation to encourage individuals to bear greater responsibility for their retirement funding. This has resulted in a growing proportion of the nation's financial wealth being invested in superannuation relative to other investment vehicles. In addition, it has caused a shift in household assets towards market-linked investments, meaning that households are directly bearing a greater proportion of investment risk than in the past. (FSI 1997, 119)

In addition, superannuation is both a public policy instrument and a financial product. Accordingly, there was a case for prudential regulation of the superannuation sector. It has been pointed out that:

The compulsory nature of some superannuation savings, the lack of choice for a large number of members, the mandatory long-term nature of superannuation and the contribution to superannuation of taxation revenue forgone provide a case for prudential regulation of all superannuation funds, even where investors have knowingly accepted market risk. (Superannuation Working Group 2001, 2)

Willis flagged the need for changes to bank regulation (*Sydney Morning Herald* 3 February 1996). He accepted that the distinction among financial institutions had been blurred to the point where new rules might be needed (*Australian Financial Review* 2 February 1996). Similarly, Costello announced in November 1995 that the opposition Coalition would also undertake a comprehensive review of financial industry regulation (*Australian Financial Review* 2 February 1996; *Sydney Morning Herald* 3 February 1996). He argued that 'regulation should not be based on the institution concerned but the function or service provided by that institution, be it superannuation fund, major bank, regional bank or mortgage lender' (quoted in *Australian Financial Review* 5 February 1996). Both Willis and Costello shared similar views on the review of the Australian financial regulatory structure.

However, the Treasury's problem was that it had difficulty connecting its solutions to the political leadership during the years when Paul Keating was Prime Minister. The Labor government was not considering such a review, as Keating once declared (*Sydney Morning Herald* 3 February 1996). In response to Keating, Costello said in December 1995 that 'Mr Willis wants to follow the Coalition policy. Mr. Keating does not. Mr Willis is right' in restating the Coalition policy position (cited in *Sydney Morning Herald* 3 February 1996).

As Kingdon (1995) suggests, there are three kinds of processes involved in determining the governmental agenda – problems, policies (or solutions) and politics. For Kingdon (1995, 16), first contributors to governmental agendas might be 'problems pressing in on the system.' In the Australian context, there were not financial problems pressuring for a regulatory change. However, as a member of the Wallis Committee puts it, 'there was a sense that the industry was changing in such a way that the old regulatory framework, particularly those focused on industries rather than functions, were constraining the industry in an unhelpful way' (W1).

Policy makers can learn about problems through three mechanisms: dramatic events (eg crises), changes in widely-respected indicators (eg crime rates, cost indices), or feedback that there might be a problem which needs addressing (Kingdon 1995, 16-7). In Australia, the Treasury feedback brought future regulatory problems to the government's attention. In regard to financial regulation, the Treasury highlighted the policy problem: the need to address future regulatory challenges in a world of global finance where sectoral, institutional and product boundaries were dismantling: 'Whether, from a functional perspective of evolving institutions, markets, and products, institutionally-based regulation is appropriate will increasingly be open to question' (Treasury 1996a, 24). It argued that the institutional regulation made banks special. For the Treasury, this would rise to a moral hazard (which occurs when consumers' deposits enjoy government

protection)<sup>17</sup> and systemic problems (problems in individual institutions which threatened knock-on effects through the financial system as a whole) (Treasury 1996, 3, 17).

Again, as Kingdon suggests, a second contributor to governmental agendas 'might be a process of gradual accumulation of *knowledge* and perspectives among the specialists in a given policy area, and the generation of policy proposals by such specialists' (Kingdon 1995, 17, my emphasis). The financial industry institutions were increasingly selling a wider variety of products under one roof (financial conglomeration) due largely to technological innovations. Such developments were inevitably accelerating a need for functional regulation with two main regulators to treat all providers of functionally equivalent products or services equivalently. Therefore it was sensible to think about a more consistent supervision across sectors of the industry. For the Treasury (1996a), the main benefits of functional regulation would be fewer regulators as well as the development of appropriate regulatory arrangements that would minimise arbitrage, duplication, inconsistencies and gaps that might increasingly become main features of the then existing system. The Treasury rightly emphasised the significance of a functional approach to ensure competitive neutrality:

Ideally, products, intermediaries, or markets providing similar financial services should be subject to similar regulation. This could be defined as a 'functional' approach to regulation. Different regulatory treatment of similar institutions, products or markets can result in 'regulatory arbitrage', with wasteful time and effort directed at exploiting regulatory loopholes. (Treasury 1996a, 21)

According to the Treasury, there was a policy solution available to policy makers, namely the establishment of a functionally-based regulatory structure via the creation of new regulators: 'one option is the prospect of amalgamating the RBA and the AFIC to form a single 'prudential' regulator, and combining the ISC and the ASC to form essentially a 'disclosure' regulator' (Treasury 1996a, 4).

In the interviews conducted by the author on 16 April 2001, the Treasury senior bureaucrats frequently volunteered the 'twin peaks model' in referring to the Treasury's proposal for financial regulation (prudential and disclosure regulators constituted the 'twin peaks'). Where did this idea of 'twin peaks' come from? There is no simple answer as it is difficult to track the origins of policy ideas. Nevertheless, the rationalisation of the

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<sup>17</sup> It has been argued by the Treasury that consumers assumed that the RBA's supervision implied that bank deposits were guaranteed by the government, and that this guarantee also extended to superannuation, and the life and general insurance products offered by the banks (Treasury 1996a, 4).

regulatory framework quite clearly represents an elaboration of an idea put forward by Michael Taylor, former officer of the Bank of England, and the then director of a course in financial services regulation at London Guildhall University. Taylor, in an article entitled “Twin Peaks’: a regulatory structure for the new century’,<sup>18</sup> was the first academic to advocate functionally-based financial regulation with prudential and disclosure regulators. The model proposed the consolidation of all prudential and all consumer protection responsibilities into two separate agencies.<sup>19</sup> ‘Taylor’s article was floating around [in 1996]’ (B2) said one senior bureaucrat (see also *Australian Financial Review* 2 September 1996).<sup>20</sup> It is highly probable that the Treasury bureaucrats, who always monitored academic developments closely, were influenced by Taylor’s ‘twin peaks’ idea.

A very senior bureaucrat also said that the ‘twin peaks’ idea was ‘very influential over the Wallis Committee’ by highlighting some of the Committee members’ research trips to London without any prompting from the author (B1).<sup>21</sup> Although there was no reference to Taylor or his article in the final report of the Wallis Committee (FSI, 1997),<sup>22</sup> two Committee members met with Taylor. As Taylor, in a personal correspondence on 10 May 2002, noted ‘I also met Jeff Carmichael and Ian Harper, then members of the [Wallis] commission, when they passed through London as part of a fact-finding trip in the first half of 1996.’ The ‘twin peaks’ paper, in the words of Taylor, ‘had some influence over the outcome of the Wallis Inquiry’ (personal correspondence, 10 May 2002).

The transfer of ideas and lesson drawing are common as states are increasingly facing similar problems (see Rose 1991; Dolowitz and Marsh, 1996). As Rose (1991, 3) argues:

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<sup>18</sup> The article was published by the Center of the Study of Financial Innovation located in London in December 1995.

<sup>19</sup> Particularly, a significant factor behind the need for the ‘twin peaks’ approach was knowledge about the obsolescence of institutional regulation in the financial services industry where institutional, sectoral, and product boundaries were eroding due to technological and technical innovations in finance (Taylor 1995). Although Taylor proposed the model for the UK, its influence in Britain was more limited. Taylor disagreed with the decision to create a single regulator (ie Financial Services Authority) for the UK.

<sup>20</sup> Taylor’s ‘twin peaks’ paper was cited in the Inquiry’s Discussion Paper (FSI Discussion Paper 1996, 415). Oddly, it was neither cited in the bibliography to the Inquiry’s final report (FSI 1997) nor in that of the Treasury submission (1996). In their submissions to the Inquiry, on the other hand, National Australia Bank (NAB 1996, ch.6, 12) provided support whereas the RBA (1996, 131) offered alternatives to the ‘twin peaks’ arrangement with direct references to Taylor (1995).

<sup>21</sup> Evidence for the possible influence of the ‘twin peaks’ idea on the Wallis Committee is based on more than one interviewee including those who volunteered this expression.

<sup>22</sup> The Wallis Committee met with a large number of organisations and individuals both in Australia and overseas. Appendix B of the Inquiry’s final report lists institutions and individuals that the Committee met with (FSI 1997, 717-22). Oddly enough, Taylor was forgotten in this list. In addition, he was not affiliated with any of the listed institutions at the time.

Every country has problems, and each think that its problems are unique ... However, problems that are unique to one country ... are abnormal ... confronted with a common problem, policy makers in cities, regional governments and nations can learn from how their counterparts elsewhere responded.

Here, 'policy transfer, emulation or lesson drawing' basically refer to 'a process in which *knowledge* about policies, administrative arrangements, institutions etc. in one time and/or place is used in the development of policies, administrative arrangements and institutions in another time and/or place' (Dolowitz and Marsh 1996, 344, my emphasis). Arguably, the 'twin peaks' model, as knowledge about an alternative financial regulatory policy to the then existing institutionally-based regulatory arrangements, was transferred to and decontextualised in Australia during the Wallis era. As Richardson argues:

New ideas have a virus-like quality and have an ability to disrupt existing policy systems, power relationships and policies...Extending our 'virus' analogy policy stakeholders are increasingly internationalised - they, literally, travel a lot and meet all sorts of other policy stakeholders from foreign systems. They bring new ideas and policy frames back home. Thus, like natural viruses, policy viruses spread too. (Richardson 2000, 1018)

Following Richardson's 'virus' analogy, the virus of 'twin peaks' was first carried by the 'Treasury block' (ie the Treasurer and the Treasury) and then by the Wallis Committee.

In sum, although the Treasury itself was not a financial industry regulator, it was a pre-eminent actor in financial regulatory politics. It proposed and supported the 'twin peaks' idea of a single prudential regulator which treats all providers of functionally similar products or services equivalently, and a single disclosure regulator responsible for consumer protection. As well, before the federal election, the Treasury convinced both Willis and Costello of the validity of the idea. The solutions already existed, and were waiting for an influential political actor to connect them to problems and to the political process. Thus, the Treasury needed someone to push the proposals. The 'policy window', 'an opportunity for advocates of proposals to push their pet solutions, or to push attention to their special problems' (Kingdon 1995, 165), was opened after the election. Then, there was a new political leadership keen to achieve financial regulatory reforms and a new Treasurer who wanted to consolidate his power within markets and politics.

## Politics and coupling

A third influence on a government's agenda is political processes such as public opinion, interest group behaviours, and changes in government which may establish new agendas or modify existing ones (Kingdon 1995, 17). The establishment of a new government was an important political event affecting the financial regulatory policy agenda in the Australian context.

The March 1996 federal election was the start of a period of Coalition rule, not seen since the 1983 Labor victory. The result of this political event facilitated the transmission of the idea of regulatory change into the governmental agenda. As one government official noted 'Treasury's challenge for the future is to take advantage of a new government that wants to implement policies that it supports' (quoted in *Australian Financial Review* 8 August 1996). Kingdon suggests that 'Agendas are not first set and then alternatives generated: instead alternatives must be advocated for a long period before a short-run opportunity [policy window] presents itself on an agenda' (Kingdon 1995, 215). A 'political window', in the words of Kingdon, for the 'twin peaks' idea was opened with the new government and the Treasurer.<sup>23</sup>

In the agenda setting processes, according to Kingdon, problems, policies, and politics flow independently but policy change happens on occasions when they can be coupled (Kingdon 1995, 172-79). This coupling happens when policy entrepreneurs, individuals who invest their effort in order to implement policies they favour, seize a short run opportunity (a 'policy window') to push for the solution or to focus attention on a certain problem (Kingdon 1995, 179-84).<sup>24</sup> Kingdon (1984, 214; 1995, ch.8) argues that individuals (ie policy entrepreneurs) 'perform the function of coupling solutions to problems, problems to political forces, and political forces to proposals.' Costello performed this coupling work following the election of March 1996.

Victor Hugo wrote that 'greater than the thread of mighty armies is an idea whose time has come' (quoted in Kingdon 1984, 1). The time of the 'twin peaks' idea came with Costello who on 3 March 1996 acted as a purposeful entrepreneur to focus attention on the

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<sup>23</sup> Kingdon (1995, 174) notes that there are two categories of policy windows: 'problem window...opened by a problem that presses in on government,' and 'political window...opened by an event in the political stream - a change in administration, a shift in national mood, an influx of new members of Congress.'

<sup>24</sup> Kingdon (1995, 179) defines policy entrepreneurs as people who are 'advocates who are willing to invest their resources - time, energy, reputation, money - to promote a position in return for anticipated future gain in the form of material, purposive or solidary benefits.'

problem and to push the favoured solutions (*Australian Financial Review* 4 March 1996). In his first press interview on 13 March 1996, he coupled problems,<sup>25</sup> solutions and political opportunities:

The regulatory framework is hopelessly out of date. You have superannuation funds that are now in home lending and are essentially running banks and you have banks coming into superannuation – you have got different institutions offering the same product, different regulators regulating the same product because they are offered by different institutions. Why do not we cut all that away and say whatever the nature of the financial institution we will have a regulator covering prudential [requirements] and a regulator covering consumer protection and we can sweep a whole lot of that away? (quoted in *Australian Financial Review* 14 March 1996)<sup>26</sup>

The adoption of the Treasury agenda by Costello, however, was not the only factor behind the establishment of the Inquiry on 30 May 1996. With the Coalition coming to power after 13 years of ALP rule, he also had his own political interests. Campbell (2001, 267) emphasised that ‘only Howard and one other minister [John Moore] had served in Cabinet before...which highlighted not just the government’s inexperience but the fractiousness of some of its members as well.’ As such, the capabilities of Costello as a new Cabinet minister and a Treasurer were unknown for markets and politics<sup>27</sup> (*Australian* 16 March 1996; Aubin 1999, 201, 236-7). Thus, Costello, ‘[f]or all his high profile and his undoubted skills in political combat, remained largely an unknown quantity’ (Aubin 1999, 201). Moreover, Australia’s business and financial community thought that Costello might not be the right person for the job (*Australian* 16 March 1996). Therefore, the successful handling of the Inquiry and the Cabinet endorsement of its key recommendations would serve two political purposes for Costello: it would strengthen his move towards the party leadership, and it would provide him with the opportunity to prove to the financial community that he had both policy depth and competence. Consequently, one of Costello’s first acts was to establish the Wallis Inquiry. As a senior respondent observes:

If you are a Treasurer who wants to be a Prime Minister then one of the best things that you could do is to have a financial market inquiry...One reason why [the Wallis Inquiry]

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<sup>25</sup> Of course, in the cut and thrust of political debate, arguments for the Inquiry were inevitably framed in terms of the need to react to problems. As will be detailed later, the problems, however, were those likely in the future not those in the past.

<sup>26</sup> On 21 October 1998, Costello used the words “twin peaks” at the International Conference of Banking Supervisors in Sydney in referring to this new organisational framework for the regulation of the financial system (Costello 1998).

<sup>27</sup> Costello was elected a member of the House of Representatives in 1990. During the period the Liberal Party was in Opposition until 1996, he served as shadow minister in a number of areas including shadow Minister for Finance and shadow Treasurer.

was done was for the political advantage of the Treasurer. Paul Keating was his [Costello's] predecessor. He used [inquiries] exactly the same way. If you are a Treasurer and you are trying to gain a profile, credibility and respect what better thing could you do? Lets do something for the financial system that does not necessarily serve them but generate some respect and activity in the financial services sector. Then they [major financial firms] will boost you into other areas because they have got influence and money... (R1)

Thus, the establishment of the Inquiry provided, at least in part, a political advantage for the Treasurer. Perhaps, Costello had learned from John Howard and Paul Keating, both of whom had instigated financial system inquiries as Treasurers, and both of whom had subsequently been elevated to the Prime Ministership.<sup>28</sup>

The government was also keen to establish such an inquiry, which was one of its election promises (*Money Management* 21 March 1996, 24-6). As a senior bureaucrat articulates it:

We had [a] few special factors. One was [a] new government which was elected in 1996. I think it was interested in achieving some reforms in the Australian financial system. That was [the] thinking behind establishing the Wallis Committee. (B1)

The desire to achieve financial regulatory reform of the industry was the Treasury-guided government's proactive approach to policymaking rather than a reactive one. As a member of the Wallis Committee rightly observes:

[The Wallis Committee] was asked to tell the government how you would change the regulation in the light of what might come down the line in the future. In that sense, it was not retrospective. It was not trying to fix some problem. It was trying to anticipate the change. And get ourselves well positioned for that. (W1)

Accordingly, the government intervened in the markets in the absence of market failures or crisis. In the words of a senior bureaucrat:

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<sup>28</sup> Both Howard and Keating established financial system inquiries as Treasurers before they ran for party leadership and the prime ministership. To illustrate briefly, in January 1979, Howard established the Campbell Committee of Inquiry into the Australian financial system as Treasurer of the Fraser government. The Committee presented the final report to Howard on 29 September 1981. In September 1985, his colleagues elected Howard as leader of the Liberal Party. He subsequently became Prime Minister on 11 March 1996. Paul Keating became Treasurer when the ALP returned to government on 11 March 1983. On 15 October 1983, he formed the Martin Committee of Review to assess the Campbell Report. In February 1984, the Martin Review Group endorsed the Campbell Report. Keating served as Treasurer until 1991. He replaced Bob Hawke as leader of the ALP and Prime Minister in December 1991 and led the ALP to its fifth term of government in March 1993. Unsurprisingly, 28 days after the Cabinet endorsement of the Wallis recommendations on 2 September 1997, Costello's claim for future leadership was for the first time on a newspaper headline (*Australian Financial Review* 30 September 1997).

That is the difference from overseas situations where there were crisis-led changes. We were quite unique in that sense...They [the government and the Wallis Committee] said: 'Well, we [would] not change because [the existing regulatory arrangement] was terribly wrong but we think that a different approach to regulation/supervision might be better for the financial system of five, ten or twenty years into the future.' That was an interesting approach...This was a kind of *proactive approach*...it may happen in another government, alternative government as well, who knows. (B2)

Costello also voiced the government's engagement in broader, longer-term anticipatory policymaking to promote change and to help the industry to adapt to future competitive challenges:

The competitors to banks in the future will be, as we are already seeing in this country, anyone who has access to a customer base and access to technology. Telecommunications companies have the customer. They have the software. To the extent that they undertake risk, they could well be engaged in banking or like conduct...The opportunity is now, for Australia to try and leapfrog a decade or two, to try and *anticipate the change*, to try and put in place a system that will best allow for us to cope with it. (cited in *Sydney Morning Herald* 22 June 1996, emphasis added)

To sum up, the establishment of the Wallis Inquiry was also the government's proactive approach to anticipate changes in the financial business environment and to adjust the regulatory framework accordingly. As will be detailed in the following sections, the Inquiry's role in Australian financial policymaking was not only to create and structure the 'public agenda' in accordance with the 'governmental agenda,' but also to provide an opportunity for regulatory policy change through establishing alignments within and outside the parliament.

## Members of the Wallis Committee

Pusey (1991), in his research on the Australian Public Service, examined the political, social and economic attitudes of 215 senior public servants including Treasury executives, and found that in their approach to government policy the majority were economic rationalists. He claimed that key rationalist bureaucracies (the Treasury, Finance, and Prime Minister and Cabinet departments) captured politicians when their senior civil servants formulated and implemented public policies. The Treasury senior advisers are probably among some of the most influential advisers to the government. In regard to regulatory policy change, for example, Greg Smith, the then head of the Financial

Institutions Division at the Treasury, who later became the head of the Wallis Inquiry Secretariat, was very active in pressing for the policy change. A senior bureaucrat, for example, identifies Smith as 'one particular person who felt very strongly that there was a need for [regulatory] change' (B2) at the Treasury. Maley (2000) also argued that ministerial advisers play a very significant role in agenda setting in Australia. When Costello became the Treasurer, he had four advisers all of whom had previously worked at the Treasury.<sup>29</sup>

Costello, in consultation with his advisers and the Treasury, appointed the members of the Wallis Inquiry panel and its secretariat, and drew up its terms of reference. Although Costello said that: 'the government does not start off with preconceived results in mind [and] it [the Wallis Committee] is genuinely independent' (quoted in *Sydney Morning Herald* 1 June 1996), the Committee members were nevertheless selected from among those who were likely to subscribe to the 'Treasury consensus' (ie the twin peaks model). As one senior Treasury official put it in interview: 'You would not put people into the Inquiry if they would not believe in case in regulatory change...you want people thinking in the right direction' (B4).

The Wallis Committee was a blend of 'representative' and 'expert' committees rather than an 'impartial' one.<sup>30</sup> The five members of the Committee were market-oriented individuals from within the financial services industry and academia. The composition of the membership showed that some of them were representatives of particular interests (professionals working in the financial services industry) whereas others were expert individuals having highly technical knowledge relevant to the deliberations of the Committee. Various societal groups from banks to insurance companies and consumer groups, in turn, welcomed the Committee members and the Inquiry's terms of reference (*Australian Financial Review* 31 May 1996).

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<sup>29</sup> They were Peter Boxall (principal adviser), Matthew Ryan (senior adviser), Nigel Bailey (adviser) and Rebecca Flint (assistant adviser). The three most senior advisers of Costello met formally every Friday for 60 to 90 minutes with the then Secretary of the Treasury and his deputies (see *Australian Financial Review* 8 August 1996).

<sup>30</sup> This classification draws on the pioneering work of Clokie and Robinson (1937) in relation to Royal Commissions. They classified commissions by type: 'representative' commissions include members of interest groups; 'expert' commissions are composed of specialists on a specific subject; and 'impartial' commissions promise independent inquiry depending on the definition of impartiality. This classification is seen to be just as relevant to committees and inquiries given the similarity of importance and function (see Rhodes 1975, ch.2).

Stan Wallis, the Inquiry chairman, was the individual representative of Australian big business. He was the then president of the Business Council of Australia which is 'the most significant voice of big business on economic issues' (Head 1997, 347). Before the March 1996 federal election, Wallis voiced the need for more reform: 'In recent years, I think the foot's gone off the pedal in terms of that reform process and Australia is just not achieving the potential that it could otherwise do' (cited in *Sydney Morning Herald* 2 March 1996). He was also a professional as the then director of Australian Mutual Provident Society Limited (AMP), the insurance and funds management giant of the financial industry.<sup>31</sup> The AMP was a typical example of life offices and insurance companies moving into the banks' traditional territory. For example, it established its Priority One subsidiary, a direct-selling mortgage company that provided bank-like services from cheques, and credit cards to saving products even though it did not have a banking licence and therefore could not accept deposits.<sup>32</sup> Accordingly, Wallis had first-hand knowledge of the institutional, sectoral and product blurring in the industry. Thus, Wallis was supporting financial supervision based on functions rather than institutions<sup>33</sup> (*Sydney Morning Herald* 1 June 1996).

Another member of the Inquiry from the industry was Linda Nicholls. She was a full-time financial company director and consultant.<sup>34</sup> In a speech in February 1996, she described the existing financial regulatory system as one of 'fragmentation, duplication and incoherence' (quoted in *Sydney Morning Herald* 22 June 1996). She also said:

In the past, when banking without banks threatened, regulators stepped in to ensure Australian household customers and their banking went back to banks... We have housing loans available from banks under the RBA, from life offices under the ISC and from Aussie Home Loans under the ASC... the challenge for future governments of Australia today was adjusting Australia's financial laws and regulations not just to accommodate banking without banks, but to take advantage of its potential to foster more saving and better investing for Australians. (quoted in *Sydney Morning Herald* 22 June 1996)

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<sup>31</sup> The final report of the Inquiry has a section on the brief background of its members (FSI 1997, v). Interestingly, Wallis's previous affiliation with the AMP just before joining the Committee was not mentioned in the section. Instead, Wallis's previous career as Managing Director of Amcor Ltd between 1977 and 1996 was indicated.

<sup>32</sup> Following the Wallis Inquiry, the insurance companies were permitted to take deposits.

<sup>33</sup> Not surprisingly, the AMP in its submission into the Inquiry proposed functionally-based prudential regulation with new prudential and disclosure regulators (see AMP 1996, vi, viii, 3, 10).

<sup>34</sup> She was former executive director of County NatWest Australia Investment Management Limited which operated in the investment (fund) management business between 1986 and 1997. It was sold to the NAB in October 1997.

The third representative member of the Inquiry was Bill Beerworth. He was a solicitor and a merchant banker experienced in Takeovers and Trade Practices Law.<sup>35</sup> His views on prudential regulation were not publicly known. As a senior bureaucrat noted, among the members of the Committee, 'the only unpredictable one was Beerworth' (B3).

The Wallis Committee also included highly influential 'expert' people from academia. As a senior bureaucrat observed, 'two academic members, [Ian] Harper and [Jeffrey] Carmichael, were clearly influential' (B3). Ian Harper was a professor of International Finance at the Melbourne Business School. The *Sydney Morning Herald* notes that 'in evidence before the Martin Committee into the banking system in 1991, he also sought to argue for a more equal regulatory treatment of deposit-taking institutions, whether they be banks or co-operatives or mutual organisations' (*Sydney Morning Herald* 22 June 1996).

Jeffrey Carmichael was also working as a professor of Finance at Bond University.<sup>36</sup> Carmichael had publicly noted the dismantling of market boundaries and a need to reconsider institutional regulation to cope with future changes. As he stated in a speech to a seminar in 1995:

The boundaries that we observe between markets today could disintegrate very quickly...the focus of regulation (in the financial services industry) beyond 2000 will shift away from institutional supervision to supervision of markets. The emphasis will shift to establishing the legal and ethical frameworks within which commerce will take place in different markets and away from detailed supervision. (quoted in *Sydney Morning Herald* 22 June 1996)

To sum up, the government in accordance with its regulatory policy preferences stacked the Wallis Committee.

## **The inquiry process**

On 10 April 1996, Costello urged the industry to prepare its submissions to the Inquiry immediately (*Australian Financial Review* 11 April 1996). Public submissions were preferred in order to break down vested interests in the regulatory structure. In doing so, the

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<sup>35</sup> He was principal partner of the corporate and financial advisory firm, Beerworth and Partners Limited.

<sup>36</sup> He had 20 years with the RBA and served as chair of the AFIC and the Queensland Office of Financial Supervision.

government aimed to coordinate its financial regulatory policy closely with its business community. As Costello put it:

Everyone is going to get a fair hearing. I have not predetermined the outcome. It is a question of running a cogent argument. Everybody is going to get an opportunity to have their say on this. If anybody does not like (the idea of super-regulator) they can come into this inquiry and state the reason they do not like it...At the end of the day the Inquiry will come up with certain recommendations that the government will accept, reject or change. (cited in *Australian Financial Review* 11 April 1996)

In announcing the terms of reference of the Inquiry, Costello stated that it was established in order to examine the results of financial deregulation in Australia after the Campbell Inquiry,<sup>37</sup> analyse the forces driving further change, and make recommendations on the future regulatory arrangements<sup>38</sup> (FSI 1997, vii). The government drew information in the form of submissions from individuals, firms, interest associations and bureaucratic institutions. Following the release of the Discussion Paper (see FSI 1997, 711-22) the Inquiry received a total of 268 initial submissions and a further 155 supplementary submissions. The procedure of public submissions and the transparent inquiry process was no doubt seen as facilitating a close cooperation between business and the government in order to build political support for the regulatory change both inside and outside of the parliamentary arena (for example, see *Sydney Morning Herald* 14 April 1997, 20 August 1997; *West Australian* 3 September 1997). Accordingly, the Inquiry was used as a 'venue' to generate the industry and public support for the regulatory change. The observation made by Peters and Barker (1993) seems highly relevant to the Wallis Inquiry process:

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<sup>37</sup> Anderson (1993, 59) is mistaken that the Campbell Inquiry was 'the first Inquiry' into the Australian financial system. In fact, there were three major reviews of the Australian financial system: the 1936 Royal Commission, the Campbell Inquiry (1981), and the Wallis Inquiry (1996). There were also two minor inquiries established by the Labor government (elected in early 1983) to evaluate the Campbell Inquiry recommendations: the Martin Review Group (1984) and Martin Committee Report (1991). These inquiries followed key reforms consistent with the Campbell study's market-oriented approach. As Lewis noted: '[t]he two Martin Committee reviews had the more limited purpose of reviewing the deregulatory processes set in train by the Campbell Inquiry' (Lewis 1997, fn.2, 230). For excellent comparisons of the main recommendations of these three major inquiries, see Lewis (1997); Edwards and Valentine (1998).

<sup>38</sup> The Inquiry was established by Costello with the following mission:

The Inquiry is charged with providing a stocktake of the results arising from the financial deregulation of the Australian financial system since the early 1980s. The forces driving further change will be analysed, in particular, technological development. Recommendations will be made on the nature of the regulatory arrangements that will best ensure an efficient, responsive, competitive and flexible financial system to underpin stronger economic performance, consistent with financial stability, prudence, integrity and fairness. (FSI 1997, vii)

If government is willing to allow groups in society to put forward their ideas for serious consideration, then any policy-making must be seen as properly democratic, rather than imposed along preconceived lines. Further, this openness to participation may allow government to co-opt the groups which do participate; having had their say once, the groups should be expected to keep quiet even if the decision goes against them. Thus, taking even requesting advice helps democratic governments to legitimate their decisions. (Peters and Barker 1993, 1-2)

Although the Treasury made an independent submission to the Inquiry as would any other interested public and private sector actor, behind the scenes it also dominated the Inquiry process. The Inquiry secretariat, which wrote its final report, was located in the Treasury building in Canberra. The Treasury provided eight staff out of 14 to the secretariat including its head (Treasury 1996b, 2; for information on Treasury staff, see note on table 12, 75). As a senior bureaucrat observes 'obviously the secretariat of the Committee came mainly from the Treasury so the Treasury had a significant influence' (B3). The composition of this support team for Committee members, and its physical location, mirrored the Treasury's desire to retain influence over the Inquiry as it derived its power 'also from access to, and sometimes monopolisation of, information' (Whitwell, 1986, 24).<sup>39</sup>

The Treasury's influence, however, was not limited to its role in the selection of the members of the Committee or its domination of the secretariat. It was also influential over the Wallis Committee in devising its recommendations. A member of the Committee replied to the question of whether there was a significant Treasury proposal which was not accepted by the Committee in the following way:

I do not believe so. The converse is not necessarily true. There might have been something we said there that would not have been accepted by the Treasury. (W1)

Not surprisingly, key industry regulators whose political capacity and existence would likely be undermined by the new regulatory regime resisted the proposed policy change.<sup>40</sup>

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<sup>39</sup> Apparently, data required were collected on the Treasury computers and evaluated by the secretariat using Treasury economic models.

<sup>40</sup> Bernie Fraser, the then RBA governor, opposed the creation of a new prudential regulator and the removal of the RBA's and AFIC's supervisory powers over deposit-taking institutions (*Australian Financial Review* 8 July 1996). Similarly, George Pooley, the ISC commissioner at the time, also strongly resisted the idea of prudential supervisory change in the focus of regulation. For Pooley, financial supervision was 'necessarily institutionally-based and cannot be functionally-based' (cited in *Sydney Morning Herald* 1 June 1996). The ASC also supported the preservation of the status quo. As the then deputy chairwoman Lynn Ralph of the ASC said 'there was a risk that the Inquiry was throwing the baby out with the bathwater by ignoring the benefits of the current system' (quoted in *Sydney Morning Herald* 1 June 1996, see also *Australian Financial*

Particularly, banking and insurance sectors regulators (ie the RBA and the ISC) strongly opposed the regulatory change in order to defend their regulatory territory (*Sydney Morning Herald* 1 June 1996; *Australian Financial Review* 3 June 1996, 9 September 1996). Graeme Thompson, the then RBA deputy governor, offered competing interpretations to the Treasury block's representations of regulatory issues. He argued that:

Despite claims that banks and insurance companies are 'converging' by offering similar products, there remained a clear division between these two finance categories with different regulatory needs...a bank balance sheet and an insurance company balance sheet remain very different, and the relevant supervisory techniques are correspondingly dissimilar. (cited in *Age* 6 September 1996)

Accordingly, the RBA (1996) in its submission to the Inquiry proposed that the then existing institutional prudential regulatory structure should be preserved due to the differences in the structures of balance sheets and the risks involved which called for institutional supervision. The RBA highlighted the danger of a moral hazard problem if the government adopted functional regulation:

If all financial products were under one government regulator, the public could see them all as being equally safe - "the Government stands behind them all". This could have implications for the public purse in the event of a financial disturbance (or even a large fall in asset values). The extra risk from the moral hazard is that institutions would be deterred from competing on safety, and they would be encouraged to take greater risks to maximise returns. (A recent well-publicised case of this concerned the Savings and Loans institutions in the US.) (RBA 1996, iii)

Senior officials at the RBA questioned the impact of change on the overall stability in the financial system. These policy perceptions were derived from the mandate of the RBA for which these officials work.<sup>41</sup> Consequently, any proposal challenging the RBA's regulatory authority in the industry faced strong resistance from these officials.

On 18 March 1997, the Wallis Committee made 115 recommendations which added up 'to a call for radical reform of financial sector regulation' (Harding 1997, 17). Two of the more controversial recommendations of the Committee concerning prudential regulation were numbers 31 and 32. The former recommended the creation of a single prudential regulator

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*Review* 3 June 1996). The AFIC also argued that prudential supervision of deposit-taking institutions must be institutionally-based and building societies and credit unions were regulated more appropriately at the State level (AFIC 1996, 7).

<sup>41</sup> The RBA was mainly responsible for monetary policy and banking regulation for systemic stability.

to replace the RBA, the ISC and the AFIC while the latter said that this agency should not be the RBA.

Brian Gray, the then head of bank supervision at the RBA, described these prudential regulatory proposals as 'naïve conceptually' (*Sydney Morning Herald* 24 March 1997). Not only the regulators at the time, but also some of the regulated firms such as the Commonwealth Bank of Australia (CBA), the Australian and New Zealand Banking Group (ANZ) and the Westpac Banking Corporation (WBC) criticised the Committee's proposals and argued that the RBA should retain its role as a prudential regulator (*Age* 11 April 1997; *Australian Financial Review* 24 April 1997).<sup>42</sup> Particularly, David Murray, the then managing director of the CBA, argued that Australia was in danger of a US savings and loans-style crisis if it adopted the Inquiry's recommendations on functional supervision (*Age* 11 April 1997).

However, technical dominance of the Inquiry panel enabled the regulatory discussions to be framed in a way which was difficult for opposition voices to challenge. Thus, the *raison d'être* of the Committee was to provide the intellectual justification for the regulatory change. For example, Carmichael (*Herald Sun* 28 April 1997) and Harper (*Australian Financial Review* 13 May 1997) generated credible academic arguments that were then arguably used as a lobbying tool in order to achieve a degree of professional 'capture' of the policy debate and frame policy issues in a way which was difficult for such opponents to challenge. After underlining the growing obsolescence of institutionally-based prudential regulation, Harper, in response to Murray, argued that:

About half of the world's central banks do not act as prudential regulators within their jurisdictions...Central banks are, first and foremost, banks. They understand banking and do not profess expertise beyond the confines of traditional bank functions, like deposit taking and payments. But these functions increasingly will be provided by institutions very different from banks. We need a regulator whose expertise is not restricted to a sub-set of institutional types...There is a second reason for separating prudential regulation from the central bank. So long as the central bank is associated with prudential regulation, it is implicitly seen to guarantee the liabilities of those it regulates - such as the Reserve Bank's "implied" guarantee of bank deposits. There is, of course, no explicit guarantee of deposits.

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<sup>42</sup> Specifically, the Australian Bankers' Association (ABA 1996, iii), the ANZ (ANZ 1996, 3-6); the WBC (WBC 1996, 4, 8, 12), and the CBA (CBA 1996, 10) were criticising a move towards functionally-based regulation and the establishment of a new single prudential regulator regulating all deposit-taking institutions (DTIs). They argued that the RBA should be the sole prudential regulator responsible for all DTIs. Contrary to these big three banks and the ABA, the National Australia Bank (NAB) and the two biggest insurance companies - Australian Mutual Provident Society Limited (1996) and National Mutual (1996) - supported a move towards functional regulation with new regulators. Thus, their policy preferences were closer to that of the 'Treasury consensus.'

Such a guarantee did exist in the sad case of the S & Ls [Savings and Loans] raised by David Murray, giving rise to “moral hazard”, which caused the crisis. It is important that, over time, people come to see that the Reserve Bank does not guarantee banks. Bringing a wider range of institutions under the prudential wing of the Reserve Bank would make it even harder to underline the absence of a formal guarantee (and potentially create a “moral hazard” problem of our own). (*Australian Financial Review* 13 May 1997)

Accordingly, Harper justified functional regulation and moving regulation of banks outside the responsibility of the RBA.

Such responses from the Committee members to the critiques of the regulatory change also allowed the Treasury consensus to be promoted in the political arena by an apparently ‘independent’ or ‘autonomous’ source of advice. For example, the then opposition Treasurer, Gareth Evans, welcomed the Wallis mandate on prudential regulation<sup>43</sup> and gave Labor’s first detailed response to the report in August 1997:

As a country we must put in place a new regulatory framework to accommodate the tremendous changes that are occurring. This is exactly what the Wallis report recommends...We see the creation of a single national prudential regulator in this form as desirable. While the current system generally works well, there are *no compelling arguments against moving to a new structure* that will accommodate more naturally the profound changes that are taking place in the financial services market. (cited in *Sydney Morning Herald* 20 August 1997, emphases added)

The ALP’s support cleared the way in the Senate for the government to fully embrace its regulatory policy agenda.<sup>44</sup>

The Treasury was also playing the leading role in preparing a Cabinet submission which would outline the government’s full response to the Wallis report.<sup>45</sup> Consequently, a Treasury taskforce for this purpose was established (*Sydney Morning Herald* 8 July 1997).

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<sup>43</sup> As the *Sydney Morning Herald* pointed out ‘Evans’s response also indicates that the Reserve Bank and three of the four major banks [ANZ, CBA, WBC], which have been lobbying hard against the prudential shake-up, may be about to lose out’ (*Sydney Morning Herald* 8 July 1997).

<sup>44</sup> The Howard government did not have the numbers to control the Senate and therefore any legislation could be blocked, amended or delayed in the Senate if the opposition were to vote against the government. Accordingly, the ALP support for the regulatory change was significant. Thus, Costello had to tread a more cautious path than Keating did with the Martin Inquiry which was essentially commissioned to sell microeconomic reform agenda of the Campbell recommendations to the ALP ranks (Carew 1992, 97-8; Edwards 1996, 205-8).

<sup>45</sup> Some of the Cabinet members in 1996 also worked previously with the Treasury. They were, apart from Howard and Costello, Peter Reith (the then Minister for Industrial Relations), Alexander Downer (the then Minister for Foreign Affairs), and John Fahey (the then Minister for Finance and Administration).

Smith, along with Costello's advisers, also participated in a special Cabinet meeting to decide on the Inquiry's recommendations (*Sydney Morning Herald* 29 August 1997). In other words, given the fact that the report was in line with the Treasury's main policy preferences manifested in its Inquiry submission, it influenced the Cabinet submission. On 2 September 1997, the government fully accepted 114 of the 115 recommendations.<sup>46</sup> Apparently, the banking community gained the most from the Wallis Inquiry. Tony Aveling, the then ABA chief executive, enthused about the Wallis report: 'the government's action is in line with the banking industry's submission to the Wallis Inquiry into Australia's financial system and will provide a more efficient regulatory regime' (cited in ABA Media Release, 11 March 1999).<sup>47</sup>

The central premise of the financial regulatory changes proposed by the Inquiry and adopted by the government was the reorientation of the then existing institutionally-based prudential regulation towards a functionally-based one.<sup>48</sup> The result was the creation of a new single prudential regulator: the Australian Prudential Regulation Authority (APRA) taking prudential regulatory powers of the RBA, the ISC and the AFIC.<sup>49</sup> The second institution established following the Inquiry's recommendations was the Australian Securities and Investment Commission (ASIC) which became the disclosure regulator responsible for consumer and investor protection. It took consumer protection responsibilities in the area of finance away from the ASC, the ISC and the Australian

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<sup>46</sup> The only recommendation partly accepted by the government was number 83, which advocated removal of the six pillars policy – a government ban on in-market mergers among the big four banks and any of the big two insurance companies. The government replaced the six pillars policy with the four pillars policy which only prevented the mergers and takeovers between the four major banks.

<sup>47</sup> Similarly, Don Argus, the then chief executive officer of the NAB, had welcomed the government's official response to the regulatory changes proposed by the Wallis Committee: 'The measures outlined today by the Treasurer are in accord with the recommendations consistently made by the National during the past two years' (quoted in *West Australian*, 3 September 1997).

<sup>48</sup> Apart from this obvious rearrangement of the prudential regulators, the Wallis Committee (FSI 1997, 386) recommended reform of the Australian payments system, including various payments services (eg cheques, credit cards and post office money order). Focusing the RBA's role as a systemic risk regulator has led to the establishment of the Payments System Board within the Reserve Bank in July 1998. The government enacted the *Payment Systems (Regulation) Act 1998* giving strong regulatory powers to the RBA to control risks and promote efficiency and competition. On 27 August 2002, the RBA released its final reforms to credit card schemes forcing banks to charge lower fees for credit card transactions. The reform is expected to result in a reduction of nearly 40 per cent in average interchange fees (what banks charge each other for processing transactions) in Australia.

<sup>49</sup> A package of legislation to give effect to the new prudential regulatory structure came into effect on 1 July 1998 with the establishment of APRA, and other Wallis recommendations contained in the Financial Sector Reform Bill became effective on 1 July 1999.

Consumer and Competition Commission (ACCC).<sup>50</sup> As a result, the financial regulatory change took place although all of the then existing financial regulators opposed it and some of the key private sector actors criticised it.

Knowledge in the form of new ideas has been a powerful change agent. As Richardson argued:

For well established policy communities who have long-held the 'franchise' for a policy area, new ideas are a *potential* threat, unless they emanate from the community itself or can be adapted to suit the existing needs of the community. (Richardson 2000, 1018, his emphasis)

Apparently, in addition to the government's intervention, the 'twin peaks' idea destabilised the financial policy community, since it did not emanate from the community itself.<sup>51</sup>

## Conclusion

Two broad public policy objectives in the regulation of financial services are to ensure the stability and soundness of the financial system, and to protect consumers. The Wallis Inquiry sought to base the redesign of the financial services regulation in Australia on reflection of these objectives of financial regulation, and how these might be best achieved proactively in a rapidly-changing financial market place. The recommendations of the Inquiry on financial regulation enabled the government to restructure the Australian

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<sup>50</sup> The Wallis Committee also suggested the establishment of a Financial Sector Advisory Council to advise the Treasurer on: progress of implementation of new regulatory arrangements, and their effects on the financial sector and the economy; new and potential developments in the financial system and their regulatory implications; the cost effectiveness and relevance of the regulatory framework for the financial system; the compliance costs occasioned by financial regulation; and the international competitiveness of Australia's financial sector and how Australia could become a preferred location for financial activities in the region. (FSI 1997, 541)

The Council was established in 1998. It will review whether the Wallis outcomes were either satisfactory or not five years on (ie 2003). One of its general items is to calculate whether a significant efficiency improvement (ie a 10 per cent improvement in efficiency that would translate into savings of over A\$4 billion per annum) has been achieved through the creation of functional regulation, as was argued in the Wallis Report (see FSI 1997, 204).

<sup>51</sup> As a result of the creation of these two new national regulators, the ISC, the ASC and the AFIC were abolished whereas the RBA lost its bank regulatory powers.

financial regulation according to the 'twin peaks' arrangement to ensure an efficient, responsive, competitive and flexible environment of action for private actors.<sup>52</sup>

The purposes of this paper have been to identify the factors leading to the establishment of the Inquiry and its role in government-business relations. The paper has shown that there were three main reasons behind the creation of the Wallis Inquiry. First, the review of the then existing regulatory structure was on the agenda of the Treasury department. It pushed for functionally-based financial regulation with new regulators, and sold the idea to both the then Treasurer Willis and the then opposition Treasurer Costello before the 1996 federal election. The Treasury was the pre-eminent bureaucratic institution in financial policymaking and it dominated microeconomic policy advice on financial regulation during the Wallis era. Second, when Costello became the new Treasurer, he was keen to establish the Inquiry in order to gain a profile, credibility and respect from the financial community. He was also keen to gain a substantial political victory for leadership within the Liberal Party with the Cabinet endorsement of the Inquiry's key recommendations. The Treasury solutions seem to have been out there, connected later to the problems and to the political process by Costello. Finally, the Howard government supported the establishment of the Inquiry as it aimed to be proactive in the achievement of regulatory reform in the financial services industry despite the fact that the then existing regulatory system was working well and there was no external constituency pushing government for a change.

Before the Inquiry was established, the government had already provided answers to the questions 'What should we do?' and 'How can we do what we have already decided to do?' as the regulatory framework (ie the twin peaks model) was already in existence and the 'Treasury block' had exercised great influence to set the regulatory policy agenda and, accordingly, provided policy prescriptions. The government selected the Wallis Committee members from industry and academia in accordance with its regulatory policy preferences. The Committee, in turn, was 'packed' by the government. In the consultative process of the Inquiry, both the industry regulators and regulated institutions had to face this already structured and to some extent unveiled agenda: a shift towards functionally-based regulation from one that was institutionally-based with the new prudential and disclosure regulators. Thus, the role of the Wallis Inquiry, which was neither independent

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<sup>52</sup> The late 1990s witnessed responses by countries around the world to changing market structures by adjusting the institutional structure of their financial regulatory arrangements (for an international comparison, see Mwenda and Fleming 2001; Hadjiemmanuil 2001). In this perspective, the Australian experience was the first case of the global trend towards switching to a unified regulatory structure shifting the responsibility for financial supervision to new regulators.

of government nor business, was to legitimise the government's intervention into the financial regulatory structure through transferring the government's agenda into a public agenda.

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